Chapter 6
Payment Cards and Interchange

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6.1 Introduction and synopsis

6.1.1 Evolution of means of payment and arrangements between banks

In the historical progress of trade from barter, through local monetary exchanges and paper systems, to the global division of labour and the electronic transfers and settlements of the present day, security, reliability and efficiency in the means of payment (or payment instruments like credit and debit cards) have been fundamental requirements for development.

In *The Virtuous Circle: Electronic Payments and Economic Growth*,¹ it is observed that the development of money has depended on the actions of the people using it:

> Ultimately, consumers determine what form of money is most desirable – people simply substitute cheaper and more convenient forms of money for expensive and inconvenient forms. It is ultimately through this substitution in use that new money forms embed themselves in the marketplace.²

Nonetheless, in the development of means of payment from the earliest standard coinage, the state or public power has always played a necessary role.

> History demonstrates a compelling need to standardise payment forms to enhance their utility. Examples are as ancient as the Qin Dynasty in China (221-207 B.C.), when the Emperor unified three or four forms of currency into one coin, and as contemporary as the creation of the euro in the 21st Century.³

Also crucial to the development of means of payment and payment systems has been the role of banks, and the arrangements which they make with each other in this regard, in order that such forms of money or payment instruments are mutually acceptable.

Regulatory authorities around the world have been paying increased attention to interbank arrangements. Central among these arrangements is “interchange”. This obscure but important subject has long exercised, and continues to exercise, competition authorities in many countries. In the United States in the 1980s it became a focus of antitrust scrutiny by the courts. The European Commission has been concerned with interchange since at least 1992, and continues to wrestle with the issue. It has led to successive rounds of litigation in Britain involving the Office of Fair Trading. It has become a matter of contention in competition enforcement in Spain, Portugal, Austria, Poland and elsewhere. In Australia it has led to an extensive regulatory intervention by the Reserve Bank. It is a subject central to

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¹ Visa International and Global Insight, June 2003. This document is publicly available on the internet. The same document (with only a few trivial differences in presentation) was submitted as document V in Visa’s Second Submission, June 2007, under cover of a claim of confidentiality! It also appears within Annexure M of Visa’s First Submission, October 2006, without such a claim. Our references to and quotations from the document are derived from the public source.


this Enquiry.

6.1.2 What is interchange?

Although interchange in some contexts may involve institutions other than banks, it is best understood initially as a particular transfer of value between banks. In contrast with payments in cash, where the payer pays the payee (the beneficiary) directly, every other mode of payment in South Africa currently requires in the ordinary course the assistance of one or more banks. For this service, a charge is made. It is when two banks are involved, each needing to levy a charge for its service to its customer, that interchange comes, or may come, into play.

Interchange, as we know it locally, is a transfer made by interbank arrangement whereby, in the context of a payment made by the customer of one bank to the customer of another bank, one of the two banks contributes a part of its revenue to the other bank. At present interchange is to be found in some form in the great majority of instances where one person makes a payment to another person other than in cash, and where the payee has his or her bank account at a bank other than that of the payer.

Classically, the need for interchange has arisen in connection with the development of payments by card. Typically, such payments are made by a cardholder buying goods or services from a retailer (or "merchant"). It is in the context of payment by card that we shall first analyse interchange, and then consider its applicability to other modes of payment (payment streams).

"Issuing" and "acquiring"

The cardholder making payment to the merchant will have obtained the payment card from an "issuer", and the merchant accepting the card will have contracted with an "acquirer" in order to accept the cards of the relevant card scheme. In some cases the issuer and the acquirer will be the same institution, but in other cases the two institutions will be different. Where issuer and acquirer are the same institution, the transaction is referred to as on-us; where they are different institutions, the transaction is referred to as off-us.

The EC Interim Report of April 2006 dealing with payment cards defines interchange fee as the "fee paid by an acquiring institution to an issuing institution for each payment card transaction at the point of sale of a merchant." This definition assumes, of course, that the

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4 It could conceivably have arisen much earlier, with the development of payments by cheque, but evidently the need for it then was not such as to bring it into existence.

5 European Commission, Competition DG, Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, "Interim Report I: Payment Cards", 12 April 2006, Glossary. Under the rules of the MasterCard scheme, "financial institutions" which are regulated as such and supervised by government authorities may issue cards and acquire card transactions. Such institutions are not necessarily limited to banks. In the case of Visa, the institutions must ordinarily be authorised to take deposits. In South Africa, only banks are currently able to issue cards and acquire card transactions within the
transaction is off-us. An acquiring institution is defined as a “credit institution or other undertaking, and member of a card scheme that has a contractual relation with a merchant.” An issuing institution is a “credit institution, and member of a card scheme, that has a contractual relation with a card holder for the provision and use of a card of that card scheme. In a closed system, the card issuer is the scheme owner, while in open systems several credit institutions act as card issuers.”

The distinction between “closed” and “open” card systems has relevance to our understanding of the dynamics of interchange. We now turn to this.

6.1.3 Three-party (“closed”) and four-party (“open”) card schemes

In a “closed” system, the card scheme owner – examples are American Express and Diners Club – is not only the issuer of the card but also the acquirer of the merchant’s transaction. It may licence banks or other financial institutions, or utilise franchisees, to issue its cards to customers, or to contract its acquiring services to merchants, but they do so on its behalf.

To analyse such a scheme we must therefore look through the licensee to the principal (the scheme owner). We can identify, in essence, three parties to each payment transaction using the card of such a scheme: (i) the cardholder, (ii) the merchant and (iii) the scheme owner. Hence such a scheme is conventionally referred to as a “three-party” scheme.

Here there is no possibility of a transfer of revenue from acquirer to issuer (or vice versa), since issuer and acquirer are one and the same. All transactions are on-us. Interchange thus does not arise as such in a three-party scheme. At most there may be an internal transfer of revenue in a notional or accounting sense – an “intrachange” (to coin an expression) – from the acquiring side to the issuing side of the scheme owner’s business. No arrangement between different firms is required to bring this about.

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6 Visa and MasterCard schemes (see further below).
7 Id.
8 Id.
9 Also referred to as a “closed loop” system: see Transcript 19 April 2007, p 13 (Nedbank, Mr Shuter). Closed or closed loop systems are also sometimes referred to as “proprietary” card schemes: see e.g. American Express, October 2006, Comments in response to the South African Competition Commission Enquiry into Banking, p 4.
10 Transcript 17 April 2007, p 15. Private or proprietary “white label” cards (including buy-aid society cards such as those issued by Pretorium Trust) also function as closed systems.
11 American Express stated in its Submission, October 2006, p 2: “Amex itself operates the network and typically acts as both the issuer and acquirer of cards. … Amex’s merchant agreements are bilateral agreements between the merchant and Amex as acquirer.” Describing the essential characteristics of a “closed” system, it says that the scheme itself “acts as issuer and acquirer” and “[o]wns the direct relationship between scheme and end-users, namely cardholders and merchants. … No legal or contractual relations exist between or amongst the various licensees of the proprietary system.” Id., p 4.
12 Transcript 17 April 2007, p 15.

Id., p 16; id. 18 April 2007, p 35; id. 19 April 2007, p 13, p 16. “Notionally Amex is a discreet business unit and we have everything all together.” Nedbank (American Express’s licensee in South Africa), id. 19 April 2007, p 17. American Express confirmed that there are no interchange fees between its licensees: “[T]here is no fee – in particular an interchange fee – and no settlement between these licencees.” (American Express, October 2006, p 2.)
The matter is different with the card schemes which dominate the payment card scene in South Africa. MasterCard and Visa are "open" systems, conventionally referred to as "four-party" schemes.

The four-party model evolved from the three-party model. It was a natural progression for banks which had acted as mere licensees for the issuing of a scheme owner’s cards, to become direct issuers to customers in their own right, albeit within the governing framework and under the logo of the particular card scheme. Likewise on the acquiring side, banks could contract directly with merchants. Recruitment of tens of thousands of banks and other financial institutions around the world as issuers and acquirers has greatly expanded the reach of these card schemes. With this change, the triangle of relationships in a payment transaction under the three-party model becomes replaced by a rectangle.
Standard Bank has correctly defined card interchange as “the fee paid by acquirers to issuers in a card purchase transaction within a four-party payment system.” However, as is discussed further below, interchange should not be seen as a fee for service.

However, it should be noted that, where the payer (the cardholder) and the payee (the merchant, for example) are served by the same bank or financial institution as issuer and acquirer – in other words where the payment transaction is on-us – only three parties are involved in the payment transaction notwithstanding that the scheme itself is an open one. A triangular diagram (comparable to the depiction of the three-party schemes above), and not a rectangular or four-party diagram, would thus illustrate the relationship in that transaction.

Nevertheless, the whole point of the open scheme is that it greatly expands the scope and flexibility of card-issuing, acquiring and use precisely by allowing for off-us transactions, in which it is unnecessary for either the user or the acceptor of the card to be concerned with the institution that has provided the necessary services to the other party. It is thus appropriate to describe and analyse open schemes essentially in terms of an off-us, four-party model.

6.1.4 Necessity of interchange in principle

Whenever a payment card is used to buy goods or services, or otherwise to effect a payment, two independent demands have to be matched. This applies to both three-party and four-party schemes. Just as a wedding requires two people to say “I do”, a payment by payment card requires one person (the payer) to choose to use the card as the means of payment, and another person (the payee, usually a merchant) voluntarily to accept it. If the

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16 SBSA, October 2006, First Submission, p 53.
cost to the one or to the other – the charge levied for the use or acceptance of the card respectively – is such as to deter either of them, then the card will not come to be used to effect payment.\footnote{Whether a particular purchase-and-sale transaction will also fall away will depend, of course, on whether there is a substitute means of payment (cash, for example) that is adequate and acceptable to both parties. The theory of “two-sided” markets is discussed in the section of this chapter dealing with the necessity of interchange in principle.}

In the case of a “closed” or three-party scheme, the scheme owner itself must be able to match – to bring into effective correspondence – the two independent demands, by way of its own pricing of its issuing service\footnote{We use this simplified terminology to include card-issuing, transaction processing and related services on the issuing side.} to cardholders on the one hand, and of its acquiring service\footnote{Likewise here we use a simplified expression for something with complex elements.} to merchants on the other hand. The scheme owner’s issuing and acquiring costs are aggregated in its own hands, and so are its issuing and acquiring revenues. Within the constraints set by its aggregate actual and potential costs, and by its aggregate actual and potential revenues, it can maximise output (and profit) in terms of card usage by effectively cross-subsidising the one side of the business with the help of the other. It can, for example, price below cost on the issuing side (i.e. in its price to cardholders) to the extent that it can recover the shortfall by pricing above cost on the acquiring side (i.e. in its price to merchants). The different price elasticities of demand\footnote{“Price elasticity of demand” refers to the responsiveness of consumers, through quantity demanded, to changes in price. For example, cardholders may be very responsive to changes in price – meaning that demand on the issuing side would be more “price elastic”. On the other hand, merchants may be far less responsive to changes in price – meaning that demand on the acquiring side would be “price inelastic”} relative to cost on the different sides of the market for its card payment services can thus be reconciled by way of a balancing exercise, performed by the single supplier matching two supplies in a way that brings into effective correspondence the two independent demands.

While the market in this case may be characterised as two-sided insofar as two separate demands are met by two different supplies, the fact that there is only one supplier to these two demands in respect of any particular payment transaction means that no special balancing mechanism is needed.

Where an open or four-party scheme is concerned, however, a special balancing mechanism has been shown to be necessary in principle. Here, in off-us transactions, there are two separate suppliers to the two independent demands. Costs and revenues in respect of issuing and acquiring are thus no longer aggregated in the hands of a single supplier. The balancing exercise, to the extent needed to match the two demands with each other and the two supplies with them, can now only be performed effectively by a transfer of revenue between the two suppliers. In our view interchange is, at least in principle, a reasonably necessary and thus legitimate means of bringing this balance about.

In arriving at this conclusion we have had to consider in some detail the nature of the joint...
venture in open card schemes and various arguments advanced concerning their need for interchange. We have given attention to the true nature of interchange as a means of revenue allocation between financial institutions participating in a card scheme, rather than as a price for a service by one such participant to another. We have addressed the question whether the necessity of interchange in principle is refuted by the success achieved by card schemes in some countries without interchange, or refuted by evidence that payment card issuing may be profitable even when interchange is left out of account.

Our theoretical analysis is preceded by a compilation and analysis of the data on card issuing, merchant acquiring, revenues and profitability which the participants in the Enquiry furnished voluntarily, and is based further on questions and answers aired at the hearings on this subject.

6.1.5 Danger of abuse and how best to prevent it

In our view, the necessity of interchange in principle as a balancing mechanism (and thus its legitimacy in principle also) does not serve to justify the methodologies currently employed by the card schemes, and by their participating banks, in arriving at the actual levels of interchange which are applicable to the various types of payment card transactions. Unsatisfactory aspects and implications of these methodologies are considered in detail in the course of this chapter. Here the broadest outline must suffice.

Interchange enters invisibly into the merchant service charges levied by acquirers. As a common component in acquirers’ costs, it sets a floor for their merchant service charges which cannot be competed away. In turn, it enters invisibly into consumer prices. If interchange is necessary, it has nonetheless the nature of a necessary evil — and should be kept as low as reasonably possible. In fact, as our investigation shows, the art in interchange setting has been for the schemes or their participants to assess the maximum share of issuing costs which merchants are likely at any time to be willing to bear by way of merchant service charges, and to keep interchange at this level or just a little below it.

As a subsidy from the acquiring to the issuing side, interchange obviously facilitates card issuing. Competition between schemes for issuers has the paradoxical tendency to drive interchange upwards rather than downwards. Where, as in South Africa, the major issuers are also the major acquirers, the interests in maximising interchange are generally far more powerful than any that might tend to bring it down. Where interchange has come down, the likelihood is that issuing costs have come down even faster, or some immediate purpose of overcoming merchant resistance to card acceptance has been the aim.²¹ The true constraint on interchange, and on merchant service charges, is ultimately the “competition” of increasingly archaic substitute means of payment. Little comfort can be taken from this.

²¹ The bargaining power of larger merchants allows them to negotiate more favourable merchant service charges. This can, however, not be seen as an effective constraint on the level of interchange fees set between participating banks.
Even a monopolist in the payment card business would not be able to price beyond the level at which the merchant would rather refuse cards and elect to accept only cash or cheques.

Interchange revenue (more broadly the interchange component concealed in the merchant service charge) can be applied by issuers so as to increase cardholder demand — which then, by way of network effects, increases the degree of economic “captivity” of merchants. The more cardholders there are wanting to use cards to make purchases, the less can merchants really afford to refuse them. Thus the elasticity of merchant demand for acquiring services can be reduced, and their willingness to endure above-competitive prices for the benefits that go with acceptance of payment cards can be increased. Interchange setting can therefore serve as a means of market manipulation, by the schemes themselves or collectively by their participating banks.

Moreover, by including in credit card interchange a contribution by the merchant to the issuer’s costs of extending credit, the current interchange methodologies of the schemes and their participating banks serve to privilege this line of business over competing forms of credit extension.

Higher rates of interchange for credit cards compared with debit cards have helped make the former cheaper for the cardholder to use, while the potential for debit cards to replace cash and cheques has probably been retarded. At the same time, to the extent that the level of credit card interchange causes merchant service charges for such transactions to exceed debit card service charges and the merchants’ costs of cash, any resulting addition to consumer prices would imply that poorer consumers are to this extent being obliged to subsidise the rich.

All these aspects are explored in this chapter. In short, it does not follow from the necessity of interchange that the actual setting of interchange is free from the danger of abuse. Such abuse can improperly enhance the power producers have over consumers, make poorer consumers pay for the privileges of richer ones, and put the suppliers of one means of payment or credit in a privileged position, thus distorting competition and harming both producer and consumer welfare in general.

As payments by card — along with other methods involving interbank transactions through the national and international payments system — become ever more common in consumer purchases and in the settlement of retail debts, so the subject of interchange will rise in importance as a public issue. The advantages for society of replacing cash to an ever-increasing extent with non-cash methods of payment are, we believe, considerable. The increased use of payment cards and the development of payment card schemes have an important, progressive role to play. Interchange is a complex mechanism. Once the necessity for such a mechanism is accepted, the focus must shift to the best means of ensuring that it is not abused. In our view, while our present framework of competition law
provides an ultimate back-stop to protect the public, it is too blunt an instrument involving too many case-specific uncertainties to be a fully adequate means of addressing the interchange problem.

At the same time, in proposing any regulatory intervention in this area, great care has to be taken to ensure that pro-consumer competitive dynamics in the market for payment services are not stifled, and that innovation is not obstructed.

6.1.6 A transparent and objective interchange methodology

Transparency and objectivity, and resulting confidence on the part of both suppliers and consumers, are crucial to the setting of appropriate levels of interchange in the different payment streams in which it is shown to be necessary.

We do not consider that a multiplicity of interchange levels bilaterally negotiated between the various participants in each relevant payment stream would offer a satisfactory way forward. Indeed, bilateral interbank arrangements in this sphere are more likely to result in enhancement and abuse of market power than would a uniform level of interchange applicable to all issuing and acquiring participants in the particular payment stream.

It became evident from submissions made by banks which participated in the Enquiry, taken together with subsequent exploratory consultations with them, that all would favour or accept a change from the present methods of setting domestic levels of interchange, to a process under compulsory regulation –

• based on a transparent methodology
• with objective criteria being established for each relevant payment stream through a participatory process and justified in public
• with the resulting appropriate levels of interchange, where applicable, being independently assessed on the basis of audited data
• with the integrity of the process being verified under regulatory oversight
• with the levels of interchange so determined being thereafter enforced.

We recommend that the necessary regulatory scheme be drawn up and implemented so as to enable this change to be effected and enforced as soon as practicable. Details of the proposal are set out in the section of this chapter dealing with appropriate regulation of interchange.

We note here that the need for such a change, and the wisdom of it, was not supported by card schemes – and we shall address their particular arguments and reservations in some detail in this chapter. Among retailers consulted, while there was unanimous support for
safeguards against excessive interchange, there were different views as to the best means of achieving that outcome.

6.1.7 Interchange and other payment streams

In this chapter we also consider interchange arrangements in the electronic funds transfer (EFT) and early debit order (EDO) payment streams. Our recommendations in this regard are that interchange fees in these payment streams be brought within the transparent and objective regulatory scheme proposed where the necessity and level of interchange can be determined.

6.1.8 Card scheme rules

In this chapter other issues raised in connection with the card schemes, in particular the “honour all cards” rule and the “honour all products” rule, are also addressed. We have concluded that the former is legitimate while the latter is not.

We consider whether the schemes should be obliged to permit merchants to surcharge customers who use cards to pay for purchases. In the context of our proposal for a regulatory solution to the interchange problem, we advise against interference with the schemes’ rules against surcharging.22

We also deal with scheme rules which have restricted merchants in providing cashback at the point of sale (POS), and make recommendations aimed at lifting them.

We briefly consider and make recommendations concerning current restrictions which limit the acquiring of card transactions to banks, and indeed to those banks which are also substantial issuers of cards. The regulatory issues involved are addressed in the chapter of this report dealing with Acess to the Payment System.

6.2 Payment cards in South Africa

6.2.1 Types of cards and card transactions

Payment cards are ordinarily classified as credit and charge cards on the one hand, and debit cards on the other. American Express explains the distinctions between these different types of cards:

Charge cards require the balance to be paid in full every month. Credit cards allow the cardholder to delay payment of all or a portion of the balance under a revolving credit line which can be tailored to the financial situation of the cardholder. Both are distinguishable from

22 See Section 6.10 below.
debit cards, which debit the cardholder's [bank]23 account for the amount of a charge immediately upon conclusion of the charge transaction.24

Usually charge cards are included when the expression “credit cards” is used, a practice we adopt in this report, unless otherwise indicated.

A simple classification by type of card tends, however, to obscure the fact that technological developments may allow the same card to be used as a credit card or a debit card depending on the cardholder’s choice on each occasion at the point of sale. The more crucial classification is thus according to the type of card transaction which is involved when the card is used – a debit card transaction25 or a credit card transaction26. In South Africa a unique card named a “cheque card”,27 which functions like a debit card but only requires a signature for identification instead of a personal identification number (PIN), has also been developed.

As Ms Louw of the Enquiry’s Technical Team outlined during the hearings:

The criteria to be able to have a credit card or debit card are significantly different. Credit cards are seen as a product in their own right, where debit cards are more used in conjunction with the facility of a bank account or the banking service. So if you open a bank account you will be issued with a debit card, [whereas] you have to apply for a credit card.28

Obviously the issue of a credit card depends upon the applicant qualifying in the eyes of the issuer as credit-worthy. In South Africa, the credit card is thus effectively available only to a better-off minority. Among payment cards, it is the debit card which, while arriving later on the scene, has the potential of replacing cash with plastic as a mass means of effecting or achieving retail payments.

6.2.2 Global development of payment cards and electronic payments

American Express began in 1850 as an express delivery business in New York.

Although in its early years American Express was not itself a financial services company, its largest and most consistent clients were banks. Delivering the banks’ typically small parcels – stock certificates, notes, currency and other financial instruments – was considerably more profitable than transporting larger freight. Soon the company would scale down its parcel and
freight delivery business in favor of creating and selling its own financial products.\(^{29}\)

It launched a money order business in 1882, and the first travellers’ cheques in 1891. Extending to Europe in 1895, it began conducting commercial banking services in 1904, and official currency exchange services in the US in 1905. Having expanded its travel and financial services business after the First World War, and again after the Second World War, American Express issued its first charge card in 1958.

\[\text{... Within five years, more than 1 million cards were in use at approximately 85,000 establishments within and outside the United States. Soon, the company began introducing local currency cards in markets outside the United States, adding programs that made it possible for cardmembers to extend payment on large travel expenditures, and launching additional products...}\]

Despite the introduction in 1987 of a new revolving credit product in the United States, the company’s share of the U.S. card market fell during the late 1980s and early 1990s. Trouble was also brewing on the merchant front. In Boston in 1991, a group of restaurateurs, upset about what they felt were American Express’ unfairly high rates, staged a revolt that came to be known as the Boston Fee Party. Outside the United States, card suppression – when merchants try to dissuade customers from using the American Express Card – began to rise.

\[\text{Years later, the company’s chief executive would say, in retrospect, “If not for the strength of our brand name, American Express would have collapsed by the late 1980s.” ...}\]

\[\text{Rebuilding relationships with merchants became a top priority, as did significantly increasing American Express Card acceptance across a wide range of industries and geographical markets. The company also began forming a number of strategic partnerships with selected airlines, banks, retailers and other key businesses around the world. ...}\]

\[\text{Within the decade, American Express was again operating from a position of strength.}^{30}\]

American Express describes itself today as “a world leader in providing charge and credit cards to consumers, small businesses and corporations.”\(^{31}\)

Diners Club, with cards issued today in more than 200 countries, began in 1950 in New York to meet the needs of wealthy diners. Within a year its charge cards were held by 20,000 people and were soon being accepted by restaurants, hotels, car rental agencies and florists. Membership and card acceptance soon spread around the globe. The paper card was replaced with a plastic card in 1961. A corporate card was introduced in 1979, and “the industry’s first rewards program” in 1984 (frequent flyer miles etc). In 2004 it entered an alliance with MasterCard to enhance card acceptance.\(^{32}\)

\[\text{Although Diners Club claims to have issued the world’s first charge card,}^{33}\text{ other accounts differ. The following is stated by Visa International and Global Insight, Inc. in The Virtuous...}\]

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30 Id.

31 Id.

32 Diners Club International, About Diners Club, [http://www.dinersclubus.com/dce_content/aboutDinersClub](http://www.dinersclubus.com/dce_content/aboutDinersClub)

33 Id.
The introduction of charge cards [in the United States] in the early 1900s, beginning with Western Union in 1914, represented a breakthrough in payments. But while these cards enhanced customer loyalty and stimulated repeat buying behavior, they were generally limited to the local market or in-store use.

In 1958, Bank of America took a major step forward, introducing what eventually became the modern credit card. Based on extensive test marketing in Fresno, California it became clear there was a large market for a general-purpose bank card featuring a revolving credit facility and wide acceptance. With the launch of Bank of America’s card, the consumer was not tied to one merchant or product but was now free to make credit purchases at a wide range of outlets. As the adoption of the bank card increased among consumers, merchants, and banks, the potential size of the market for transactions expanded geometrically. It was a profound turning point in the history of money.

The development of the modern electronic payment network took an important step forward in the mid-1970s with the creation of a global joint venture that would eventually be known as Visa. Through shared investments, the Visa association created a global system to authorise transactions, clear and settle electronic payments, codify operating regulations to protect consumers and merchants alike, and set interoperability standards to ensure that, unlike cash and cheques, a Visa card could be used anywhere in the world.

MasterCard developed from the Interbank Card Association formed in 1966 by a number of banks in the United States. The right to use the name “Master Charge” was bought from the California Bank Association. It was renamed MasterCard in 1979. Under this name the association subsequently developed as a global four-party credit card scheme to rival Visa in its reach and power. In 1985 it acquired an interest in EuroCard (predecessor to Europay International) and in 1988 acquired the Cirrus® ATM Network. In 1991 it launched Maestro®, which it describes as “the world’s first online point-of-sale debit network”. MasterCard has recently converted from an association of member financial institutions to a corporation owned by shareholders trading on the New York Stock Exchange. Visa has since undergone a similar conversion.

The account given by Visa and Global Insight continues:

Two developments in the 1990s further broadened the utility of electronic payments:

- debit cards, a popular “pay now” product, allowed consumers to access funds in a demand deposit account to conduct a transaction at the point of sale; and,

- e-commerce emerged as a mainstream business channel, both relying on and stimulating electronic payments.

The rapid adoption of these relatively recent developments demonstrates the speed at which the payments landscape is changing. Looking forward, there is broad experimentation in ways to migrate electronic payment functions into consumer devices such as mobile phones, PDAs

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34 Supra.
and other popular electronic products.  

Similar developments are well under way in South Africa. E-commerce transactions increased by 35 per cent in 2006, amounting to 14.5 million transactions estimated at a value of R9.5 billion. The March 2004 launch of Wizzit—an alliance banking partner with The South African Bank of Athens, under which it operates as a division providing “a low cost, transactional bank account that uses cell phones for making person-to-person payments, transfers and pre-paid purchases, and a Maestro debit card for making payments in the formal retail environment”—is an example of how electronic transactions are facilitated among even poorer sectors of the population.

6.2.3 Card issuing in South Africa

Accounts of the origins of payment card issuing in South Africa are difficult to reconcile. According to the Diners Club South Africa website, “Diners Club International was established in South Africa in the sixties as the leading charge card operator in the country.” Mr Jordaan of FNB said however—evidently referring to credit cards—that the market for payment cards had begun with Barclays in 1968. Absa, for its part, told us that credit cards were first introduced by Barclays in the 1980s.

Writing in the *South African Journal of Economic History*, Stuart Jones provides this more detailed account:

> The acquisition of Wesbank in 1975 not only provided Barclays National [Bank] with the country's biggest car finance company, it also brought with it the Wesbank card. Schlesinger's Wesbank had introduced the credit card to the South African public in the early 1970s. It was characterised by two features, revolving credit and high interest rates. The Wesbank card began the revolution in the way of making payments that has transformed retail transactions in the last quarter of the twentieth century. Today it seems hard to believe that in the early 1970s bank managers were advising customers against the use of such cards on the grounds that they would encourage them to get into high interest debt. Less than thirty years ago ordinary bank managers still reflected the conventional wisdom of an earlier era and, in 1970, certainly did not foresee the way in which credit cards would mushroom in the decade that followed. Modern banking had emerged to provide a means of making and receiving payments at the time of the Industrial Revolution and the introduction of the credit card in the 1970s was a continuation of this process with the aid of modern technology. In the 1970s, though, it would not have been possible without a multi-divisional structure. This enabled

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39 Wizzit, October 2006, Banking Enquiry submission, p 5.
40 [http://www.wizzit.co.za](http://www.wizzit.co.za), Wizzit offers a full banking functionality including internet banking, debit orders, transfers and access to all point of sale and ATM devices.
41 [http://www.dinersclub.co.za/pages/personal/about.php](http://www.dinersclub.co.za/pages/personal/about.php), Diners Club South Africa is one of 158 Diners Club franchisees worldwide.
42 Transcript 19 April 2007, p 159.
43 Exhibit LL, slide 19.
Barclays to reorganise Wesbank with its focus on vehicle finance and to abolish the Wesbank card, whose business was merged into that of Barclay’s Visa card.45

According to Absa,46 Standard Bank began to issue MasterCard in the late 1980s. The issue and use of debit cards is a more recent development. Absa says it was the first to introduce these in the 1990s, with Standard Bank following in the late 1990s.47

Credit and charge cards

According to figures submitted to the Enquiry in respect of locally issued cards, roughly 6 million credit and charge cards bearing the Visa or MasterCard labels are in circulation in South Africa — American Express credit and charge cards issued amount to fewer than 150,000,49 and Diners Club cards approximately 100,000.50

Debit cards

Figures given by the big four issuing banks indicate that at least 22 million debit cards are in circulation in South Africa. Taking all issuers into account, the total number of debit cards will be marginally higher.52

Taking the available figures together, the big four issuing banks account for well over ninety per cent of the payment card base in South Africa.54 The following table shows the...
approximate percentage share of the debit card and credit card market held by each of the big four banks, and by other banks.

Table 1 Percentage share of debit and credit card market

<table>
<thead>
<tr>
<th></th>
<th>ABSA</th>
<th>Standard Bank</th>
<th>Nedbank</th>
<th>FNB</th>
<th>Other</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Cards</td>
<td>65</td>
<td>26</td>
<td>33</td>
<td>14</td>
<td>21</td>
</tr>
<tr>
<td>Debit Cards</td>
<td>38</td>
<td>29</td>
<td>10</td>
<td>21</td>
<td>2</td>
</tr>
</tbody>
</table>

Source: Banks submissions, March and April 2007, Second submission, Issuing

Table 2 sets out the figures made available to the Enquiry for the various payment cards issued by the big four banks in South Africa.56

55 Combining membership information provided to the Enquiry by Visa and MasterCard, other issuers of four-party scheme cards in South Africa would be: African Bank, Albaraka Bank, Capitec Bank, Investec Bank, Ithala, Mercantile Bank, Rennies Bank and Teba Bank.

56 In the case of American Express cards, the figure given for Nedbank (the exclusive licensee of American Express in South Africa), the issuer is actually American Express itself with the issuing function performed by Nedbank on its behalf.
## Table 2 Payment cards issued by the big four banks in SA

<table>
<thead>
<tr>
<th></th>
<th>ABSA</th>
<th>Standard Bank</th>
<th>Nedbank</th>
<th>FNB</th>
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</thead>
<tbody>
<tr>
<td><strong>Credit Cards</strong></td>
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<td></td>
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<tr>
<td>MasterCard</td>
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<tr>
<td>Diners Club</td>
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<tr>
<td>American Express</td>
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<tr>
<td><strong>Total Credit Cards</strong></td>
<td>58</td>
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<td></td>
<td></td>
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<tr>
<td><strong>Total Credit Cards for Big Four</strong></td>
<td></td>
<td></td>
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<tr>
<td><strong>Debit Cards (MasterCard/Maestro and Visa)</strong></td>
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<tr>
<td>PIN</td>
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<tr>
<td>Signature based</td>
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<td><strong>Total Debit Cards</strong></td>
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<tr>
<td>% Visa</td>
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<tr>
<td>% MasterCard</td>
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<tr>
<td><strong>Total Debit Cards for Big Four</strong></td>
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<tr>
<td><strong>Other cards</strong></td>
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<tr>
<td>Buy Aid</td>
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<tr>
<td>Private</td>
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<tr>
<td>Gift Cards</td>
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<tr>
<td><strong>Total</strong></td>
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<tr>
<td><strong>Total Other Cards for Big Four</strong></td>
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</tr>
</tbody>
</table>

**Total cards issued by these banks:**

*Source: Banks submissions, March and April 2007, Second submission, Issuing*

Visa estimates that the South African banks issue approximately 6 to 7 million proprietary ATM cards. It further estimates that there are 6 to 7 million store cards in circulation.

**MasterCard states:**

Payment cards constitute the principal means of payment that support e-commerce and continue to enable the rapid expansion of the on-line economy. This has led to the establishment of new distribution channels and to greater convenience and lower prices for consumers, and increased economic productivity, competition, innovation and growth.

Whether in fact competition generally has increased, or has increased to the extent that it could and should as a result of card schemes – and whether prices to consumers are indeed lower or as low as they could and should be – are matters which we consider below.

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57 FNB does not issue MasterCard cards except for Maestro Travelcards (cards included in the PIN based debit card figure).

58 Diners Club figures do not appear here, as their cards are not issued by any of the banks. Diners Club did not provide its own data.

59 It is not clear how that estimate fits with the banks’ figures reported above. ATM cards are usually now combined with debit cards, which are scheme-branded.

60 Visa, October 2006, First Submission, p 38.

61 MasterCard, October 2006, First Submission, pp 18-19.
Nevertheless, the greatly increased convenience and other aspects of utility for card users, the increased productivity generally inherent in this utility, and the potential for enhanced competition and lower prices inherent in the spread of payment card networks, seem beyond serious dispute.

In the opinion of Mr Carl Munson, Associate General Counsel of MasterCard who came from New York to participate in the hearing on 18 April 2007,

the technological development of [South Africa] and the development of the payment systems here … is in some respects even ahead of many developed countries in the world. …[T]his year the banks and the schemes in South Africa will introduce Chip & Pin, the most advanced form of electronic payment. … [T]hat has only recently come to Europe. There are many countries in Europe that are no farther ahead than South Africa …, and I can tell you as an American to my disappointment, that there are no plans in the United States to introduce Chip & Pin, so from a technological standpoint the South African payment system and the card systems in general in South Africa is favourable.62

But the relative sophistication of the South African financial and payments system is not automatically, and not readily, translated into benefits for the broad majority of the South African people. The huge inequalities in property, income, education, infrastructure and facilities which characterise our society reveal themselves in — among other things — the continued predominance of cash in retail transactions.

6.2.4 Continued predominance of cash

Figures provided by ABSA during the hearings indicate that cash is the means of payment used in 49 per cent of transactions in which that bank is involved.63 FNB found that cash made up about 60 per cent by transaction volume when payments by cheque, cash, credit cards and debit cards are compared.64 In the case of major food retailers, cash is still used by customers in 87 per cent of transactions.65 In other words, payment cards would account for only some 13 per cent of such transactions in this country, whereas in the UK 63 per cent of retail sales are done using payment cards.66

About two-thirds of the world’s population is unbanked. In Visa’s submission, payment card products "draw the unbanked into the banking system", thus suggesting that their payment instrument promotes financial inclusion.67 While there may be truth in this point at a general level, we have not been provided with evidence to show this effect in South Africa. The picture here indicates that, even as poorer people have begun to have bank accounts and to

62 Transcript 18 April 2007, pp 11-12.  
63 Transcript 17 April 2007, p 67.  
64 Transcript 19 April 2007, pp 123-124, referring to Exhibit PP, slide 5.  
65 Exhibit LL, slide 5.  
be issued with debit cards as a consequence, their actual utilisation of those cards has initially been very low.

It does appear that debit card transaction volumes are growing much faster than credit card volumes, but this growth is off an extremely low base. As Mr Fergus of Standard Bank acknowledged, the number of debit cards has grown exponentially but the problem has been to get them used.

We have been unable to reconcile the Euromonitor figures for debit and credit card numbers and usage (provided by Nedbank) with the figures provided by Bankserv. The differences cannot be accounted for simply by the fact that Bankserv’s figures relate mainly to off-us transactions processed through it. Nevertheless, it seems clear that average debit card usage is in general much lower than average credit card usage. Figures for 2006 suggest that the average usage of a debit card was no higher than 4 to 5 transactions during the entire year, whereas the average annual number of transactions per credit card may be as high as 40. Whatever the case in this regard, debit card usage presents a far from satisfactory picture nationwide.

The low usage of debit cards appears in part to be a consequence of a lag in merchants’ acceptance of cards in both rural and impoverished urban areas. During the hearing on 18 April 2007, Mr Bodibe (of the Panel) observed:

I live in Kempton Park. If I cross the road to Tembisa, it is a cash economy, no usage of cards, so why is that situation like that, and why are we not seeing a proportionate increase of terminals in those type of situations?

Mr Grobler of MasterCard answered as follows:

You know, I think it is a question that should be asked to the acquiring banks, but I can give you my view on it. I think if you look at the growth of the point of sales infrastructure over the

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68 Transcript 19 April 2007, pp 17-18 (Nedbank); FNB Exhibit PP, slide 5, gives the compound annual growth rate in volume of credit card transactions in 2002-2006 as 20%, while that of debit card transactions has been 129%. This is FRB data and cannot account for the entire industry. Bankserv data (submitted September 2007) indicates that the compound annual growth in debit card transaction volumes of which it is aware has been 124% and in credit card transaction volumes 21%.

69 In 2002, Bankserv processed only 4.4 million debit card transactions, compared to 56 million credit card transactions. In 2006 Bankserv recorded 112 million debit card transactions and 120 million credit card transactions (Bankserv, November 2007, Data submitted to the Enquiry).

70 Transcript 19 April 2007, p 84.

71 Nedbank presented figures showing that in 2006 there were 24 million debit cards and 88.5 million debit card transactions in South Africa. In the same year, there were 7.2 million credit cards and 302.2 million credit card transactions, an average of approximately 42 per card, per year. (Exhibit NN, slide 3. These are figures extracted from Euromonitor, March 2007, Financial cards – South Africa.)

72 See footnote above.

73 Transcript 18 April 2007, p 108.
last two years, in the last two years the point of sales infrastructure grew by about 30 per cent in South Africa. There are about 655,000 point of sale devices in the market at this stage – not merchants, devices – and I would like to make the assumption that the markets you are referring to, are starting to be addressed. So, that is the one point. The other point is that communication is obviously very important for the merchant to establish the transaction and this is where I believe that technology can play a role. ... Capitec Bank actually launched chip card technology where it is not ... necessary for every transaction to go online to get authorisation for the transaction. So it is a transaction that is not dependent on telecommunications infrastructure. I would like to make the assumption that that technology will facilitate the development of point of sale infrastructure into the areas that you are referring to.

So, just to summarise, I think there is a wonderful growth of the point of sale infrastructure. I think those markets are in the process of being addressed, but I think technology will actually support that going forward as well. ... 

In a subsequent hearing, addressing the question of limited merchant acceptance of payment cards, Mr Gericke of Nedbank said:

To see greater acceptance there have to be a few factors in play. First of all, merchants need to have point of sale presence. Secondly, and this is really the crux for me, ... cardholders need to demonstrate that they want to purchase rather than draw cash on their debit cards. And then thirdly, we need to be able as acquirers to provide technology that is appropriate for that market.

... Generally we see that debit card holders have used their cards in the main to draw cash – they just go the ATM and draw the cash. What we have seen in recent times is that there is a strong multiplier when those card holders who used it purely for cash start purchasing [with the card], so there is a strong growth in the market and we see, as that connection is made, there will be more demand at the merchant to present the card for payment for purchases.

... The point I want to raise around the appropriate technology is that a point of sale device as we have seen in many of the stores we go to is not necessarily the most appropriate for the spaza shop in Tembisa, and what we as Nedbank have done is to create telephony solutions over cellphone where the merchant can acquire that transaction over the cellphone, or phone into a call centre and acquire that transaction on that basis.

And so it is a function of really the three things: the need of those merchants to say, “I want to start accepting card”; that is in part driven by customers who present their card for payment; and then thirdly, enabling technology beyond just the point of sale device. 

Caution related to unfamiliarity and relatively low financial literacy of many merchants and cardholders, may contribute to the low level of acceptance and usage of cards.

The tendency of debit-card holders to use them only to draw cash, and then to use cash for their purchases rather than insist on using the card to effect transactions, is likely to be connected with the per transaction charge which debit card users currently have to pay their issuing bank – a matter to which we return below. In turn, as Mr Gericke’s testimony bears

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74 Id., pp 109-110.
75 Transcript 19 April 2007, pp 38-40.
76 No per transaction fees are levied on credit card transactions, whereas debit card transactions attract a per transaction fee ranging between R2 and R5 (for an average transaction value of R225 as specified in Table 8) on the basic savings and current accounts offered by the big four banks.
out, this must retard the process of merchants in poorer areas signing up to accept cards.

Benefits of non-cash and paperless means of payment

Visa and Global Insight\(^{77}\) say that the trend away from cash and cheques internationally is driven by the well-established benefits of electronic payments to all parties. Putting matters in a favourable light for the card schemes, they provide the following list of typical benefits to buyers and sellers:

**Benefits to Buyers**

- The convenience of global acceptance, a wide range of payment options, and enhanced financial management tools.
- Enhanced security and reduced liability for stolen or misused cards.
- Consumer protection through an established system of dispute resolution.
- Convenient and immediate access to funds on deposit via debit cards.
- Accessibility to immediate credit. Intuitively, the comparative cost of arranging for a consumer loan relative to the ability to obtain credit at the point of sale is substantial in considering both the direct processing costs as well as the implicit opportunity costs to borrower and lender.\(^{78}\)

**Benefits to Sellers**

- Speed and security of the transaction processing chain, from verification and authorisation to clearing and settlement.
- Freedom from more costly labor, materials, and accounting services that are required in paper-based processing.
- Better management of cash flow, inventory, and financial planning due to swift bank payment.
- Incremental purchasing power on the part of the consumer.
- Cost and risk savings by eliminating the need to run an in-house credit facility.\(^{79}\)

There is also increasing reliance by governments on payment cards for the safer and more efficient distribution of certain social welfare benefits. Net1 has been in the forefront of this development in South Africa, developing its own electronic payment system linked to a payment card with an embedded chip, capable of being used by those without a formal bank account.\(^{80}\)

\(^{77}\) Op cit.

\(^{78}\) We don’t accept the accuracy of the expression “obtain credit at the point of sale”, but if the point is to emphasise the flexibility of this form of credit it is a valid one. Flexible access to credit is not unique to credit cards, however. A debit card can also be used to draw against a credit (e.g. overdraft) facility arranged in connection with the cardholder’s bank account. See Transcript 17 April 2007, pp 108-109 (Mr Volker).

\(^{79}\) *Id.,* p 8. This latter element would be irrelevant, of course, in the case of most small and medium-sized merchants who would not in any event run such in-house schemes. We deal with this aspect further in the section of this chapter dealing with appropriate regulation of interchange.

\(^{80}\) Net1 describes itself as a “provider of smart card technologies and systems that create a secure and affordable transacting channel between formal businesses and the ‘un-banked’ and ‘under-banked’ populations of developing countries.” [http://www.aplitec.co.za/About_Us.htm](http://www.aplitec.co.za/About_Us.htm). “The Net 1 PENSION AND WELFARE product was designed to enhance the participation of social grant beneficiaries in the economy of their countries. The system seeks to eliminate previous deficiencies and improve the lifestyles of all its users. The system creates a secure and affordable transacting
Visa and Global Insight also explain the way in which increased volumes of card transactions tend to reduce average transaction costs in a way that cash transactions cannot match.

The cash-based system is a physical system driven by *variable* costs, so that transaction costs decline only slightly as volume increases. The payment card system, however, is more of an information system, whose cost structure is driven primarily by the *fixed* costs of setting up its interconnected components. The greater the volume of transactions carried over an electronic network, the *lower* the average cost per transaction.  

The relatively low use of the payment card system in Belgium results in a cost per transaction of US$0.60, higher than the cash cost of US$0.52 – because low volume does not allow for maximum exploitation of the fixed costs.

The advantages where non-cash forms of payment take over from the use of cash are further described and elaborated from the Visa and Global Insight point of view as follows:

The stock of currency held outside of the banking system constitutes a potential source of unproductive economic resources because these cash stores are not available for credit expansion.

Expanded use of electronic payments in the system reduces friction and increases the velocity of transactions.

Electronic payments expand the available options for the secure receipt of wages and income as well as for spending.

Electronic payments empower the consumer in several fundamental ways that cash and cheques cannot. One of the clearest ways is the security that dispute resolution provides, offering consumers a form of insurance against purchases of faulty goods or services that are not delivered or lower in quality than expected. Insurance against lost, stolen or otherwise unauthorised use allows consumers to quickly shield themselves from liability, at zero cost in some markets, unlike lost cash or cheques.

Electronic payments also provide the ability to control payment for goods and services over time by allowing buyers to pay now, pay later, or prepay. Credit cards provide liquidity through pre-approved credit availability, something that transaction-specific loans cannot do. This works favorably for consumers, merchants, and banks because the process facilitates current period sales while minimising the cost of obtaining credit. Debit cards offer convenient and

channel between formal businesses or Government and the ‘un-banked’ and ‘under-banked’ populations who have no or limited access to traditional banking facilities." The Net 1 U.E.P.S. (Universal Electronic Payment System) has secured a foothold in a number of African countries by supplying turnkey banking solutions that are ideally suited for developed and developing economies. The U.E.P.S. system enables traditional financial institutions to surpass the offerings of competitors through the technological innovations available in the U.E.P.S. solution.

http://www.aplitec.co.za/Our%20Solution/Products/Banking.htm. See also Transcript 30 November 2006, pp 91-183 (Dr Belamont).  

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81 Op cit, p 10. This and the immediately following paragraphs quoted are selected extracts, and are not necessarily contiguous in the original.

82 Id., p 11.

83 Id., p 13.

84 Id.

85 Id., p 11.

86 Id., p 15.

87 We have noted above that debit cards can also be used to access a pre-approved credit facility.
immediate access to funds on deposit. Globally branded electronic payments have the ubiquitous and interoperable features that lend themselves to immediate acceptability by consumers and businesses.\textsuperscript{88}

No matter what the physical vehicle used to transmit the information – whether credit card, debit card, PC, PDA, mobile phone, or smart card – the underlying electronic payments system is critical to facilitate transactions in the global, digital economy.\textsuperscript{89}

Increasingly, cash and even cheques represent a legacy form of payment that act as a drag on economic efficiency, present significant levels of security risk, and have no capacity to support the type of value-added payment functions that are now expected among consumers, small- and medium-sized enterprises, corporations, and the public sector.\textsuperscript{90}

With regard to the dispute resolution benefit that electronic payments apparently provide consumers, we believe the benefit is somewhat idealised. In practice, many cardholders experience considerable time-consuming difficulties in getting issuing banks to reverse debits on their cards despite the promises of the card schemes. The Ombudsman for Banking Services indicated that his office does not receive a great deal of credit card complaints.

Our impression is that all the major banks have a clear process in place to deal with disputed debits… [The process] is however not communicated to customers or merchants very well. Our impression is that most customers and merchant have no idea of how the charge back process works and the time frames within which disputes must be lodged. We have further found that the bank’s credit card divisions do not keep the customer informed of the progress on a dispute.\textsuperscript{91}

Garcia-Swartz et al, in “The Move Toward a Cashless Society: A Closer Look at Payment Instrument Economics”,\textsuperscript{92} confirm the benefits of non-cash means of payment as a record keeping and consolidation mechanism:

All payment methods except for cash provide consumers with a record keeping mechanism useful for budgeting, planning, and income tax preparation. Rather than having to keep track of each paper receipt, [cheques] and payment cards provide itemized monthly statements; many also have online statements accessible anytime.\textsuperscript{93}

… [P]ayment cards offer the option of consolidating payments – consumers charge everything on one card and pay only one bill at the end of the month. Many consumers value the enforced fiscal responsibility that cash, [cheques], and debit cards provide (Thaler, 1981\textsuperscript{94};

\textsuperscript{88} VISA and Global insight, op cit, p 15
\textsuperscript{89} Id., p 18.
\textsuperscript{90} Id.
\textsuperscript{91} Ombudsman for Banking Services, March 2008, Response to Competition Commission Enquiry question.
\textsuperscript{92} Review of Network Economics, vol 5, issue 2 – June 2006, pp 189-191. Although the authors are dealing specifically with the United States, the essentially standard features of card payment systems means that their observations may be applied more widely.
\textsuperscript{93} Cash payment, on the other hand, offers purchasers a degree of privacy inasmuch as their payments are not recorded. Understandably, the authors have difficulty quantifying this benefit in monetary terms.
Moreover, where these non-cash forms are not linked to credit,

… they can help consumers to limit their debt. [Cheques] and payment cards also provide improved theft and loss prevention as compared to cash, as well as easier dispute resolution in the event of problems.96

Using a payment card to obtain cash back at the point of sale saves consumers the need to make a separate trip to an ATM, and may reduce merchants’ cash handling and banking costs.

Other claims are made for the special utility of credit cards. The credit card combines the benefits of a non-cash and paperless means of payment with a flexible source of unsecured credit. MasterCard says:

Credit cards and charge cards are now such a part of everyday life that their benefits are often taken for granted. A cardholder can walk into a shop anywhere in the world and make purchases with no local currency. The shopkeeper can sell confidently to customers whom they have never met before secure that he will receive payment.97

However, there seems no reason why this advantage should not apply equally to debit cards within a global scheme operating in an on-line environment.

According to Visa,

For the business owner, accepting credit cards could increase sales by enabling customers to make impulse buys even when they don’t have cash on hand or sufficient funds in their [cheque] accounts. Experts advise that accepting credit cards can also improve a business’s cash flow, allowing businesses to receive the money within a few days rather than waiting for a personal [cheque] to clear or an invoice to come due.98

The “payment guarantee” removes the risks involved in accepting personal cheques.99

Arguments in favour of the welfare benefits of credit cards include the following:

• Consumers benefit by having greater control over the timing of their outlays, thus being able to take better advantage of opportunities that arise for favourable deals.

• This in turn increases competition between merchants.

• As a result of the credit card schemes taking on the risk of lending to the merchants’ customers in order to finance their purchases, the smaller merchants, who would not

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96 Garcia-Swartz et al, op cit., p 191.
97 MasterCard, October 2006, First Submission, p 17.
99 Id. The nature of the “payment guarantee” and the extent to which merchants are relieved of risk under the rules of the card schemes are discussed below.
be able to engage in credit extension themselves, are able to compete on a more equal footing with larger merchants.

- The increased spending resulting from credit cards enables merchants to benefit through higher turnover and increased economies of scale and scope.

In fact, these latter benefits are not nowadays exclusive to credit cards. They are intrinsic to any flexible credit facility which can be accessed with a payment card. Where a debit card is linked to a bank account with a credit facility, the issuing bank takes the risk that the cardholder may fail to repay. The risk in this respect is ultimately the same with credit card debt.  

**Relative cost of cash**

According to Visa:  

In fact when everything is taken into account, there is convincing evidence that it costs retailers less to accept cards than it does for them to handle cash – because cash handling costs are significant. They include, for example, the costs of sorting, administering, securely transporting and banking cash. In addition, when merchants accept cash they inevitably suffer from ‘shrinkage’.

In addition, the fact that so many retailers offer ‘cash back’ to card-paying customers suggests that they prefer not to deal with large amounts of it. Cards are far more efficient. They provide a fast, flexible service to customers. They tend to lead to higher sales. And when accepting cards, merchants benefit from a valuable payment guarantee. Millions of merchants worldwide accept Visa, suggesting that the benefits of the system far outweigh the costs.

These obviously self-serving paragraphs blend together a number of valid points with others that do not withstand critical examination.

We do not accept that there is convincing evidence that accepting cards is cheaper for merchants than accepting and handling cash. We believe it has the potential to be significantly cheaper, and this is one of the reasons why the methodology and the levels of interchange – which feed downstream into merchants’ costs and prices – need to be scrutinised.

No adequate data is available to us from which we could draw firm conclusions regarding the relative cost to merchants in South Africa of accepting payment by card as compared with payment in cash. However, Shoprite Checkers provided some figures suggesting that its

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100 In the case of credit cards however – as we shall show further in this chapter – the schemes and their participating banks have contrived via interchange to shift a significant part of the cost of extending credit to their privileged customers onto the shoulders of merchants and, through them, onto consumer prices.

costs of cash are lower than its costs incurred in card acceptance. We have not probed these figures further and we lack comprehensive comparative data for South Africa which might make them meaningful.

Mr Munson of MasterCard argued that studies of the costs to merchants of accepting cash are likely to understate them:

There are a number of costs of accepting cash that typically are not mentioned when people consider cash costs. People will generally consider for example, the cash handling costs, they will measure the fees … that the bank charges the merchant for handling the cash at the end of the day. There are also cash handling costs that are often not accounted for; in other words, you have to have employees who are spending time counting the cash, balancing the cash register and doing things like that. Another [cost] that is often not taken into account is what is sometimes euphemistically called slippage [or "shrinkage"], which means that the clerks are taking money out of the cash register, so that the merchant is not getting the full amount of cash that was expended by consumers. So the … actual cost of the cash to the merchant will vary and … there are hard studies to do to measure this.

We did a study in Australia a number of years ago and I would say one of the difficulties of doing these studies, is the merchants are very reticent to provide these numbers, not surprisingly because if they tell the credit card companies what their cash costs are, it could affect the negotiations, so they tend to hide these facts, but we did a study with merchants in Australia a number of years ago. The only way we could get any information at all, was to agree not to publish the data itself and so, you shall have to take my word for it, but what it showed was that … [the] fully measured out of pocket cost to merchants for handling cash varied quite considerably, depending upon the nature of the merchant. For very large retailers, supermarkets in particular, cash handling costs were relatively low and they were lower than the cost of accepting a credit card, but for small merchants, single proprietary stores, cash handling costs were several times the cost of accepting a credit card.

So, once again, these are questions that cannot be answered in the abstract. If you really want to know what is the cost of accepting cash, you would have to go out and collect the information. You have to collect the data and then you would have to look at what is the cost to this type of merchant or to that type of merchant, and it would probably … vary country to country and merchant category to merchant category. …

Despite these observations, international comparative data which was submitted to the Enquiry on MasterCard’s behalf at the hearing on 18 April 2007 does suggest that Shoprite Checkers’ position as last disclosed to us would not be at all unusual.

Slide 10 of Exhibit MM1, presented by Dr Koboldt for MasterCard, showed that in the United States, for a typical grocery transaction, the cost to a retailer of accepting cash is in fact

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102 In a letter to the Commission from Shoprite (through its attorneys) dated 20 July 2006, it estimated a total annual turnover of R32 billion in 2005 for its retail operations (p 1). Of this, 68.8% (R22.016 billion) was attributable to cash and 29.19% (R9.34 billion) to debit and credit cards (p 2). On p 12, the total amount of merchant service fees charged to Shoprite by Absa was said to amount to about R34 million per annum, or “about half of Shoprite’s annual total merchant’s fee expense”. (R68 million would be about 0.73% of the total debit and credit card turnover.) However Shoprite also made the contradictory statement on p 2 that its costs arising from the payment of merchant’s fees amounted to approximately R100 million a year (which would equal 1.07% of the debit and credit card turnover). On p 16 Shoprite stated that its cash handling fees amounted to about R213 million per annum (0.97% of the cash turnover) – including the processing of cash, the transit charges, insurance and in-store theft. That would make cash more expensive than card acceptance, if the more conservative figure given for merchant service fees is correct. In a subsequent spreadsheet submitted, however, Shoprite lowered its total figure for the costs of cash to roughly R111 million per annum, making cash (at 0.5%) cheaper than card acceptance.

103 Transcript 18 April 2007, pp 103-105.
lower than for every other means of payment. However, when the full cost to society is also factored in, cash turns out to be roughly as costly as credit cards, and costlier than both signature-based and PIN-based debit cards. Dr Koboldt explained:

By social costs I mean the entire cost incurred by the economy within the economy as a result of using cash for that particular transaction rather than another bank.\textsuperscript{104}

Garcia-Swartz et al,\textsuperscript{105} say with reference to the United States:

[M]erchants face relatively high net private costs for electronic payment methods as compared to paper payments.\

Consumers, on the other hand, face far higher net private costs for cash and [cheques] as compared to cards. In fact, consumers receive net benefits from using credit to pay for larger transactions. Consumer private costs are almost entirely time-based for all instruments, including such items as the time cost of obtaining cash at an ATM and the time cost of processing a payment at the point of sale, both of which favor electronic payment methods. Consumer private benefits are driven by cash back for [cheques] at the grocery store, which enables consumers to avoid going to an ATM for smaller cash purchases. For credit cards, rewards are by far the largest item, although the option value of credit is non-trivial for larger purchases.\textsuperscript{106}

Merchant studies have found that paper methods are the cheapest for merchants. This is confirmed in our study of the distribution of private costs and benefits. But what is cheap for merchants is relatively expensive for other parties to a transaction. Certain parties, especially consumers, receive considerable benefits from payment cards, which tip their net private costs in favor of that method of payment.\textsuperscript{107}

Making an analysis of grocery store transactions in the United States, these authors conclude:

[C]ash – the cheapest instrument for merchants – is not the cheapest instrument for the economy as a whole, at either the smaller or the larger transaction size. Counting all parties, PIN debit transactions are cheapest, followed closely by signature debit. For the smaller transaction, cash is third and credit is fourth. But for the larger transaction, paper instruments, especially cash and non-verified [cheques], emerge as more costly forms of payment. Thus adding other parties to the transaction has changed the relative cost situation considerably.\textsuperscript{108}

They find that the “implicit cost of cash increases dramatically with transaction size.”\textsuperscript{109}

Included here is also the increased risk of loss through theft. Where small purchases are concerned, the transactional costs of cash may well be lower than the costs of cards for merchants.\textsuperscript{110}

\textsuperscript{104} Id., p 97.

\textsuperscript{105} Op cit.

\textsuperscript{106} Id., pp 194-195.

\textsuperscript{107} Id., p 196.

\textsuperscript{108} Id., pp 187-188.

\textsuperscript{109} Id., p 185.

\textsuperscript{110} On the consumer side, however, per transaction charges associated with withdrawing cash for purchases are consistently higher compared to the charges associated with a POS debit card transaction. On basic savings accounts offered by the big four banks, the per transaction charges (for an average transaction value of R279.42) range between R2.80 and R2.00 for a debit card POS purchase, whereas for an on-us ATM transaction, the charges range between
The social costs of cash relative to payment cards and other electronic means of payment would obviously include the costs to consumers associated with robbery and theft, and the inconveniences involved in minimising such risks.\textsuperscript{111} The banks’ costs incurred in cash handling relative to electronic payment processing must be counted as a social cost. And the central bank incurs production costs for cash; society thus subsidises the individual user.

Dr Koboldt made the valid observation that

private payment systems such as the MasterCard payment system, consisting of the scheme, issuers and acquirers, must be self-financing. They must recover their costs exclusively from fees charged to users of the payment system. By contrast, cash is a subsidised payment system. The users of cash are not bearing the full cost incurred in providing the payment system – the cost of printing and distributing notes, the cost of collecting notes that are to be taken out of services and actually [destroyed] – they are not borne by the merchant deciding to accept cash for the transaction, nor are they born by the cash user. They are borne by society as a whole, because cash, being legal tender, is a publicly subsidised payment system. And it is just important bearing in mind when you then look at the welfare impact.\textsuperscript{112}

Moreover, merely comparing the (net) costs of card usage with the (net) costs of cash – whether the private costs or the social costs – is surely too narrow a framework for judgment. The utility to the user of each means of payment is quite different, not only for the individual user but also in the aggregate. Value-in-use cannot ultimately be reduced to monetary equivalents. If the aggregate social benefit (utility) of card usage is so great in comparison with that of cash as to warrant a greater social expenditure in providing them, then so be it.

The point remains, however, that the comparative benefits of payment cards – however great they may be when compared with cash – would not entitle the card schemes or their participating institutions to appropriate to themselves a supra-competitive profit by virtue of providing payment card services. If such services could be provided more cheaply and yet the benchmark for the remuneration of the providers is set against the private cost of cash, then it implies a power in the market to price up to the cost, or near the cost, of that unsatisfactory and increasingly archaic substitute. If the benchmark is the social cost of cash, then the implication is even more serious – that the schemes and/or their participants have the power to appropriate to themselves by their private decisions an element of social subsidy which, in the case of cash, is provided by the public power under ultimate democratic control.

Accordingly, what must be sought in the case of payment card services and other innovative means of payment is the full utilisation of their progressive potential at the lowest, i.e., most

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\textsuperscript{111} Cf Mr Munson’s example concerning the dangers of making ATM cash withdrawals to pay for purchases in some areas: Transcript 18 April 2007, pp 102-103.

\textsuperscript{112} Later he added that “for cash, the difference between the cost to the merchant and the cost to society is very, very large, which basically shows that cash is a heavily subsidised payment system.” \textit{id.}, p 67.
competitive, prices to consumers and cost to society. For reasons which we shall explain shortly, there are serious grounds for concern that the aggregate prices of payment card services may be kept artificially high by the actions of the schemes and the combination of their participating institutions in interchange arrangements.

6.2.5 Global strength of Visa and MasterCard

In understanding the current competitive landscape for payment cards in South Africa, it is important to take account of the extent to which the four-party schemes, Visa and MasterCard, have established their position internationally.

According to MasterCard, it provides services in more than 210 countries and territories.\(^{113}\) It has a network of more than 24 million merchant acceptance locations around the world.\(^{114}\) More than 1 billion cards have been issued worldwide under the MasterCard brand and its related brands\(^ {115}\) – Maestro®, Cirrus® and MasterCard® PayPass™.\(^ {116}\) Financial institutions issuing cards under these brands numbered almost 25,000 worldwide by 2005.\(^ {117}\) In that year, cardholders across the world used MasterCard-branded cards (excluding Maestro and Cirrus) for more than 19.1 billion transactions, generating a gross domestic volume of $1.7 trillion\(^ {118}\) and net revenue for MasterCard of $2.9 billion.\(^ {119}\)

According to Visa, it has 1.5 billion cards globally, issued by some 22,000 banks (and other licensed institutions). The total annual expenditure by cardholders, using these cards in about 50 billion transactions with 24 million merchants, is US$4.5 trillion.\(^ {120}\)

Both Visa and MasterCard are able to switch and settle transactions internationally. Domestic transactions may also be switched offshore via processing centres located in the USA, Europe and elsewhere. Currently, for example, domestic transactions involving cards issued by Investec Bank are switched through Visa’s international network.\(^ {121}\) Switching a transaction in this way takes a fraction of a second, and both the MasterCard and Visa networks have vastly greater technical capacity than is currently used.

\(^{113}\) Company Fact Sheet on www.mastercard.com.
\(^{114}\) Id.
\(^{115}\) Id. People may, of course, hold more than one card.
\(^{116}\) Company Fact Sheet, supra.
\(^{117}\) MasterCard, October 2006, First Submission, p 16.
\(^{118}\) Id.
\(^{119}\) Id., p 15.
\(^{120}\) Visa, June 2007, Second Submission, document B (first part) p 7.
\(^{121}\) Also, Mercantile Bank testified that it has been switching its credit card transactions through Visa. (Transcript 28 May 2007, p 162.)
6.2.6 Network advantages of four-party schemes

Global cooperative associations combine the competition and innovation of the private sector with economies of scale, shared technology and infrastructure, and interoperability.\(^\text{122}\)

It is claimed that the four-party or open loop system allows and encourages competition among issuers for cardholders and among acquirers for merchants,\(^\text{123}\) and that “the benefit that arises from competition amongst issuers and from competition among acquirers that is seen within a four-party scheme is not found”\(^\text{124}\) in the three-party or closed loop system. This section explores the evidence presented to the Enquiry in this regard.

With a roughly 50/50 split of the South African market between Visa and MasterCard scheme cards,\(^\text{125}\) the tendency on the part of the major banks is towards issuing both.\(^\text{126}\) In this situation, once some major banks issue both scheme cards, others that did not follow could well find the amount of their interchange receipts falling and the amount of interchange they pay away rising, relative to those that did. This process must tend to consolidate the dominance of the four-party schemes in the payment card market.\(^\text{127}\) Efficiencies and network effects evidently drive the market towards convergence (and towards four-party schemes).

According to Mr Volker of Absa, although the big four banks might each be able to operate its own three-party scheme in the longer term, the duplication of infrastructure would make the system generally less efficient, and smaller banks would simply not be able to afford to enter the acquiring market.\(^\text{128}\)

Mr Fergus of Standard Bank said in this regard:

> If you have a three party scheme the cardholders [in that scheme] all have to be with one [issuing] organisation. So, if Standard Bank had a three-party mass market product, it could

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\(^\text{122}\) The Virtuous Circle: Electronic Payments and Economic Growth, supra, p 5.


\(^\text{124}\) Absa, Transcript 17 April 2007, p 68.

\(^\text{125}\) Transcript 18 April 2007, p 144 (MasterCard).

\(^\text{126}\) See Table 1 above.

\(^\text{127}\) At the same time, an advantage to banks in issuing (and acquiring) for both schemes is that banks can take advantage of certain competitive dynamics between the schemes in respect of scheme charges, introduction of new products, etc. (Absa, Transcript 17 April 2007, pp 164-165 (Mr Sweeney).) Despite the strength and scale of the major card schemes, banks do have some ability to play one scheme off against another, having regard to the fact that there are different choices of cards available, including “white cards”. (Nedbank, Transcript 19 April 2007, pp 64-65.)

\(^\text{128}\) Transcript 17 April, pp 160-161. The duplication of infrastructure should not be exaggerated. Where acquiring infrastructure is concerned, there can be and is significant sharing between schemes. Thus the same merchant terminals can usually be used for Visa and MasterCard, as well as Diners Club, American Express and other (white label) card transactions. Nevertheless, each three-party scheme at least has to have a separate acquiring contract with each merchant. This points to the relative efficiency of schemes which link all the participants without their having to conclude multiple direct contractual arrangements. Moreover, the ability of a three-party scheme like American Express to operate its merchant acquiring via an existing communications network with merchants has depended on that network being established in the first place to meet the needs of four-party scheme transactions.
only issue it to its customers. It could not issue it to anyone else and the card would only be accepted at retailers who had signed up for that scheme. So, you would not have one scheme, you would have in South Africa twelve schemes, all potentially with different systemic risk, different financial risk, different standards, different operating rules, different dispute resolution criteria, you know, and you have then got to have the management and the supervision of all those schemes.

The open scheme says that the four banks [sic] can issue cards to their cardholders and those cards can be used at merchants acquired by all of those four banks, and that is the difference. … The costs [of numerous competing three-party schemes] would be absolutely enormous to the … merchants, and the cardholders. … [T]he greatest advantage that MasterCard or Visa have, is thirty years of financial settlement experience and thirty years of experience in the rules and regulations that we all comply with. [Especially in] dealing with disputes, … dispute resolution between the cardholder and the merchants, so they are not favouring one or the other. Those rules have evolved over thirty years and they are a fantastically balanced set of documents. To start that from scratch has an enormous cost. … The costs in payment cards is in the disputes.129

Mr von Zeuner of Absa explained that a change to a multiplicity of three-party schemes would be a step backwards:

The card of any individual bank would never enjoy the same level of merchant acceptance as a Visa and MasterCard and can I illustrate our point by our own experience over white label cards when we in the late 90's had a bank teller card equivalent to a white label card that just never took off other than being a mechanism that we used in our ATM’s.130

MasterCard’s representatives, beginning with Mr Munson, were questioned by members of the Panel about the need to retain the four-party model:

MRS NYASULU: … [Y]ou asked the question, is interchange necessary? Can I turn that on its head and say rather – and let’s just assume for one minute that I am not going to fight with you on whether interchange is necessary or not, but rather say – is a four-party payment system necessary?

MR MUNSON: … Four-party payment systems, as compared with the other models? … I would call it a two-party system, or a private legal system, where the merchant actually offers the credit card. That is the original model. In four-party systems as compared to three-party systems like the American Express system, and there is even another variation which you might have seen a slide in my remarks, a 3½-party model, where you have issuers, but only a single acquirer, I call that a 3½-party model. So, … to answer the question I think you have to say, in comparison to what, and then you can conclude a few things.

First of all, given the history of the business. The business started with the two-party systems and then there was the introduction of the three-party systems, and then the introduction of the 3½- and the four-party systems. … So, if you look at the evolution of the business, the business evolved from the two-party model, where if you wanted to use your credit card at a store, you had to get a credit card from that store. So, if you shopped at a lot of stores, well then you had to have a lot of credit cards. … Now, that evolved to a three-party system. The advantage of a three-party system is that the entity that runs the system can sign up multiple merchants, different merchants to accept its cards and then can go to the cardholder and say you only need one card, and you can shop at many different locations, and … I think it is pretty obvious that it provides a benefit to the cardholder. At the same time it provides a

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130 Transcript 17 April 2007, p 72. Standard Bank, April 2007, Second Submission, Issuing, Part I, p 10, defines a “white label” card as “a piece of plastic that is issued by a bank or non-bank and is interoperable in certain respects, but is not association branded.”
benefit to the merchant.

First of all, the merchant does not have to go to the expense and run the risk of running its own business, especially smaller merchants, who probably could not afford their own credit card business, and they now have a greater number of customers to draw from .... No one knows me if I go into a shop in South Africa. They do not know if I have good credit or bad credit, but if I have a MasterCard, they are pretty comfortable that if they sell me something, they are going to get paid. .... I should say American Express, because we are talking about [the] three-party [model]. If I would have pulled out the American Express [card], they would be pretty comfortable that they will be getting paid. That is three-party. But there is a further improvement. We can have a four-party system.

In a four-party system, instead of having just one company offering cards, and just one company signing up merchants, we can allow different companies, typically banks, to issue these cards and we can allow different companies to compete for the business of the merchants. Now, from both the cardholder’s and the merchant’s point of view, I would contend that is an advantage. .... There is now a new form of competition in the market, so that cardholders and merchants will have additional choices. If you want a MasterCard card as a consumer in South Africa, you are not limited to dealing with one entity. You can go out, and from what I heard yesterday, have as many as eleven choices to choose from, and if you are a merchant and you want to accept MasterCard cards, from what I heard yesterday, you have a choice not just of one entity to go to, one acquirer, you have a choice of four. ...

There is another benefit which I think in the long run may even be more significant, and that is because these issuers and acquirers within the system are still competing with each other, they are constantly innovating, and because MasterCard has to worry about the desirability of its service, it is also competing and this tends to drive innovation. If you look at the major innovations in the payments market over the last 20 or 30 years, for example the introduction of electronic payments – because in the old days credit card transactions were not electronic, they were paper-based. You know, you zip-zapped the card, and you filled out a receipt, and that was physically transported somewhere and then someone keyed in their numbers. And one of the greatest innovations which took place in the 1970’s was the introduction of the electronic terminal. That introduction was driven by the four-party systems. A more recent example of sort of the same thing is the introduction of chip cards, where you replace the mag-stripe with a much more secure and much more versatile computer chip in the card, and that innovation is driven by a four-party system.

MRS NYASULU: Okay, I am going to stop you there for a while if you do not mind, because you have answered the first part of my question. What I now want to probe with you is, you are obviously assuming that the only way that we can introduce competition is to follow the four-party model, whereas I am saying, there is nothing that stops us introducing competition within a three-party model, and having many American Expresses, in other words, compete that way. .... Hence my question about why the four-party scheme is being touted as the only one, because the three-party model also gives merchants access to a system that they want, it gives consumers or cardholders access to a system that they want, so it does everything that the four-party model does. It just does not charge interchange.

MR MUNSON: Two points I would make. First of all, I perhaps I did not express it well, but in fact the three-party model does not do everything that the four party model does. There is no intra-brand or intra-system competition. If you want an American Express card, you have one choice. You go to American Express ...

MRS NYASULU: Is that a bad thing?

MR MUNSON: It is for you folks to decide whether more competition is better than less competition, but it is a fact, that there is an additional form of competition within a four-party system. It is a fact that if you look at merchant fees around the world, you compare merchant fees, MSC’s between three party systems and four party systems, generally the merchant fees of four-party systems are lower.
CHAIRPERSON: But there is no interchange.

MR MUNSON: So, let me address that. There is no interchange fee. Why is that? Well, because once again, interchange fee is this term that we use to apply to the – to use Mr. Bodibe’s example before of reallocating the costs within the system, and I say, yes that is the purpose of interchange. But do not misunderstand. The mere fact that a three-party system does not formally need an interchange, because it does not have to move money between different banks, does not mean it is not moving money between the acquiring and the issuing sides. In fact, there is some good indication to believe that in most cases they are actually moving more money from the merchant’s side to the cardholder’s side, in other words there is even more subsidisation of cardholder fees going on in three party systems.

So yes, four party systems need interchange, but both systems need to balance the demand as Dr Koboldt explained, and therefore you do not avoid the need to balance the system just because you have a three-party model.

MR GROBLER: Can I just possibly … explain in the context of South Africa … [the point about] the development of the acceptance infrastructure. Through the four-party model it is developed through the four – we actually have got five – acquiring banks in South Africa. I want to include Capitec as an acquiring bank as well. So, the collective result is much wider than the three-party context.

But I think if you look at the amount of products that has been issued in the four-party model in comparison to the amount of products that has been issued in the three-party model, currently in South Africa there are about 24 million debit cards that can be used at point of sales in the four party model, that have been issued. Part of that is the Mzansi card, and really for us to address the market that we really need to address I would make the assumption that in the context of the three-party model it may be much more expensive … to penetrate the market as deep as we can do potentially through the four-party system. I do not want to argue it is an either or. I think it’s a both factor.

MRS NYASULU: I would support it on the basis that I said I would support theories. You and I can only put theories on the table, we have not tested it. But if I am willing to explore theories I am quite happy for you to explore the same and it is quite possible that it would be expensive.

MR MUNSON: And, we are not against three-party models.

MRS NYASULU: And I am not against four-party. I am looking for a different way to do things and whether …

MR MUNSON: My own personal view is that consumers and merchants are most benefited when they have as many choices as possible. Personally I do not think it is a bad thing that American Express exists. I mean, certainly they prompt us to pay even more attention to our business, because we know they are a very effective competitor and they run a very fine company. So, to me though, it should not be a choice between three- and four-party, it should be both, and three-parties do bring certain advantages to the market and four-party systems bring other advantages, and I think consumers and merchants are benefited if they have both choices.

DR KOBOLDT: Can I just add one observation that is more a theoretical observation. The benefit of intra-scheme competition I think extends further than just being able to say, well I [can] get my MasterCard from Nedbank, ABSA, or whoever. The benefits extend to fostering competition amongst banks for a whole range of services, to the extent that there is a tendency for customers to want to have relationships or a single relationship with the bank for a range of services if you had only three-party systems competing with each other. Centrally, if I wanted a credit card, I could only go to one of those few banks who are sufficiently large to be able to run a three-party system. We heard yesterday from ABSA that it is not even guaranteed that they could … launch a three-party system on their own, so that would severely limit the number of three-party systems that could be sustained in the market. So, if I
am a smaller bank and I cannot run a three-party system of my own, I am also limited in terms of access to customers who want single bank relationships. So, if somebody wants a credit card, and a current account and maybe some other products, and I cannot offer a credit card ..., I cannot compete in that space, so there are wider competition benefits from a four-party system than just intra-scheme competition in terms of choice of provider of issuing services.\textsuperscript{131}

On similar lines, Visa and Global Insight say:

As a highly decentralised entity, Visa permits a great degree of autonomy to member institutions in product development, product management, pricing, and promotion. The unique characteristics of this governance structure\textsuperscript{132} enable the central organisation to ensure cooperative efforts in the management of common assets, while fostering a competitive market model at the retail institutional level. While the common benefits of system sharing are conferred on all members, greater product innovation, quality and diversity are achieved at lower prices locally.\textsuperscript{133}

There are considerable benefits in maximising joint assets and ensuring interoperability in the payment system. Huge investments in physical and knowledge capital are required to establish and maintain the infrastructure that drives the flow of international transactions – including instantaneous authorisation, ongoing risk management processes, and daily clearing and settlement. The nature of the system’s cost structure, with high fixed costs relative to low marginal costs, requires a substantial volume of transactions to warrant the infrastructure investment. But it is through the interoperability of the system that common benefits are produced with larger volumes. This results in efficient sharing of common resources, fully utilising the fixed assets of the business, and exploiting economies of scale and scope.\textsuperscript{134}

Nedbank confirmed that the four-party model has promoted interoperability between banks which, in the South African context, has been “a great success story”.\textsuperscript{135} Visa noted that interoperability between banks drives electronic payments, which are more efficient than cash, bring people into the banking system, increase spending, and reduce the grey economy and increase tax revenue.\textsuperscript{136}

FNB expressed the advantages of the four-party model in this way:

MS DE BEER: ... Essentially, the four-party model has many contributors. It is a global interoperable system as we know it in South Africa today. So there are many contributors that contribute to the cost of that model. There are many contributors to maintaining that infrastructure, maintaining the integrity of that infrastructure. So … the four party model has succeeded in gathering critical mass. A three-party model has not…. [Through the four-party model], one is able to gain efficiencies, economies of scale, etc. In the three-party model as we know it today, the three-party model in fact [feeds] off the infrastructure that a four-party model eventually provided to the market. And that is the point that we are trying to illustrate, that the four-party model has already achieved critical mass which makes it necessarily more

\textsuperscript{131} Transcript 18 April 2007, pp 121 - 131
\textsuperscript{132} In fact the structure of MasterCard is essentially similar.
\textsuperscript{133} Op cit., p 16.
\textsuperscript{134} Id., 16.
\textsuperscript{135} Nedbank, Transcript 19 April 2007, p 3.
efficient in that sense.\textsuperscript{137}

In the roll-out of debit cards by Absa it was found to be important to get a brand more universal than the bank’s own brand – hence the involvement of the card associations.\textsuperscript{138}

\textit{[O]n top of the brand, they also offered a world class body of rules, operating regulations, security standards that we could access at a marginal cost, compared to if we had to that ourselves. Plus, it would also open up the ability to have other bank’s terminals acquiring our systems, and I [Mr Volker] think that whole system enabled greater economies of scale benefits to our consumers, and ultimately also to the merchants.}\textsuperscript{139}

However, most South Africans have no immediate need of a card that can be used overseas. This raises the question regarding the scope for developing white label or locally-branded cards as cheaper alternatives to the brands of the major card schemes – especially for consumers who do not enter into global internet transactions or use cards beyond the border of South Africa or beyond SADC.

Indeed, South Africa does have several successful, albeit small, white label cards in circulation. Expansion of such cards on a national basis has intuitive appeal, especially given the successful national white label schemes developed in the past in countries such as Norway. However it is important to point out that the successful national white label schemes were generally developed together with the banking industry and before global standards of interoperability became widespread. Even in the Scandinavian countries, as we discuss below, the movement now is in the direction of link-ups with globally branded four-party schemes.

In South Africa, interoperability in the payment card arena was developed in conjunction with these four-party schemes. Establishing or developing an entirely new proprietary or interoperable network on a national scale is inherently complex and expensive.

MR GERICKE: So Chair, as I understand the question it’s around extending effectively white label cards to look and feel and operate like a Visa and MasterCard but not through the Visa or Master [schemes].

CHAIRPERSON: Yes that is exactly the question.

MR GERICKE: There would be real difficulty in that because for interoperability you will have to create a payments platform of sorts, with its own rules. What works in these two-sided models or the private label card businesses is that that there are very specific retailers and only their stores that can be shopped at by clients. As soon as one wants to take a private label, white label card, across multiple domains you need a payments platform of sorts to...

\textsuperscript{137} Transcript 19 April 2007, pp 191-192.

\textsuperscript{138} Transcript 17 April 2007, p 100. Visa advanced much the same argument: A four-party scheme not only enables the cooperation between the participating institutions and their customers in a fundamental way. It also facilitates this cooperation by assisting participants with dispute resolution, fraud protection and compliance monitoring, and provides a clearing and settlement system between them should they need it. (Visa, June 2007, Second Submission, document B (first part) p 16.)

\textsuperscript{139} Transcript 17 April 2007, p 100. Buy-aid societies’ cards do not carry a global or international cards scheme logo; they might carry a bank logo but they are only national cards and they can only be used in South Africa. Examples are Pretorium Trust, Cape Consumers, Koopkrag and so forth. See id. pp 12-13.
allow for the interaction and allow for the exchange of the messages and make sure the technology can talk to one another.

CHAIRPERSON: Well … I am setting up this particular scenario with a payment system of some sort [in mind]. … [Y]ou can in cooperation with the others set up a payment system of some sort.

MR SHUTER: Yes, Chair, that is possible. If one looks at many European countries and how they started their debit card schemes, they were local within country and [they were] proprietary systems that the banks created, or the regulator created, that facilitated that card payment within that region. So that is possible, but it still requires a payments platform to be created and to be synthesized with all the rules of acceptance, but it is possible.¹⁴⁰

Mrs Nyasulu observed that both closed systems – American Express and Diners Club – are aimed at high net worth individuals.¹⁴¹ Mr Fergus offered the explanation that this is on account of “the intrinsic cost of the closed scheme,” which required higher than normal transaction values for merchants on the one hand, and higher than normal benefits to cardholders on the other hand, in order to generate the necessary revenue. “There are relatively few people in any market who are prepared to pay the premium for all those services.”¹⁴² Although he was not prepared to say that three-party schemes are suitable only for high net worth individuals, he did not know of any three-party scheme that is suitable for the lower end of the market.¹⁴³

In the light of the information presented to the Enquiry, it appears that the actual and potential benefits arising from the four-party networks are considerable and that an attempt to prohibit and replace them domestically with only three-party schemes would be misconceived. To the extent that remedies are required to address abuses, or the dangers of abuse, brought about by the growth and power of these schemes, those remedies must be so constructed as not to isolate South Africa from the mainstreams of global development, or throw the baby out with the bathwater.

### 6.3 Merchant acquiring and merchant service charges

#### 6.3.1 Merchant acquiring in the three-party and four-party schemes

As we have seen, an essential characteristic of four-party card schemes such as Visa and MasterCard is that the schemes themselves do not issue cards or acquire merchants’

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¹⁴¹ Transcript 19 April 2007, pp 95-96. American Express acknowledged in its Submission, October 2006, p 2, that its credit card network “is focused on the premium segment – aimed at high-spending, financially reliable cardholders – thereby offering a significant range of innovative and value-added benefits to merchants and cardholders above those generally available from other credit card networks.” Likewise on p 3: “Amex’s business model permits it to operate as a significant niche player, focusing principally on providing premium services to high net-worth card members and Amex merchants.”
¹⁴² ld., p 96.
¹⁴³ ld., pp 96-97.
transactions. The functions are separately carried out by independent issuers and acquirers who do so as participants in the schemes concerned. Both MasterCard and Visa have recently restructured their global operations, so that participating issuers and acquirers are no longer technically "members" but simply licensees in terms of the schemes.

In South Africa, at the time of making its first submission to the Enquiry, MasterCard had nine principal member banks and one affiliate member bank. Visa, at the time of making its submissions, had ten principal members and two associate members in South Africa. However, at the time of the initial submissions, while all these participating banks were allowed to issue Visa and/or MasterCard scheme cards, only the four big banks were allowed to acquire both credit card and debit card transactions. Capitec and Mercantile joined these ranks only recently (see further below).

Visa says:

The traditional model for Acquiring in the South African market is a very simple model in which the Acquiring Bank contracts with the Merchant to process all card transactions that are accepted at the merchant.

The original point of sale (POS) devices used a dial-up modem across a normal telephone line and the communications costs associated with the use of the POS device were for the merchant to settle directly with Telkom. A number of variants and improvements have developed, including improved communications, host-to-host systems, third party processors and outsource network providers.

Currently, GPRS (General Packet Radio Service) telecommunications technology is allowing faster connectivity at lower costs in previously underserved and inaccessible areas. Larger retailers have established direct host-to-host links between their own mainframe and the mainframe of their acquiring banks. Measures are in place to maintain the security of these connections. Settlement of merchants’ entitlements to payment is able to take place several

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144 Nor does the scheme itself interact directly with cardholders. See e.g. Visa, June 2007, Second Submission, document B (first part), p 11.
145 Visa Europe, however, continues to function within the new structure as a members’ association under licence. (Press release by Visa, 11 October 2006, accompanying letter to the Competition Commission from attorneys Denyes Reitz on behalf of Visa International Service Association, 14 June 2007.) MasterCard now refers to what were formerly “members” as “simply customers”. (See e.g. MasterCard, October 2006, First Submission, p 4.) They continue to operate under licence to MasterCard. (Id., p 6.)
146 MasterCard, October 2006, First Submission, p 14.
147 In the Visa scheme, a Principal Member may issue cards and acquire merchants, subject to Visa licensing. (Visa, First Submission, October 2006, p 20.)
148 An Associate must be sponsored by a Principal Member. (Id., p 21.)
149 Capitec, March 2008, Further questions for Capitec.
150 The MasterCard license for Mercantile was approved in November 2007, and the Visa application is expected to be approved shortly (Mercantile, March 2008, Competition Enquiry Questions and Answers).
151 Visa, June 2007, Second Submission, document G.
152 ld.
times a day.\textsuperscript{153}

The process typically involved when a participating bank acquires a merchant for a card scheme, and the scheme’s concern with the risks involved, were described by MasterCard’s representatives as follows:\textsuperscript{154}

MR GROBLER: I think typically when an acquiring bank will approach a merchant, part of the process will be to look at the viability of the business case of the merchant. And the second point that will be addressed is … the Merchant Category Code, that is the business segment in which the merchant operates typically. That will play a very important role in terms of the risk inherent in the business. The acquiring bank will also then do an assessment in terms of the business practice and the integrity of the merchant and at that stage the acquiring bank will typically engage in discussions with the merchant on the merchant service fee. After they have reached agreement on that, there will be typically a merchant acquiring agreement which the merchant will engage in and the acquiring bank then has got the responsibility to do training with the merchant in terms of risk and security. … [T]hat is more or less, on a very high level the process. It is also expected from the acquiring bank to visit the merchant or to do site visits on an annual basis. That is a normal conventional merchant. I have not referred to the typical mail order or the telephone order environment. …

I have referred to a typical smaller merchant, you know, where the acquiring bank will typically install a point of sale device with the merchant, so that is normally not an integrated system. In the scenario of larger retailers obviously the point of sale equipment is integrated with their infrastructure and that may be a … more complex process. But I think on a high level what is important is assessment, is the training of the merchant and then the merchant agreement.

MR MUNSON: … [E]ssentially MasterCard has two concerns that it relies upon the acquirer to address. One is, to make sure that we do not bring into the system a fraudulent merchant or a merchant that is operating a business in a way that will increase the risk to the business, and secondly to make sure that the merchant is abiding by the rules, terms and conditions of the system, accepting cards, etc. … [T]he acquirer provides two essential services and the first is, the acquirer actually assumes the risk, financial risk to the system if the merchant does something wrong, and secondly the acquirer assures us that the merchant is following whatever rules are applicable to the merchant’s business as it participates in the system.

MR GROBLER: … [W]e also expect the acquiring banks to monitor the incidence of charge backs. Now, a charge back is a technical term that we use for transactions that have been disputed by cardholders with merchants and if it exceeds a certain ratio, then we expect the acquiring bank to take some action with that merchant, you know, normally it is corrective action, it is training and some kind of intervention with them.

MR BODIBE: Now that the merchant is now compliant and the agreement has been signed, what financial outlays should the merchant invest to participate in the system? So basically how much do they pay for the terminals and also for ensuring integration of their communication systems with the bank’s system? …\textsuperscript{155}

MR GROBLER: … You know, it is obvious that there is a business agreement between the acquiring bank and the merchant but what will typically happen in South Africa, and again I am referring to the smaller merchant, I am not referring to the bigger retailers, is that the smaller merchant will typically rent the point of sale device from the acquiring bank. The acquiring bank will provide the merchant with stationery and the necessary supporting material … [T]here is a move away from fixed line telecommunication to GPRS

\textsuperscript{153} Id.

\textsuperscript{154} Transcript 18 April 2007, pp 73-81.

\textsuperscript{155} Mr Munson intervened to point out that the question could be answered by MasterCard only at a general level, and that the details of such arrangements with merchants would best be obtained from the acquirers. Id., p 76.
communication, so [normally] that will be set up for the merchant and I would say that is more or less the capital outlay for the smaller merchant. For the bigger merchants it is obviously a bit more complex in terms of integration with their systems.....

MR MUNSON: .... [If you look at the way the acquiring business is structured around the world you find different models, [but] ultimately what it boils down to is to connect a merchant to the MasterCard system. It does require investment in equipment, in communications, in training and in ongoing monitoring, and the model can vary from country to country and from merchant to merchant. Essentially the negotiating process is to decide, is the acquirer going to put up the capital and then charge a monthly fee or a service fee or make it part of the merchant service charge, or is the merchant going to provide that equipment on its own and thereby reduce the amount of money it pays the acquirer and assume the cost itself, and there are many, many variations that can be made to accomplish those purposes.

Mr Bodibe asked MasterCard about the factors usually built into the service charge paid by the merchant to the acquirer.

MR GROBLER: As I have indicated and I am typically referring to the single acquiring model, .... what will typically be reflected in the merchant’s service fee, will be the risk profile of the merchant; it will be the turnover of the merchant; it will be the product set of the merchant, the kind of products, internal risk involved in that, whether the merchant is well established or not; and the cost of service to merchant. .... [In the single acquiring scenario where we made the assumption that the acquirer provides the terminal and the stationery, there is obviously a cost involved in that as well, a maintenance cost. So, I would say those are more or less the variables that will play a role in the merchant’s service fee. ....]Obviously there is some business strategy behind it as well. Some of the acquirers may try to focus on smaller merchants, some may focus on bigger merchants or retailers...

... [T]ypically if it is a product that has got inherent risk to it, let me think about mail order, telephone order, and there may be a higher level of risk in terms of the delivery of the product on that, [then] that may play a role in the setting of the merchant’s service fee.

MR MUNSON: Risk can be a huge factor. I recall earlier in my career at MasterCard, in the 1990’s, you may recall there were a wave of airline failures. Pan American ran out of business, TWA went out of business, Continental went through chapter 11 and if you think about it, if you were an acquirer of an airline where huge amounts of tickets are bought in advance and then the card holders come back to the bank and say, I bought this ticket and the airline is out of business, give me my money back, and then under the charge back process that Eddie mentioned, the issuer then charges that back to the acquirer and says, give me my money back, and now the acquirer is sitting there with a liability and its customer, the merchant, is out of business. .... [It] is just an example that the risk that the acquirer takes can be very large. On the other hand, if the acquirer is dealing with a mainline retailer or large department store that has a long track record, you know, the risk may be relatively small. So risk plays a huge part in the setup and management of the payment system for the issuer, for the acquirer, .... and for the scheme because we actually guarantee the payment of the issuer to the acquirer and if the acquirer cannot [meet] the charge backs, we guarantee that. So we are very concerned about who are our issuers and who are our acquirers, how well are they running their businesses. Are they taking excessive risks? So risk becomes one of the most important factors in just about every aspect of the business.

(The main scheme rules relating to the allocation and management of risk are outlined below.)

Visa explains that third party processors have arisen to take on some or all of the processing

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156 In answer to Mr Bodibe, Mr Munson confirmed that merchants would ordinarily have a choice whether to invest in their own equipment or rent it from the acquiring bank. (Id., p 78.)
responsibilities on behalf of their clients – whether these clients be retailers or acquiring banks. “A number of these Third Party Processors connect directly to Visa and MasterCard on behalf of their customers.” Visa allows outsourcing by its members [licensees] of certain card payment services, albeit under careful scheme rules.\textsuperscript{157} The acquiring bank must nominate the processor and remains responsible to the scheme for adherence to standards and good business practice.\textsuperscript{158}

As has been explained above, three-party schemes like American Express and Diners Club do their own card issuing and merchant acquiring. However, to extend its operations, a three-party scheme may give acquiring and issuing licenses to institutions to carry out these functions on its behalf. In the case of American Express, this is described as its Global Network Services (GNS) business model.\textsuperscript{159} In South Africa this model prevails, with Nedbank functioning as the sole licensee for American Express.\textsuperscript{160}

Essentially Nedbank is licensed by American Express to issue and acquire Amex cards in the South African market. We are the only entity that is licensed, so we commonly call that a closed loop system. We are the single issuer – you won’t find an American Express card which does not say Nedbank on the back – and we are the single acquirer. So for a merchant to accept American Express cards, they have to sign a merchant agreement with Nedbank.\textsuperscript{161}

Acceptance of American Express cards by a merchant is a simple matter where Nedbank is also the acquirer for the merchant’s acceptance of MasterCard and Visa cards: the same Nedbank infrastructure is readily available. Where an American Express card is used at a merchant whose acquiring service for accepting MasterCard and/or Visa cards is from another bank, that other bank plays a “courier role” by routing the American Express transaction to Nedbank.\textsuperscript{162} That other bank is allowing its infrastructure to be used for the acceptance of American Express cards.

Such an arrangement depends on a bilateral agreement between Nedbank and the other bank, before a merchant relying on that other bank’s infrastructure can accept American Express cards. However, the actual acquiring relationship where the merchant accepts American Express cards is not with that other bank, but with American Express through its sole licensee, Nedbank. Thus it remains a closed system in this situation as well.\textsuperscript{163}

\textsuperscript{157} Visa, June 2007, Second Submission, document E.
\textsuperscript{158} Id., document G.
\textsuperscript{159} American Express, October 2006, Comments in response to the South African Competition Commission Enquiry into Banking, p 3.
\textsuperscript{160} Nedbank describes itself as the appointed ‘Independent Operator’ of the American Express Card Service (Nedbank, March 2007, Second Submission, Issuing, p 13). On behalf of the scheme, Nedbank negotiates, sets and receives all fees applicable to end users on these cards. (Id.) In turn, the payments to American Express are negotiated bilaterally between Nedbank and the scheme.
\textsuperscript{161} Transcript 19 April 2007, p 13 (Mr Shuter).
\textsuperscript{162} Id., p 14.
\textsuperscript{163} Id., pp 14-16. This is confirmed by American Express in its Submission, October 2006, p 2: “Amex’s merchant agreements are bilateral agreements between the merchant and Amex as acquirer.”

Banking Enquiry Report to the Competition Commissioner Contains confidential information
Diners Club is likewise a closed system. At the time when submissions were made to the Enquiry, Diners Club South Africa (Pty) Limited was a wholly owned subsidiary of Standard Bank (SBSA), operating under a franchise from Diners Club International.\(^{164}\) Diners Club South Africa is the issuer and acquirer of Diners Club cards in South Africa, negotiates merchant service charges with merchants and decides on the level and incidence of fees on Diners Club cards.\(^{165}\) Diners Club transactions are acquired using, for a service fee, the merchant acquiring infrastructure of banks acquiring under the four-party schemes.\(^{166}\)

### 6.3.2 Scheme rules and practices in the allocation and management of risk

The four-party card schemes allocate liability for the costs of fraud and other risks in the system by means of various rules and practices. Visa states:

> How the liability is distributed between the cardholder and merchant, by the issuer and the acquirer is a matter of local law, custom and practice, and the commercial bargaining position of the merchant and cardholder, and set out in the cardholder agreement and the merchant contract.\(^{167}\)

However, in general, “the liability [loss] lies where it falls.”\(^{168}\)

Once [the card transaction has been] approved, the cardholder receives the goods and the merchant receives a ‘payment guarantee’ from the acquiring bank.\(^{169}\)

In providing such a guarantee, the acquiring bank is supported by a “promise of the issuing bank to honour payments made by the acquiring bank.”\(^{170}\)

Visa and MasterCard both underwrite these guarantees, and take initial responsibility to cover any losses that a member institution may incur because of another member institution’s default.\(^{171}\)

In most instances the issuing banks are liable for fraudulent transactions in the system.\(^{172}\)

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\(^{164}\) SBSA, April 2007, Second Submission, , Acquiring, p 4; Issuing, Part I, p 3. SBSA bought a controlling interest in Diners Club SA in 1966 and acquired the rest of the shares in 1987. (Id., Issuing, p 11.) As franchisee, Diners Club SA pays Diners Club International a royalty fee of \(0.2\%\) of turnover. (Id., Issuing, p 12.)

\(^{165}\) Id., Issuing p 12 and Acquiring p 29. For Diners Club fees to cardholders in South Africa, see Id., Annexure 4A. Diners Club itself did not make a submission to the Enquiry.


\(^{167}\) Visa, June 2007, Second Submission, Annexure H, p 1

\(^{168}\) Id.

\(^{169}\) Id., Annexure S, p 6.

\(^{170}\) Id.

\(^{171}\) Transcript 18 April 2007, pp 73-81 (MasterCard) and Visa, June 2007, Second Submission, Annexure E, p 2.

and transactions for which the cardholder ultimately defaults. The payment guarantee, in most instances, enters into the cost calculations of the interchange fee that is paid over from the acquiring bank to the issuing bank.

However, the merchant – and likewise the merchant’s acquiring bank – will be vulnerable to “chargebacks”. A chargeback, as defined by Visa, is “the ability of the Issuing bank to ‘charge back’ a transaction to the Acquirer unpaid.” The acquirer will usually then have recourse against the merchant. Issuing banks are only entitled to make chargebacks to acquirers, and acquirers to merchants, for valid reasons which are described in the operating rules and regulations of the schemes.

Mr Herzfeld of the South African Retailers Payments Issues Forum (SARPIF), while supporting the right of cardholders to dispute transactions during the chargeback period, pointed out that this leaves the “payment guarantee” to the merchant far less than “unconditional”. In his experience, where a chargeback is made, the merchant is ultimately left to resolve the dispute with the cardholder.

Absa explains that:

For point of sale transactions made by either credit cards or debit cards, the customer is liable for lost and stolen cards up to the point of reporting a card lost or stolen. …

After the customer reported the card lost or stolen, the liability passes on to the issuing bank. This card is then loaded onto the “hot card” file which updates to each of the point of sale terminals. This takes two days to be effective and the card remains on the hot card file for 60 days. The verification of the hot card file then happens automatically by the terminal. The merchant will then have a message that the card is lost or stolen and what the appropriate protocol to follow at this stage is. If the merchant follows the appropriate procedure then the liability remains with the issuing bank. If the merchant does not follow the procedure then the merchant bears the risk of potential loss.

For point of sale purchases made by credit cards, suspected fraudulent transactions are first charged back to the merchant who then has to prove that the transaction is authentic by submitting the point of sale slip signed by the customer. The merchant may then submit the transaction for settlement whereupon the liability will move to the issuer. If fraud has occurred then the issuer is liable for this; if it has not occurred (e.g. where the cardholder forgot about the transaction) then the transaction would be paid by the cardholder. Where it

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Visa, June 2007, Second Submission, Annexure H, p 1. Chargebacks are an integral part of the system, provided for in the scheme’s operating regulations. There is a range of possible reasons for chargebacks, but typical instances are where the cardholder asserts that he or she did not authorise or participate in the transaction, or where a processing error has occurred. Also, as Visa puts it, “The cardholder by using their Visa card is offered protection where a merchant fails to deliver goods and services in accordance with the cardholder’s specification or contract. If the cardholder used cash, the cardholder would have to sue the merchant directly; instead, they raise a concern with the issuer who deals with the Acquirer, who looks to resolve this situation with the merchant.” Where there is a dispute between the issuer and acquirer, the scheme will arbitrate. (See Visa, id., document H, read with Attachment 6.)

See e.g. Visa, id., Attachment 6.


Absa’s account deals further with exceptional cases, which we omit in quoting this summary of the general rules.

Since debit card transactions are on-line PIN based transactions, this circumstance does not arise for debit cards.
can be shown that the merchant was negligent, (for example, if the signature is vastly different to that on the card), then the acquiring bank would be liable and would pass the charge through to the merchant.

In the mail order, telephone order and internet environments (where the card is not physically presented to the merchant) if the customer signs an affidavit stating that he or she did not make the transaction, it will be charged back to the acquiring bank which in turn will charge it back to the merchant. However, if special security requirements of MasterCard and Visa in respect of such transactions have been met, the issuing bank would be held liable (and so would have to recover the payment from the cardholder). In counterfeit fraud (such as card “skimming”) and application fraud (identity theft), unless negligence on the cardholder’s behalf can be proven, the issuing bank is also responsible in respect of all types of cards.

With the introduction of the EMV card, a “liability shift” has occurred. This means that the acquiring side becomes liable for fraudulent EMV card transactions if they take place through terminals that are not EMV compliant. At the same time, the improved technology should significantly reduce the risks of fraud.

6.3.3 Flow of payments in three-party and four-party schemes

The diagram below indicates the flow of payments involved in three-party systems. In this instance, as we have seen, a single organisation issues the cards and acquires the transactions resulting from use of its cards. The card scheme (i.e., the scheme owner) itself is the only true intermediary between cardholder and merchant. The only fees payable by

179 “3DSecure” and “Verified by Visa”.
180 Absa, id, p 12.
181 EMV stands for “Europay MasterCard and Visa”, which jointly introduced the innovation. EMV chip cards, now being actively promoted in South Africa, entail improved security for card transactions because they are harder to counterfeit, can support offline PIN verification, can support biometric verification, and make use of sophisticated mutual authentication between the terminal, the card and the authoriser. (Visa, June 2007, Second Submission, document I.) For the first time, the issuer can set various risk parameters that can be personalised on the card. New market segments can be penetrated, as more information can be stored on chip cards. Visa has introduced a “chip incentive rate” in respect of the interchange on EMV card transactions. In fact there is a combination of incentive and disincentive applied to acquirers (and thus ultimately to merchants). It is not necessary to set out all the details of it here. Essentially, where a magnetic-stripe card is presented by the cardholder, the interchange rate normally applicable to such cards will be reduced if the device used by the merchant is a chip data device. The lower rate will also apply if a chip card is presented and such a device is used – and a still lower rate if the device has PIN capability. Conversely, a rate of interchange higher than normal is charged if a chip card is presented but a magnetic-stripe terminal is used. This obviously encourages the roll-out of such devices. As chip cards become the norm, the incentive rate will fall away. (Id.) When asked for more information concerning the application of the incentive rate in South Africa, Visa stated that “There is no incentive interchange rate (e.g. CHIP) applied to South African domestic transactions” (Visa, March 2008, Banking Enquiry – Request for Information). Confidential: MasterCard

182 SARPIF stated: “ ‘Liability shift’ date for EMV enabled transactions in South Africa was 1 January 2005 – to date no South African bank has issued any cards. However, merchants are expected to be EMV compliant and certified from that date. The shift in liability is from the issuing bank to the acquiring bank who will seek to pass the risk on to terminal-owning merchants.” (Exhibit R, slide 11. See also Transcript 13 November 2006, pp 34-35.) Despite the existence and evident rationality of the particular scheme rules, disproportionate power relations between banks and their customers must tend to leave both merchants and cardholders vulnerable in actual disputes with their acquirers and issuers respectively as to where any loss should ultimately fall.
parties to a payment transaction under this model are the merchant service charge (MSC) paid by the merchant and an annual fee and/or a per transaction fee charged, along with the price of the purchase, to the cardholder’s account. The scheme withholds or deducts the merchant service charge when remitting the price of the cardholder’s purchase to the merchant. Because the issuing and acquiring functions are performed by the same institution – i.e., the scheme owner, although it may perform these functions with the assistance of licensees – there is no explicit interchange fee as in the four-party schemes. As explained above, there is nevertheless an implicit or notional flow of interchange (or “intrachange”) within the scheme owner, in the sense that revenue raised on the acquiring side would be applied by the scheme owner to support the issuing side of its business. Such a notional flow, being purely internal, does not appear in the diagram below.

Figure 3 Flow of payments in a three-party system

In the open or four-party schemes, where issuing and acquiring is done by separate institutions (in South Africa, banks), interchange flows from the acquirer to the issuer in off-us transactions. When a cardholder uses a card of one of these schemes to make a purchase at a merchant, the bank that provided the card (the issuing bank), debits the cardholder’s account with the price of the goods or services purchased. The issuer then pays the merchant’s bank (the acquiring bank) the retail price, less the interchange fee applicable to the specific card used. Finally, the acquiring bank pays the merchant the retail price less the merchant service charge negotiated with that merchant.  

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183 Visa, June 2007, Second Submission, document C, provides a detailed description of what occurs in a typical payment card transaction within its scheme. (Essentially similar processes occur within the MasterCard scheme: see http://www.mastercard.com/za/merchant/en/how_works/index.html.) “The transaction flow is the same for debit cards, credit cards or charge cards.” The cardholder presents the card to the merchant as payment. The merchant is obliged to check that the card is valid. If the transaction is below a pre-established “floor limit”, the merchant must check to see if the issuer has listed the account number in the current scheme bulletin (the “Card Recovery Bulletin” in Visa’s case). If the transaction amount is over the floor limit, authorisation is required. The card is swiped through a point of sale terminal, or in the case of a chip card its chip is read. The data in the magnetic stripe or the chip instructs the terminal. The authorisation request is directed to the issuer, via the designated switch. In South Africa this is usually Bankserv, but could be one of the global switching centres of the card scheme. The issuer either responds directly, or authorises the switch to respond on its behalf. If the transaction is approved, the transaction receipt is completed. The cardholder is billed (the cardholder’s account is debited) by the issuer, whom the cardholder pays. The merchant is paid by the acquirer, either immediately or following settlement between the issuer and the acquirer. In international transactions, clearing and settlement would take place via the card scheme’s own systems involving accounts with overseas banks.
The fee charged by the issuing bank directly to the cardholder varies according to the applicable card used in the transaction.

**Figure 4 Flow of payments in a four-party system**

Apart from fees paid by participating banks or other institutions to the scheme owner, the significant fees in a four-party model are the interchange fee (a), the fees payable by the cardholder (f) and the merchant service charge (MSC).\(^{184}\) (There is also a switching fee payable by the issuing bank to the designated switch, which facilitates authorisation of the transaction. In most cases in South Africa, Bankserv will act as the switch and will charge a small fee of around 10 cents per transaction – where large volumes are involved.) The interchange fee is typically set on a multilateral basis for all the members participating in the card scheme,\(^{185}\) whilst the merchant service charge gets set by each individual acquiring bank in a bilateral negotiation between the acquiring bank and each of its merchants. Even though the level of the merchant service charge differs significantly between merchants and acquiring banks, the flow of payments discussed above applies to both credit card and debit card transactions. The only major difference between debit card and credit card transactions is that the per transaction fee (f) currently only applies when a debit card is used. In the case of a credit card the cardholder pays an annual fee but no per transaction fee.

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\(^{184}\) The merchant service charge is sometimes referred to as a “commission” or as a “merchant discount”. For reasons discussed later in this chapter we consider “discounting” to be an incorrect way of analysing payment card transactions.

\(^{185}\) We deal further below with how interchange is set.
6.3.4 Merchants accepting cards

According to information submitted to the Enquiry, more than 130,000 merchants\textsuperscript{186} in South Africa are contracted to the big four banks to accept payment cards.

<table>
<thead>
<tr>
<th>Table 3 Number of merchants acquired by the big four banks in South Africa</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ABSA</strong></td>
</tr>
<tr>
<td><strong>Nedbank</strong></td>
</tr>
<tr>
<td><strong>Standard Bank</strong></td>
</tr>
<tr>
<td><strong>FNB</strong></td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
</tbody>
</table>

**Source:** Banks submissions, March and April 2007, Second submission, Acquiring

Citing figures from Euromonitor International for the 4\textsuperscript{th} quarter of 2006, MasterCard indicated that there had been a 25 per cent growth in the number of point of sale (POS) terminals in South Africa over the preceding two-year period.\textsuperscript{187} FNB’s annual growth in POS devices has been 36 per cent compound over the last four years.\textsuperscript{188}

**Merchant service charges**

From the data provided to the Enquiry, the merchant service charge for credit card transactions applied by the big four banks to transactions involving the Visa or MasterCard schemes ranges between 1.8 per cent and 7 per cent of the transaction value. The range for debit card transactions is between 0.6 per cent and 6.5 per cent.\textsuperscript{189} The merchant service charge or so-called “discount rate” for American Express transactions range between \[\square\] per cent and \[\square\] per cent.\textsuperscript{190} For Diners Club, the rates range between \[\square\] per cent and \[\square\] per cent.\textsuperscript{191} The average MSC for American Express cards is, however, consistently higher than on MasterCard and Visa cards.\textsuperscript{192} We have not been provided with comparable data for

\textsuperscript{186} This category refers, more precisely, to separate merchant locations. Large retailers, for example, will have a number of such locations. It is not clear to what extent multiple acquiring relationships may have led to some double counting in this figure. MasterCard reported that over 124,000 merchant locations in South Africa accept its cards. (MasterCard, October 2007, First Submission, p 14.) Visa refers to 127,000 merchants accepting its cards – by which merchant locations are presumably intended. (Visa, June 2007, Second Submission, document B (first part) p 7.) American Express has about \[\square\] merchants in South Africa that have contracted to accept its cards. (American Express, October 2006, p 7. We do not have comparable figures for Diners Club.

\textsuperscript{187} MasterCard Worldwide. “South Africa: The Card Payments Landscape”, Exhibit MM slide 12. (ATM’s had increased 15% over the same period.)

\textsuperscript{188} Transcript 19 April 2007, p 113 (FNB).

\textsuperscript{189} Transcript 17 April 2007, p 28.

\textsuperscript{190} Nedbank, March, 2008, Supplementary submission to the Banking Enquiry, p 7. The MSC is at an average of \[\square\] per cent for American Express (Nedbank, March 2007, Second Submission, Questions on Issuing, p 13).

\textsuperscript{191} SBSA, April 2007, Second Submission, Acquiring, p 29.

\textsuperscript{192} Cf Nedbank, August 2007, Questions from hearings and Technical Team, p 4.
Diner’s Club, but we suspect the same will apply.

The variation in the merchant service charge on VISA and MasterCard transactions, within and between the big four banks, is depicted in the table below.

<table>
<thead>
<tr>
<th>Table 4 Merchant service charges (MSC)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
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<tr>
<td></td>
</tr>
<tr>
<td>Credit Card</td>
</tr>
<tr>
<td>Debit Card</td>
</tr>
<tr>
<td>Hybrid Card</td>
</tr>
</tbody>
</table>

Source: Banks submissions, 2007 and 2008

Revision of the merchant service charge commonly occurs on an annual basis. Typically, banks categorise merchants according to turnover size and apply differentiated rates of merchant service charges accordingly. Several banks point out that they review the volumes and applicable fees of a newly signed up merchant after 3-6 months, and adjust the merchant service charge accordingly.

<table>
<thead>
<tr>
<th>Table 5 Merchant classification</th>
</tr>
</thead>
<tbody>
<tr>
<td>Classification based on turnover</td>
</tr>
<tr>
<td>ABSA</td>
</tr>
<tr>
<td>Nedbank</td>
</tr>
<tr>
<td>Standard Bank</td>
</tr>
<tr>
<td>FNB</td>
</tr>
</tbody>
</table>

Source: Banks submissions, March and April 2007, Second submission, Acquiring

However, various other factors also affect the particular level of the charge. Nedbank gave the following account of the factors which it takes into consideration when negotiating a merchant service charge:

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See e.g. ABSA, March 2007, Second Submission, Acquiring, p 11.
MR GERICKE: ... [W]hat we would be using in determining the fee level and those pricing ranges would typically be ... the volume of transactions per number, the value of those transactions, the average transaction value, very importantly the merchant category. Merchant category has a direct bearing on costs like fraud for instance. We are also aware of what our competitors are doing in this market, it is a very aggressive market and as Nedbank we win and lose business daily, so we do take close heed of what our competitors are doing. We then also evaluate the depth of the overall banking relationship with Nedbank – where we have clients who are multiple users of other products and services, we bring that to bear on the price. We look at the complexity of integrating that merchant into our system: some of them have multiple lanes in their stores, they need multiple devices or in fact they have their own infrastructure which we need to then electronically plumb into our backing systems. And then, also very importantly, we look at the value added services having done a needs analysis. What I mean by that [is], we offer things like cash-back to our retailers [i.e. the ability of retailers to provide customers with cash back at the point of sale]; we offer airtime top-ups; and depending on the needs analysis and going through these factors at a high level we then determine a range and we would then negotiate the final fee with the merchant within that range, generally.

MR BODIBE: So the application of this principle means that you will charge differently depending on the size of the merchant and so forth...?

MR GERICKE: That is correct.  

Nedbank would not, as a general rule, price the rental for a terminal into the merchant’s service charge; it would be distinct and separate. This is evidently the norm.  

Interchange sets a floor for merchant service charges

It has been pointed out that, despite the uniformity of interchange, merchant service charges vary considerably under pressure of competition between acquirers and could theoretically be below the level of interchange.

Taken in isolation, however, it would not be possible for an acquirer’s merchant service charge to be less than the cost to it of paying interchange to issuers, because then the acquirer would be out of pocket, as Mr Volker of Absa acknowledged. Mr Munson of MasterCard put the same point this way: “banks have shareholders, banks are regulated, banks must cover their costs, banks must engage in profitable activities, banks cannot take

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195 Transcript 19 April 2007, pp 33-34.
196 Id., pp 62-63. Rentals are shown “as a separate line item” and are not included in the figures for merchants’ service charges. Id.
197 See further below.
199 See e.g. Transcript 17 April, pp 156-157 (Mr Sweeny and Mr Stillman).
200 Transcript 17 April, p 151.
Financial risks.” Interchange “is one of [the acquirer’s] costs, and it will have to recover that cost from its customer which is the merchant. If the acquirer wishes to run its business profitably, it will have to recover all of its costs.” As Mr Shuter of Nedbank stated: “It is indisputable that interchange is a significant input cost in the merchant service [charge] in the four-party model”.

According to the acquiring figures provided to the Enquiry by Absa, Standard Bank, Nedbank and FNB, per cent of the total merchant service charge goes towards the interchange fee paid away.

Visa says, referring to the situation internationally,

Acquirers use a wide range of methodologies to ensure their total MDR [merchant discount rate i.e. merchant service charge] revenues sufficiently cover Interchange Fees and other costs to build a positive business case. In certain circumstances, Acquirers have used so-called ‘Interchange Plus’ contracts which involves pricing to the merchant based on Visa Interchange rates plus additional ‘processing’ fees as appropriate. Some Acquirers may bundle their Visa payment card acceptance business with other banking services for their merchant customers, and offer pricing options reflecting the suite of services offered.

As Mr Volker also argued, “the merchant is not just a customer of the bank in terms of the acquiring relationship but in terms of a broader banking relationship which includes cash handling, foreign exchange dealings, capital market lending, etc., so it could be that in terms of the broader relationship there is some kind of special deal that is made that could affect the acquiring business” so as to make the merchant’s service charge lower than the rate of interchange on card transactions.

The potential for this might also be greater in the case of banks whose issuing base is large enough relative to their acquiring base to ensure that minimal net interchange is actually paid away, or that are net receivers of interchange. However, the evidence showed that it would be highly exceptional, if indeed it ever occurs, for a merchant service charge in South Africa to be lower than the rate of interchange applicable to the type of transaction concerned.

201 Transcript 18 April 2007, p 14
202 Id., pp 84-85.
203 Transcript 19 April 2007, p 46.
205 Absa (Mr Volker), Transcript 17 April, p 151. See also Visa, June 2007, Second Submission, document J.
206 The merchant service charge stays the same regardless of whether the transaction is on-us or off-us: Transcript 17 April 2007, p 33.
207 Note that, in Table 4 above, the lowest rates of merchant service charge reported are in all instances higher than the
Realistically, therefore, the interchange fee generally sets a floor for the merchant service charge.\textsuperscript{208} Being a fixed fee charged to acquirers, the \textit{interchange component} in the merchant service charge is sheltered from competition on the acquiring side.\textsuperscript{208} It is no answer to this to say that the acquiring market is fiercely competitive (see below) – because that competition, whether mild or fierce, is going on ultimately above the interchange floor.\textsuperscript{210}

Fundamentally, if the interchange charge were not passed through or substantially passed through to the merchant, it could not be effective in its declared purpose of achieving a balance between merchant demand and cardholder demand. As Visa expressed it,\textsuperscript{211} interchange is a coordination mechanism. “It seeks to achieve indirectly, by influencing behaviour, what is achieved directly in a three-party system by its proprietor.”\textsuperscript{212} This vital function of interchange in four-party systems is discussed further in this chapter in the section on the necessity of interchange (Section 6.6).

\subsection*{6.3.5 Interchange enters into consumer prices}

By means of the merchant service charge, interchange further passes through into the prices which merchants charge to consumers.

Mr Bishop, appearing as part of FNB’s team, tried to persuade us to the contrary,\textsuperscript{213} but we found his argument difficult to follow. Varying market conditions and varying competitive circumstances of merchants will obviously affect the extent to which the costs incurred by this one or that can be recovered through the prices individually charged to consumers. But

\begin{quote}
 applicable rate of interchange. FNB indicated that it does not have any agreements where the merchant service charge for a transaction is lower than the applicable interchange fee. (FNB, March 2007, Second Submission, Section 4, p 13.)

\textsuperscript{208} Transcript 17 April 2007, pp 49-50.

\textsuperscript{209} Transcript 17 April 2007, p 29.

\textsuperscript{210} Cf the finding of the European Commission in relation to MasterCard’s multilateral interchange fee (MIF): “A MIF effectively determines a floor under the merchant service charge and merchants are unable to negotiate a price below it. This can considerably inflate the costs of payment card usage at merchant outlets to the detriment of merchants and their customers.” MEMO/07/590, Brussels, 19th December 2007, p 2.

\textsuperscript{211} Visa, June 2007, Second Submission, document J

\textsuperscript{212} In the academic literature, likewise, the stated purpose of the interchange is to promote usage and acceptance of the payment stream by indirectly influencing the prices paid by downstream users. See e.g. Rochet, J. and Tirole, J., 2001, \textit{The economic analysis of the interchange fee in payment card systems}.

\textsuperscript{213} Transcript 19 April 2007, pp 141-145.
\end{quote}
costs unavoidably incurred by all on a sustained basis higher up in a supply chain must ultimately pass on down.

The four-party schemes and their participating institutions rely in general – notwithstanding price competition between acquirers – on interchange passing through to merchants as a component of merchant service charges. This serves as a mechanism capable of regulating merchant demand for cards, and it would seem entirely arbitrary to deny in general a similar pass-through further down (from merchants to customers.)

Indeed, it was accepted during the hearings, when the costs to the merchant of accepting various cards were compared with the costs to the merchant of accepting and handling cash, that both costs would find their way in general into consumer prices. This was the premise of the debate on whether cash customers might be subsidising card users, or debit card users subsidising those using credit cards.

Inasmuch as the “intrachange” of the three-party schemes is reflected in their merchant service charges, consumer prices are likewise ultimately affected. To the extent that a relationship emerges between the level of the merchant services charges applied by the four-party schemes and the somewhat higher merchant service charges applied as a premium by the three-party schemes, if there is an effective floor set to merchant service charges by four-party interchange then that serves as a support also for the higher three-party charges.

6.3.6 Competition among acquirers in the four-party schemes

A number of those giving evidence to the Enquiry were at pains to emphasise that competition between the acquiring banks for contracts with merchants is very intense. Nedbank’s affirmation of this has been quoted above.

Mr Jordaan of FNB argued:

First of all it is a very competitive market out there. It is not that there is one party that has exclusivity over a merchant. If we go to any of our customers and they feel that what we are charging is too high, they are very quick to go to our competitors…

Ms de Beer spoke of acquirers every day “trying to eat other acquirers’ breakfast.”

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214 As Mr Cope of Pick n Pay explained with reference to the merchant service charge: “It is part of our normal cost structure, so to the extent that we have payroll operations, occupancy and administrative costs, it is part of that cost. The fact that we do at the end of each year, make a profit... [implies that] it is recovered in prices.” Transcript, 13 November 2006, p 8.

215 As to this issue, see further below.

216 Transcript 19 April 2007, p 124.

217 Id., p 130.
Absa likewise maintained that the acquiring market is “hugely competitive with massive competition between the banks to get the best deals”, with merchants who are highly aware of the bargains they can variously extract from the banks, and with deals renegotiated annually.\textsuperscript{218}

When dealing with the ability of merchants to switch acquirer, Ms de Beer of FNB said:

\begin{quote}
In cases where the equipment is not owned by the retailer, obviously the retailer would need to take a commercial decision as to whether he wants to fund it off his own balance sheet, or whether he wishes to rent those services and the equipment through the services of another acquirer. So, switching could be very simple. For smaller merchants, it is simply a matter of signing up with another acquirer and for that acquirer to install another [point of sale] device at that customer’s outlet.\textsuperscript{219}
\end{quote}

Also, contracts with merchants tend to be of a short-term nature, normally twelve months, but typically with a 30-day notice period. In a few cases there would be a longer notice period.\textsuperscript{220}

It is evidently possible for merchants to switch their acquirer without having to switch their main banking relationship at the same time.\textsuperscript{221}

We have referred above to the level of interchange as a floor for the price competition between acquiring banks for merchant contracts. It was stated in evidence by Absa that, when interchange was lowered in 2003, this was reflected in a fall in merchants’ service charges, even though merchants were not necessarily aware of what interchange is or of the level of it.\textsuperscript{222}

Ms de Beer of FNB said that, when interchange came down in 2003, “the full benefit was passed on to the majority of the customers [i.e. merchants] that contributed to the volume.”\textsuperscript{223} According to Mr Jordaan, the extent of competition on the acquiring side compelled this.\textsuperscript{224}

\begin{thebibliography}{9}
\bibitem{218} Transcript 17 April, p 156 (Mr Sweeny).
\bibitem{219} Transcript 19 April, p 127. Standard Bank reported that 14 of its large merchants own their own POS devices, while there are others which rent POS devices from third parties. (SBSA, April 2007, Second Submission, Acquiring, p 19.) Nevertheless, Standard Bank owns about \underline{36,000} out of the roughly \underline{38,000} devices from which it acquires. (\textit{Id.}, p 20.)
\bibitem{220} \textit{Id.}, pp 128-129. See also Nedbank, March 2007, Second Submission, Acquiring, p 17. Other banks provided similar answers to the acquiring questionnaire.
\bibitem{221} \textit{Id.}, p 126.
\bibitem{222} See Transcript, 17 April 2007, pp 157-159.
\bibitem{223} Transcript 19 April 2007, p 178.
\bibitem{224} \textit{Id.}, p 188.
\bibitem{225} FNB, June 2007, Impact of interchange reduction on average merchant fees.
\end{thebibliography}
Nedbank also provided similar evidence in August 2007.  

Before attributing the reduction in the merchant service charges simply to competition, one must bear in mind that the banks themselves had just agreed to bring interchange down so that merchant service charges could be deliberately lowered and (especially debit) card usage generally increased. The 2003 reductions are therefore not proof per se that when acquirers’ costs come down in South Africa the benefit is passed through downstream.

6.3.7 Eligibility for participation as acquirers in the four-party schemes

On paper, any institution that complies with the MasterCard and Visa rules and requirements will qualify to be a member according to their acceptance criteria and can subsequently obtain access to this open payment scheme as an issuer and/or acquirer.

226 Nedbank, August 2007, Supplementary Submission – Questions from hearings and Technical Team.


228 “Financial transactions” refer to the making of commercial or consumer loans, the extension of credit, the effecting of transactions with payment service cards, the issuance of travellers cheques or taking of consumer or commercial deposits.

229 Id.

230 Id.
In the Visa scheme, an organisation must meet Visa International's eligibility criteria, as set out in its Bylaws. Section 2.01 of the Bylaws requires essentially that a participant be "[o]rganized under the commercial banking laws or their equivalent of any country or subdivision thereof, and authorized to accept demand deposits." However, an organisation "whose eligibility is required to prevent the corporation, any of its members ... from being in violation of applicable law" will also be eligible.

According to Visa,

> [o]ne of the main reasons for limiting membership to financial institutions [in fact, we would add, authorised deposit-takers] is that members have considerable financial exposure to each other and benefit from the fact that every member is a financial institution under the laws of its own country, and subject to continuing scrutiny of the local banking regulator. Visa guarantees interbank payments between members, Visa takes initial responsibility to cover any losses, which may be incurred by banks to ensure and guarantee the reliability and security of the system to merchants and cardholders.

The national and international regulatory framework applicable to banks (including applicable measures against money-laundering) mitigates risk within the four-party system. Thus "banks are logical and relatively safe business partners for Visa."

The licensing structure for participating institutions differs as between Visa and MasterCard. Visa issues separate licenses for issuing and acquiring, but includes both credit and debit cards in the same licence; MasterCard has separate licences for credit card and debit card participation, but combines issuing and acquiring in respect of that card type into one licence in each case.

In South Africa, although all registered banks clearly qualify as eligible for membership under the rules of both the Visa and MasterCard schemes, smaller banks have been unable to enter, or have faced considerable difficulty entering, the acquiring market. As stated above, there have (until recently) been only four acquirers of credit and debit card transactions (the

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231 Id., p F-1.
232 See Visa, June 2007, Second Submission, document E. We have not been advised of any change in these requirements following Visa's subsequent international re-organisation.
233 Paragraph (a). Other paragraphs extend eligibility to organisations controlled by such an organisation, and to associations of such organisations and those controlled by them.
234 Paragraph (d). Paragraph (e) further extends eligibility to an organisation "(i) whose membership the Board of Directors deems necessary to penetrate a given country in which no Principal [member] has jurisdiction, (ii) that the Principals with jurisdiction in a given country unanimously agree should be made eligible in such country". Visa does have "a very few member[s] who are not technically commercial banking institutions and/or do not accept demand deposits..." (Visa, June 2007, Second Submission, Annexure E, p 2.)
235 Id.
236 Id. The care with which applicants for membership are evaluated for risk is evident from, for example, Attachment 2 to this document.
big four banks). Two smaller banks, Capitec and Mercantile, have joined only recently.

Thus it is primarily the big four banks that have been able to benefit from the growth in the acquiring market which Mr Jordaan of FNB describes as "incredibly rapid", and which (along with the growth in issuing) has been a concomitant of South Africa's economic growth.

Despite the indications of competitiveness in the acquiring market for the four-party schemes, the competition remains oligopolistic – and it is thus open to doubt to what extent the unit cost savings which come with higher transaction volumes are being or will be passed down to merchants in the form of generally lower merchant service charges, and ultimately to consumers in the form of lower retail prices.

To a significant extent, the barrier to entry by smaller firms is of a structural character, and will not readily be resolved by remedial measures. Mr Munson of MasterCard pointed this out:

[T]he nature of the acquiring business is such that it is a business that is based upon scale efficiency. It is much more of a scale business than an issuing business, and therefore what you will find in every country with strong electronic payments is that the number of issuers in four-party systems exceeds by several times the number of acquirers. This is true in the United Kingdom, this is true in the United States, this is true anywhere….

In the UK there are only four large acquirers; in Mexico, for example, there are only two; and there are countries in Europe with debit systems in particular where there is only one acquirer.

While giving due weight to this analysis, we do consider that additional and unnecessary barriers exist which further add to the difficulties of entry by new players.

One of these barriers is caused by deficiencies in the current regulatory framework applicable to the payments system in South Africa. This aspect is addressed fully in the chapter of this report dealing with Access to the Payment System, and so will only be referred to briefly in the present chapter. Other barriers, however, are caused by what we consider to be unjustifiable restrictions in the rules applied by the Visa and MasterCard

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239 Mercantile became an acquirer for MasterCard in November 2007, and, according to the latest information provided to the Enquiry, is still awaiting acceptance of its application to Visa.
240 Transcript 19 April 2007, p 112.
241 It was persuasively presented as one of the benefits of payment cards over cash, that because most costs are fixed costs and relatively few are variable costs in the case of card systems, greater transaction volumes must translate into lower average costs per transaction. Significantly lower average transaction costs should result in significantly lower merchant service charges.
243 ld., p 11.
244 See also Mercantile Bank, March 2007, Second Submission, Issuing and Acquiring, p 14: “The cost of infrastructure requires economies of scale hence significant volume is required.”
schemes themselves. These aspects are clearly distinct.

**The current restriction of acquiring to banks**

At the hearing on 19 April 2007, when asked about the qualifications and requirements to become an acquirer for each of the (four-party) schemes and card transaction types, Mr Jordaan said it was FNB’s understanding that the acquirers must be registered as banks.\(^{245}\) It had been thought, until the questioning of MasterCard on the previous day, that this restriction derived from card scheme rules. It had now been clarified that, in terms of MasterCard scheme rules, the requirement was that an acquirer had to be a financial institution subject to regulatory supervision.\(^{246}\) In South Africa, regulatory supervision has not been developed (as it has in other countries) so as to enable non-bank institutions to enter this market. Hence acquiring is currently restricted to banks.

During the hearing on 18 April 2007, MasterCard had confirmed that it does not restrict issuing or acquiring to banks. The chairperson addressed the following questions to Mr Munson and received the following answers:

**CHAIRPERSON:** Whilst we are talking about these acquiring models, you, in your presentation, made reference to the fact that you do not prevent any banks from acquiring. Can you just expand on that. You do not have any conditions for banks who qualify to acquire?

**MR MUNSON:** Well, first of all, take away the term banks. We do not limit our business to banks.

**CHAIRPERSON:** That was going to be my next question. But carry on.

**MR MUNSON:** Let me step back and answer your question a little more broadly. If anybody, any institution, be it a financial institution, a bank, an insurance company, any kind of institution, if they want to participate as an issuer or as an acquirer in the MasterCard system, they have to qualify for membership, for participation. Okay. And generally speaking the requirements for participation are the following:

They must be engaged in the business, the payments business, and number two, they must be a regulated and supervised institution. By that we mean there must be some government regulator like a banking regulator, that is monitoring their business and enforcing sound fiscal practices. Now, why is that? Well, the answer is because ... MasterCard guarantees the settlement of its issuers and acquirers to each other. So, in other words, if one of our participants, one of our customers, goes out of business, and there is a huge amount of money owed to other participants in the system, we are on the hook for that. That is our responsibility. So, we want to make sure that whoever participates in our business, is not causing excessive additional risk to our system and to us. So the general requirement is that there would be regulation and supervision. It is a general requirement. Exceptions can be made. We have a group within MasterCard that actually will go out if there is a request to join the system and measure the specific risk of a particular entrant, and sometimes permission is granted to participate in the system, even though you are not supervised. Though very often in that case, the participant will be required to essentially post a guarantee or get a letter of

\(^{245}\) Transcript 19 April 2007, p 158.

\(^{246}\) Id., pp 171-172. This is the case with the MasterCard rules, at least.
guarantee from someone else.

So, the focus here is to make sure that whoever participates in the system, is not unduly increasing the risk or if they are increasing the risk, that that risk is covered somehow so that the system is not left holding the bag, you know, having a lot of transactions that cannot be paid off because the party that brought the transactions into the system has gone out of business. …

So, we are not limited to banks, we are looking at limiting typically to regulated and supervised financial institutions. I give you an example of how that can change over time. You may have heard that when the Reserve Bank of Australia regulated interchange fees, at the same time they made some changes in who could participate in the four-party systems. The truth of the matter is they did not change that from the standpoint affecting our rules. What they did was, based upon conversations that they had with us, and I presume with others, is they created a new system of regulation and supervision, so that entities which previously had not been regulated and supervised, if they wish to get into the business, would be regulated and supervised, and that then would allow them to participate in our system, because that would meet our requirements. So, that was the way that Australia could, at least in theory, improve their participation in the four-party systems. …

The final point is, if you want to participate in the system you have to get a licence. The licence allows you to use the trademarks, the licence allows you to submit transactions into the system and you are [governed] by the rules, etc. Our licences are not specific to issuing or acquiring. We grant you a licence.

It is then up to the licensee to decide, does it wish to engage in both the issuing and acquiring businesses, does it only wish to engage in the issuing business, or does it only wish to engage in the acquiring business, and that third choice may be restricted, depending on the location you are talking about.

In some places, I think including South Africa, we have generally frowned upon someone who is only an acquirer and is not also issuing. In other places that is permitted. But the licence itself does not prevent someone from going into the acquiring business, or into the issuing business. Both are permitted and certainly if someone is issuing and has a good issuing portfolio, they are never prohibited from going into the acquiring business, with a single exception. … The one exception is that if we perceived that a bank, a participant in a system which had not previously been involved in acquiring, who is going into the acquiring business in a risky way, for example, they are going to bring in merchants that were high risk merchants, you might frown at that. You might look very closely at that and in some circumstances we might not even permit it, because once again, it would increase risk to the system. The acquiring business is a special business. It requires experience. It requires the right kind of knowledge and expertise, and so we do reserve the right to make sure that the acquirers are running their businesses properly.

CHAIRPERSON: I just want to sum up what you have said, so that I understand exactly what your submission is. You must be a regulated financial institution, that is what you have said?

MR MUNSON: You must be regulated and supervised.

CHAIRPERSON: Financial institution. Those were the words you used.

MR MUNSON: Financial institution generally is someone who is regulated and supervised. But do you have to be a financial institution? No. But you have to be regulated and supervised.

CHAIRPERSON: Well, I am quoting you, Sir. You can clarify it. But that is what you said. You said he must be a regulated financial institution and in addition, if they are in South Africa, you cannot only be an acquirer, but you must also be an issuer.
MR MUNSON: That is my understanding.

CHAIRPERSON: … So, if I sum all of this up, it means only banks can be involved with your business. If I look at all these requirements you have set out, whatever way you want to put it, it means only banks can be involved in your business?

MR MUNSON: Let me, may I ask you a question? What do you mean by the word bank?

CHAIRPERSON: A deposit taking institution in terms of the South African law.

MR MUNSON: And what I am telling you is, that the term financial institution is not synonymous with the word bank. We have financial institutions which are not banks, which participate in our system. I give you a …

CHAIRPERSON: I am talking about South Africa …

MR MUNSON: The rules are the same in that regard. Let me give you an example.

CHAIRPERSON: … I know you are going to tell me about what is happening all over the world. I am just interested in what is happening in South Africa. That is why in particular, I also made reference to the other additional statement you made to say in addition, if you are in South Africa, you will frown upon giving somebody a licence if he is not an issuer as well. So, I am more interested in what is happening in South Africa. Let us talk about South Africa because that is my jurisdiction. I do not want to go outside my jurisdiction. So, it means if I sum up all of this, it means only banks can be involved in your business?

MR MUNSON: Wrong.

CHAIRPERSON: Okay. Only financial institutions can be involved in your business?

MR MUNSON: If you properly understand the term financial institution …

CHAIRPERSON: You are still going to tell me what you mean by financial institution.

MR MUNSON: A financial institution is an institution engaged in the business of payments that is regulated and supervised.

CHAIRPERSON: Regulated and supervised?

MR MUNSON: Yes.

CHAIRPERSON: Okay.

MR MUNSON: Can I give you an example?

CHAIRPERSON: No, no. I understand. I fully understand. I do not need an example.247

In Visa’s case, only “appropriate supervised credit institutions may be acquirers.”248 It is accepted in the UK and the EU, says Visa,249 that “only appropriate supervised credit institutions should have direct access to [a] funds transfer system which processes third
party systems." The reference to "credit institutions" is not clearly delineated in the Visa submission. The implication is that acquiring is not essentially limited to banks. Yet the Visa eligibility rules as submitted to us and quoted above do specify authority to take deposits as a basic criterion. Nor does Visa state, as MasterCard does, that its rules applicable to South Africa would currently permit non-banks to acquire its card transactions if the entities concerned were subject to local regulation.

We accept that caution is warranted in the open schemes over their eligibility criteria for acquiring. "By signing a merchant," says Visa, "an Acquirer is agreeing to underwrite that merchant's bankcard transactions." The risk here pertains essentially to chargebacks of disputed transactions. The longest period during which an issuing member may charge back a disputed transaction to the acquirer is four months.

An Acquirer is responsible to Visa for the proper performance of its merchants, processors and agents and is liable to Visa for any breaches of regulations and for any disputed transactions. Visa puts a premium both on the credit-worthiness of the Acquirer and on its knowledge of and expertise in the card business.

Visa is not in favour of allowing merchants to function as their own acquirers.

Visa has different tiers of membership, as noted above. Direct settlement risk rests on Principal Members, who guarantee those they sponsor in lesser categories of membership. There are global Visa standards applicable to the member's responsibilities in such cases, and penalties where the rules are not followed.

The potential risk introduced into the payment system by the spread of third party processors is of serious concern to the schemes. This potential risk increases as outsourced network providers develop, providing POS devices or other terminals and signing up merchants for acquiring banks. The danger is of PIN data being captured, enabling the counterfeiting of cards, and causing the public to lose faith in the system.

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250 Id., document E.
251 Id., document F.
252 Id. Visa may require the acquiring member to secure its exposure accordingly. The acquirer manages the dispute process on behalf of merchants.
253 Id., document D.
254 Id., document E. See also F. Among the measures required by Visa are the implementation of systems to monitor and detect changes in merchant activity patterns on a daily basis. See Attachment 4.
255 Id., document E. Visa does allow its members to outsource sections of the member’s card services programmes.
256 Id.
257 Id.
258 Id.
It appears, however, that this problem can be managed within the schemes through technological improvements and the enforcement of strict standards. The counterfeiting of magnetic-stripe cards currently occurs in any event through the use of illegal devices; and the identities and account details of customers are also held outside the system where they can be stolen. Recently a mass of data of this kind held by the revenue service in the UK was evidently compromised. In the United States, *Business Week* reported on 7 November 2007:

> In the past two months at least 17 computers containing personal data on a million or more individuals were lost or stolen, according to the Privacy Rights Clearinghouse. These episodes received little attention because they have become so common that they are no longer news.

As Visa points out, penetration of the TJX\(^{259}\) computer network in the United States that handles credit card, debit card, cheque and merchandise return transactions for customers reportedly compromised more than 31 million accounts in that country, and more than a million others worldwide.\(^{260}\) However, the customer records were those of the retailers, whose systems would seem to be vulnerable to penetration and theft by hackers quite independently of any direct access to the card payment system itself.

If an acquirer or issuer is not compliant with Visa's international operating regulations, then it may be fined or have its membership revoked. The acquirer is obliged to mandate the standards set out in these regulations when contracting with merchants. Commercial arrangements between acquirers and merchants on the one hand and issuers and cardholders on the other are left to the acquirers and issuers, subject to local law.

Acquirers are obliged systematically and on a daily basis to monitor, report and investigate changes in merchant deposit patterns, according to a number of specific parameters.\(^{261}\) They must likewise monitor, report and investigate significant and unusual changes in merchant authorisation request patterns. They have to employ staff resources and implement security controls in order to fulfil these responsibilities, and have their compliance certified by auditors.\(^{262}\) Before contracting with merchants they must determine that the merchant is financially responsible, and that there is "no significant derogatory background information about any of its principals".\(^{263}\) Additional requirements are laid down where risky types of business are involved, such as online gambling for example. Internet transactions generally, where the card is not present, entail a higher risk of disputed transactions.

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\(^{259}\) TJX Companies, Inc. is described as "the leading off-price retailer of apparel and home fashions in the U.S. and worldwide," with many hundreds of stores. *Id.*, document E, Attachment 1. The problem was discovered in December 2006.

\(^{260}\) *Id.*

\(^{261}\) *Id.*, Attachment 5.

\(^{262}\) *Id.*

\(^{263}\) *Id.*
An essentially similar position prevails in the MasterCard scheme.

In our view it would be unrealistic to expect the schemes, and it would be unwise to seek to compel them, to relax their standards beyond requiring acquirers and issuers to be regulated and supervised financial institutions, in the sense outlined by MasterCard. However, there is definitely a need to extend the regulatory framework of the payments system in SA so that banks are not the sole institutions regulated and supervised for this purpose. (This matter is taken up again in the chapter on access and regulation). So long as the framework restricts access to banks only, there would be no sound basis to proceed against either of the four-party schemes under the Competition Act for restricting their acquiring in this country to banks.

Regarding non-bank acquiring, FNB indicated that it saw no reason for them not to compete in the card payment area provided that they are properly regulated with a view to risk management. The acquirer does not have to hold the customer’s main bank account, or indeed any account of the customer involving a deposit.

Visa’s general international requirement that acquirers be authorised to take deposits is, in our view, too restrictive in the South African context (and indeed is likely increasingly to be challenged around the world).

However, if a proper regulatory and supervisory framework for non-bank acquirers were established here, schemes could – in terms of their own rules requiring compliance with local laws – be brought into line where necessary. To ensure this, the regulatory and supervisory framework would have to oblige the relevant card schemes to accept as eligible, without discrimination, those banks and non-banks meeting the domestic requirements.

**Acquiring restricted to issuers**

Where the four-party schemes are clearly at fault, in our opinion, is in their rules or practice of restricting acquiring to institutions which issue their cards, and indeed which issue them on a significant scale.

Testifying on 19 April 2007, Mr Jordaan of FNB at first suggested a possible justification for

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264 Transcript 19 April 2007, p 169. “[T]he appropriate entry criteria should really only relate to whether the institution is fit and proper and can manage the risks appropriately”: Mr Jordaan, id., p 173.

265 Id., pp 169-170. On the issuing side, to be able to issue a credit card, the issuer also does not have to be able to hold a customer’s deposit. It is not inherent in the issuing of credit cards that one must have a deposit-taking licence or a sponsorship or other dependency upon a deposit-taking institution. (Id., pp 170-171.)

266 A provision comparable to section 6A(3) of the National Payment System Act, 78 of 1998 as amended, but tailored for the purpose, is what we have in mind. Non-bank acquiring is dealt with fully in the chapter of this report on Access to the Payment System.
the prevailing position by saying that it would depend on the level of maturity of the market as to whether one could effectively have acquirers who are not issuers. In presenting this argument he set up the hypothetical case of a scheme being unable to develop if it only has issuers – it also needed acquiring. But then why restrict acquiring, especially when the acquiring market is considered difficult to enter? The converse – the development of the acquiring side of the market without a corresponding development of issuing – is manifestly unlikely.

Mr Jordaan acknowledged that it would merit investigation whether, in South Africa, we could have issuers completely independent from acquirers. FNB “would not be opposed to competing against somebody who is not an issuer.”

Ms de Beer of FNB said that it was a requirement of both schemes “that one should have an issuance programme, qualifying [one] to obtain an acquiring licence from the schemes.”

She added:

There are association rules that almost penalise the acquirers if they do not have an issuance programme that meets a certain threshold. The schemes have since reviewed some of those regulations and some of them are currently under review, but there is a rule in the scheme that provides for a form of a penalty if your issuance programme is inconsistent with your acquiring volumes.

Asked if this was true of both major four-party schemes, she said (evidently referring to the requirement of an issuance programme):

It is true. In the one instance it is not a rule that has ever been enforced. In the other instance the rule has been enforced but has since been temporarily suspended since we believe it is under review.

Mr Munson of MasterCard assured us that “every issuer in South Africa that is admitted into the MasterCard system is permitted to acquire as well.” However, this soothing statement should not be taken to imply that a participant is allowed to acquire without issuing. We shall return to this aspect below.

Visa stated in the introductory document (A) of its second submission that, since March 2007, “it has not been necessary to be an issuer before being an acquirer” in the Visa scheme in South Africa. On close inspection of the full submission, this statement turns
out not to be true.

Document D provides the detail. Visa has in the past applied in the CEMEA\textsuperscript{273} region a rule restricting eligibility for acquiring licences to members holding a share of 15 per cent or more of the number of cards issued in the market concerned, or account for 15 per cent of the RSV\textsuperscript{274} generated in that market.\textsuperscript{275} Also required was a business plan proving a commitment to extending the acceptance base and plan (\textit{inter alia}) for future growth in issuance.\textsuperscript{276} Such a rule was not necessarily applied in other regions, and Visa Europe has no such rule.

Visa also states that “the CEMEA rule has not been applied to South Africa: Standard Bank have been acquiring for many years although they have until recently been mainly a [MasterCard International] issuer and did not meet the Visa CEMEA issuance criteria.”\textsuperscript{277} At a Management Committee Meeting of the CEMEA on 21 March 2007 it was decided that Visa CEMEA will not apply a minimum issuance requirement before granting an acquiring licence. However, there will still be a requirement that “a member must show an issuance portfolio and history of issuance”.\textsuperscript{278} Apart from providing an indication that double standards have been in operation, this means that a misleading impression was conveyed in the introductory document.\textsuperscript{279}

The Visa and MasterCard requirements have had a perverse combined effect in raising the barriers against participation by smaller players, including smaller banks. This is illustrated by the experience of Mercantile Bank (MBL) in South Africa. At the time of making its submissions, MBL had only a Visa issuing licence.\textsuperscript{280} It had no MasterCard licence. It wished to become an acquirer, but realistically could not enter this business in South Africa on a viable scale unless it could acquire merchants’ transactions involving both MasterCard and Visa cards.\textsuperscript{281} It was initially confronted by Visa’s rule requiring a 15 per cent minimum share of issuing in the market concerned, in order for a Principal Member to be licensed to acquire. While Visa showed a willingness to relax this rule somewhat (as noted above), MBL was obliged to withdraw its application to Visa for an acquiring licence because it could not secure a licence from MasterCard at the same time.\textsuperscript{282} MasterCard refused “to allow the

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\textsuperscript{273} Central Europe, the Middle East and Africa.

\textsuperscript{274} Retail sales volume.

\textsuperscript{275} Visa, June 2007, Second Submission, document D; Visa CEMEA Regional Operating Regulations, 4.2.A.

\textsuperscript{276} \textit{Id}.

\textsuperscript{277} \textit{Id}, document D.

\textsuperscript{278} \textit{Id}.

\textsuperscript{279} \textit{Id}, document A p 1.

\textsuperscript{280} Mercantile, March 2007, Second Submission, Issuing and Acquiring, p 1.

\textsuperscript{281} See Transcript 28 May 2007, p 170.

\textsuperscript{282} Mercantile, March 2007, Second Submission, Issuing and Acquiring, p 10.
Bank to acquire transactions as a Principal Member without issuing.”

In view of the relatively small scale of its issuing business, MBL obviously did not wish to incur the costs of more than one licence to issue cards. In any event, its issuing volumes under any one scheme would necessarily be reduced if divided between two of them. MBL reported that MasterCard would only “support” an application for a licence if persuaded that MBL was committed to a strong issuance program.

Mr Bloem of MBL confirmed that it was very difficult for a relatively small bank in South Africa to make business decisions in the light of the power of Visa and MasterCard to grant or refuse access based not on technical considerations but on business volumes.

In our view this approach of the schemes and the rules on which it is based are clearly restrictive of competition on the acquiring side. It challenges one of the claimed virtues of the four-party system that it promotes competition in both issuing and acquiring. In our view such restrictions on acquiring have no legitimate basis. Acquiring should not be limited to issuers or be prohibitively priced.

If the schemes do not voluntarily – both formally and in practice – abandon these restrictions forthwith, then the matter should be addressed either by the initiation of formal complaints and investigations by the Competition Commission, or by regulatory intervention, or by both.

6.3.8 Restrictions on cashback at the point of sale

Standard Bank stated:

The proactive proliferation of pure cashback transactions at retailer stores benefits all participants (banks, retailers, associations and Customers) within the broader market in the following way:

- it enables access to cash and general banking especially in deeper rural areas where mechanisms such as ATMs do not make economic sense;
- retailers, especially deeper rural merchants, are incentivised to provide the capability through their POS devices thereby attracting customers into their stores, recycling their cash holdings and inherently reducing security risks and bank costs; and
- customers have frequent access to mechanisms that provide cash and over time can start migrating their transaction behaviour from cash to suitable electronic mechanisms such as debit card purchases.

Elaborating on cash back at the point of sale, Mr Gericke of Nedbank said:

We have enabled all our devices for cash back at the point of sale. It is not necessarily that all merchants want to offer it. It is a service that we believe is very necessary, but it is very much

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283 Id., p 4.
284 Id., p 6.
287 SBSA, October 2006, First Submission, p 57.
in its infancy and the adoption rate from a retailer perspective has been pretty low to date. But we are currently in the market piloting with a number of small merchants and it’s a distinctive strategy that we have, to promote cash back at point of sale. Where Nedbank provides an acquiring service to a merchant, it offers cash back as a value added service.\(^{288}\)

Mr Shuter added that Nedbank had a joint venture with Pick ’n Pay regarding cash back at the point of sale. More broadly enabling its merchant base in this regard was a relatively new strategy. There was resistance among some merchants because of the security issues around cash. The service, while intellectually appealing, is still in its infancy and involves more complexities than may appear to be the case.\(^{289}\)

Mr Gericke stated that Nedbank has no restriction to the effect that cash back at the point of sale may only be provided in conjunction with a purchase.\(^{290}\) However, in Nedbank’s submission of March 2007, both MasterCard and Visa rules are cited which restrict cashback at POS in this way.\(^{291}\)

According to Standard Bank, among the reasons why the adoption and proliferation of cashback at POS has been slow in South Africa are the generally slow adoption rate of debit card transactions by customers and –

the current prohibition of the card associations’ international operating rules to enabling pure cashback only transactions (although this view has changed since inception, given the uniqueness of South Africa in enabling access to cash and banking in deep rural areas in accordance with Financial Sector Charter requirements)...\(^{292}\)

Now, either there is a “prohibition” or there isn’t one. In a society in which people are entitled to know their rights and freedoms, and to act upon them, it is not enough that a “view” changes on the part of those with power. What is the true governing state of affairs?

MasterCard International’s Bylaw and Rules (published April 2005) provide:

Cash disbursements may be provided only by members [meaning, in South Africa, participating banks] at their facilities and through their authorized agents. For purposes of this rule, an authorized agent is a financial institution authorized to provide cash disbursement services on behalf of a member pursuant to a written agreement with a member.\(^{293}\)

On the face of it this would prohibit entirely not only cashback at POS but also the provision of ATM services other than by banks or other financial institutions on their behalf. However,

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\(^{288}\) Transcript 19 April 2007, p 36.

\(^{289}\) Id., pp 36-37.

\(^{290}\) Id., p 39. The amount will be limited by the issuer to the amount authorised for ATM withdrawals, but the merchant may set a lower limit. Where a customer makes a purchase and asks for cash back, the two transactions will be charged for separately. “The purchase attracts a price, a transaction fee as it would for a normal point of sale purchase transaction and the cash portion would attract a fee as if it was a cash withdrawal. So there are two separate fees, yes.” (Mr Gericke, id., p 74.)


\(^{292}\) SBSA, October 2006, First Submission, pp 56-57.

\(^{293}\) Chapter 2, Rule 8.1 (MasterCard, October 2006, First Submission, Annex O).
as far as debit cards are concerned, the *Maestro Global Rules* (published July 2005) permit “Purchase with cash back”, but stipulate:

> Acquirers and Merchants must ensure that cash is provided only when combined with a purchase Transaction.\(^{294}\)

Visa International Operating Regulations (dated 15 May 2006) also provide that cashback services may be provided “only in conjunction with a purchase”.\(^{295}\) VISA’s regulations have been amended for the CEMEA region, but evidently without altering this basic restriction.\(^{296}\) (The regional amendments seem, if anything, more restrictive. For example, an issuer or acquirer wishing to provide a cashback service must obtain prior Visa CEMEA approval.)

Absa has told the Enquiry:

> Both MasterCard and Visa implement operating rules relating to cashback at point of sale. There are a number of qualifications and requirements that need to be met. These cover aspects such as security, risk and business best practice of cashback point of sale transactions. The details of these are specified in manuals from the different card schemes … In addition, Visa and MasterCard require that the point of sale infrastructure is certified to ensure it meets the necessary standards.

... For risk reasons no issuer currently allows cashback at point of sale in South Africa on credit cards or embossed debit / cheque cards [i.e., cards which are not PIN-based].\(^{297}\)

Our concern, of course, is not with rules reasonably designed to maintain the security and integrity of the payment streams. Absa further stated that Visa default rules prevent pure cash back transactions at point of sale. The MasterCard and Maestro rules quoted above involve a similar restriction. However, says Absa,

> The restriction of cashback at POS to transactions also involving a merchandise purchase has no evident justification in the public interest. *Prima facie*, it is unduly restrictive of competition and of the free use of an important innovation that could promote consumer and producer welfare.

There is confusion in the industry as to the applicability of the scheme rules. Standard Bank refers to them as applicable, but records its understanding “that Pick ‘n Pay and Shoprite Checkers offer pure cashback notwithstanding the card association rules.”\(^{299}\)

\(^{294}\) *Id.*, Chapter 6, Rule 9.1.2.2.

\(^{295}\) Vol. I, Chapter 5, regulation 5.4.S. (Visa, October 2006, First Submission, Annexure F (supplied on CD-ROM).)

\(^{296}\) Visa Regional Operating Regulations for Central Europe, the Middle East and Africa, 15 May 2006. (*Id.*)

\(^{297}\) Absa, March 2007, Second Submission, ATM transactions, p 7. The PASA interbank clearing rules for "Non-PIN Based Card Debit Payment Instructions" (Version 2006/1) permit cash disbursement only in bank branches: Rule 2.6.

\(^{298}\) *Id.*

\(^{299}\) SBSA, April 2007, Second Submission, Acquiring, p 32.
The PASA interbank clearing rules for PIN-based card debit instructions include both “Cashback” and “Purchase with Cashback” among allowed transaction types. It would seem to be something of a leap to say that, by virtue of this inclusion, restrictions imposed by card schemes on their participants are “over-ridden” (as Absa expresses it).

In our opinion the card schemes should be requested by the Commission formally and forthwith to withdraw their prohibitions on pure cashback at POS, at least to the extent that such transactions are permitted under domestic law. Failing satisfactory responses in that regard, we would recommend regulatory measures to correct the situation decisively. If such measures are not forthcoming, then the Commissioner should give consideration to initiating a complaint and investigating the relevant scheme rules for possible contravention of the Competition Act as prohibited restrictive practices.

6.4 The setting of payment card interchange

6.4.1 History and level of card interchange in SA

According to Absa, a bilateral agreement between Barclays Bank and Standard Bank initially set the interchange rate between them for credit card transactions at 1.99 per cent of the transaction value. No bank was able to provide details regarding a date or the circumstances of the agreement. This rate appears to have been universally adopted by the South African banks involved in off-us credit card transactions before changes were made by mutual agreement of the banks in 2003.

Again according to Absa, a bilateral agreement between Absa and Standard Bank initially set debit card interchange between them at 0.75 per cent of the transaction value. We have been given no further details. Prior to the interchange rate changes in 2003, all South African banks involved in off-us debit card transactions were evidently applying that rate.

We do not know the rationale behind the particular levels of interchange which originally applied.

Ms Louw of the Enquiry’s Technical Team outlined the various approaches to the setting of interchange which have been utilised by the four-party schemes and their participating

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300 Exhibit LL, slide 19.
301 See e.g. Absa, October 2006, First Submission, Annex 3, p 66; Exhibit LL, slide 13.
302 Exhibit LL, slide 19.
303 Id., slide 13. The reference is to PIN-based debit cards. See Absa, October 2006, First Submission, loc. cit. Reference to 0.73% in Exhibit KK, slide 13, based on Visa’s First Submission, October 2006, p 46, seems mistaken.
The setting of the interchange fees by members of a scheme or a country is one method which the card schemes use, and another is the setting of the interchange fee by the card scheme itself that will apply as a default to the participating members in a country, if bilateral negotiations fail. …

In both these cases there are two important elements involved. The first one is the calculation of the costs and the second is the balancing of interests. … [A] third party like Edgar Dunn can be used to assist in the collection and the calculation of the costs associated with the provision of the service. These cost studies are then used by scheme owners as an input and the setting of the interchange fee. The cost calculations by Edgar Dunn would in essence then only be … a proxy for the imbalance in the system that would then be used as an input in the calculation of an interchange fee that would be set in a country.

… Although debit and credit cards differ, the cost studies applied to these also differ but are both done by the same institution. The setting of the interchange fee as a balance can either be performed on its own right without the consideration of these cost studies or in conjunction with the cost study that provides a proxy for the imbalance present in the system.

In neither case, however, do the elasticities of demand on the two sides of the market appear to be actively tested.

6.4.2 The “Edgar Dunn” process and the decision of the banks in 2003

In South Africa in 2002, the member banks of MasterCard and Visa decided to use a cost study methodology in reviewing and revising the uniform levels of interchange fees applying between them.

Through their Association of Bank Card Issuers and Merchant Acquirers (ABCI), they engaged Edgar, Dunn & Company (EDC) to assist them in determining the level of the interchange fees for credit cards, PIN-based (i.e. on-line) debit cards, and signature-based cheque cards or embossed debit cards (hybrid cards). The process involved EDC gathering certain cost information from the participating banks (with each one’s information kept confidential from the others), analysing this information by applying a methodology used in interchange cost studies for MasterCard, and coming to a conclusion as to appropriate cost-calculated interchange rates. A proxy (a particular sub-set of issuer’s costs) was used in each case to estimate the merchants’ demand for payment cards on the basis that the merchant would have had to incur these costs itself if it were not for the scheme. The sub-set of costs serving as the proxy was adjusted according to the type of card under consideration. 

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305 Id., p 24.
306 Id., p 24.
307 Edgar, Dunn & Company describes itself on its website as “an independent global financial services and payments consultancy.” Founded in 1978, it has offices in San Francisco, Atlanta, London, Sydney and Frankfurt, from which it provides services to clients in more than 30 countries on six continents.
309 The EDC reports outlined the same basic methodology for arriving at interchange fees on credit cards, cheque cards and debit cards. A proxy (a particular sub-set of issuer’s costs) was used in each case to estimate the merchants’ demand for payment cards on the basis that the merchant would have had to incur these costs itself if it were not for the scheme. The sub-set of costs serving as the proxy was adjusted according to the type of card under consideration.
in each case to estimate the merchants’ demand for payment cards on the basis that the merchant would have had to incur these costs itself if it were not for the scheme.

After considering the EDC report, and with effect from 1 November 2003, the South African banks agreed to reduce their interchange fees on credit and debit cards as it appears from the following table. A distinct interchange rate for hybrid cards was introduced for the first time.

<table>
<thead>
<tr>
<th>Card type</th>
<th>Pre- Nov 2003 rate</th>
<th>New rate Nov 2003</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>1.99%</td>
<td>1.71%</td>
</tr>
<tr>
<td>Debit</td>
<td>0.75%</td>
<td>0.55%</td>
</tr>
<tr>
<td>Hybrid (credit or debit)</td>
<td>1.99%</td>
<td>1.09%</td>
</tr>
</tbody>
</table>

Source: Banks’ submissions, October 2006, First submissions.

Since then these rates have been uniformly applied in South Africa to both MasterCard and Visa card transactions, and (at the time of writing) no other adjustment has yet been implemented.

MasterCard and Visa themselves did not take part in the 2002/2003 interchange-setting process. Moreover, Visa has stated that, while it accepted the result as adopted by its member banks, the methodology used was not the one which it prefers.

Visa did not participate in the cost study for a number of reasons: Edgar Dunn is a firm, used we believe by MCI [MasterCard International] members and MCI, to carry out cost studies. They have we understand [done] this in the UK market for example. Accordingly, we believed that the methodology that Edgar Dunn would use to calculate the Interchange Fee rate would be that of MCI and not Visa. We therefore did not want to let commercially sensitive, confidential data and material into the hands of a competitor’s vendor. The banks, once they had decided what rates they wished Visa to apply in the Visa systems, simply informed Visa in writing, as is their right under Section 6.5 of VIOR, a precise (sic) of which is set out in Section ‘Q’. Visa then makes any changes required by the members to the Visa system.

Document Q in the same submission (Section ‘Q’ in the passage quoted) indicates that, in the absence of agreement to the contrary, CEMEA intra-regional fees are applied as the

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310 Transcript 19 April 2007, p 153.
311 Visa, June 2007, Second Submission, Attachment 7, provides a table indicating how the November 2003 rates apply to its various cards. The table makes it clear that the rate applied to premium credit cards is the same as for credit cards generally. Visa refers also to a rate of 1.00% on “airline cards”, which we have not considered necessary to pursue.
312 Transcript 17 April 2007, p 93.
313 Id., pp 24-25.
314 Visa, June 2007, Second Submission, document M.
315 Where unanimous agreement of Visa members in a market cannot be reached, a domestic (default) rate can be implemented on the basis of agreement of 50% + 1 of the members having together 75% of domestic VisaNet volume. This is issuer and acquirer volume, in US dollar equivalents, of transactions undertaken through VisaNet.
default for domestic transactions. However, these intra-regional fees are at the default international rate. The current default rates appear to be generally lower for credit cards (1.60 per cent), and higher for debit cards (1.10 per cent 1.60 per cent) than have been set in South Africa (where, as indicated above, the rates are 1.71 per cent and 0.55 per cent respectively). Also, in the absence of agreement between all the members in a country, the CEMEA Management Committee may ratify a proposed domestic default rate. Members in a country may enter into private agreements or bilateral agreements to establish domestic interchange fees.

However, as all participating banks agreed to the domestic interchange rates for South Africa in 2003 following the EDC study, MasterCard had no need to invoke these powers.

Based on the most recent information supplied, the average credit card transaction value involving the big four banks in South Africa is in the region of R510; the average cheque card (hybrid card) transaction value is R380; and the average PIN-based (debit card) transaction value is R225.

On an average credit card transaction of the value indicated, the issuing bank would receive R8.72 in interchange. The average interchange fee received by the issuing bank per cheque card transaction would be R4.15, and for debit cards R1.24.
The banks’ decision to reduce the debit card interchange rate further

The EDC report had concluded from the cost study that debit card interchange rates could appropriately be reduced from 0.73 per cent to 0.715 per cent. The banks, after considering this, decided to reduce the rate even further – to 0.55 per cent.

It has been explained to us that debit card interchange was deliberately set at a lower rate than the one indicated by EDC in order to encourage merchant acceptance of a card which was being routinely issued to bank account holders but for which they had as yet found little use.\(^\text{325}\) Forecasts based on expected future volume growth of debit card usage over a two-year period were seen to warrant a lower rate.\(^\text{326}\)

Mr Fergus of Standard Bank explained the purpose and likely effect of the decision as follows:

My belief would be that the lower interchange encouraged more merchants to accept debit cards earlier. You normally have a chicken and egg [problem], and it is always a moot point whether it is the merchant acceptance which drives the use of the cards, or the cards that drives the merchants to acceptance. I think going into a lower interchange and hence a lower merchant service charge resulted in more merchants being prepared to accept the card, which resulted in more cardholders being prepared to use it.

The biggest challenge in debit cards, we are just going through the hump now, is getting the first transaction away from the ATM. ... [Nedbank’s evidence] this morning showed an average of four transactions [per year per debit card in 2006].\(^\text{327}\) It is actually, the vast majority of the cardholders only using the cards for cash and an increasing use by a smaller percentage to make more transactions at the point of sale. ... [T]he challenge is actually getting that switch in and I think the lower interchange encourages more merchants to accept debit cards sooner and hence it has accelerated the [use of the card]...\(^\text{328}\)

In our opinion, from the point of view of public interest, a key challenge of the period ahead is to enable and encourage the use of the debit card as a convenient substitute for cash, without the cardholder having to pay a significant per transaction charge.

6.4.3 The Visa exemption

In 2001, Visa International Service Association Inc., commonly referred to as “Visa International”,\(^\text{329}\) applied through its South African branch, “Visa South Africa”, for an exemption in terms of section 10(4) of the Competition Act.\(^\text{330}\) A new company was to be

\(^{325}\) See generally id., pp 114-115.


\(^{327}\) See Exhibit NN, slide 3; Transcript 19 April 2007, pp 41-42.

\(^{328}\) Transcript 19 April 2007, pp 83-84.

\(^{329}\) See e.g. Visa, October 2006, First Submission, glossary, p 5.

\(^{330}\) Id., Annexures A and B. Section 10 (4) provides: “A firm may apply to the Competition Commission to exempt from the application of this Chapter [Chapter 2: Prohibited Practices] an agreement or practice, or category of agreements or practices, that relates to the exercise of intellectual property rights, including a right acquired or protected in terms of
established in South Africa, to be owned and controlled by Visa’s local member banks. It was said that these members would agree on prices and set other trading conditions in a manner prohibited by section 4(1)(b) of the Competition Act, and that accordingly an exemption from the prohibition was required.

Evidently on the basis that the intended practices would “relate to the exercise of intellectual property”, the Commission granted the exemption sought – until 30 April 2013.

We make no comment either on the original validity of the exemption or on the wisdom of having granted it. It is not clear, moreover, whether the exemption granted is affected by the recent global restructuring of Visa, involving new entities which were not in existence at the time.

Assuming that the exemption could apply, it seems to us irrelevant to this Enquiry and its outcome, for two reasons.

First, we have come to the conclusion that multilateral agreement on interchange is in principle reasonably necessary to the viability of four-party card payment schemes and so should not, in and of itself, be characterised as having the purpose of restricting competition in contravention of section 4(1)(b).

Secondly, and in any event, we propose in this chapter that the problem of interchange and the danger of its abuse be addressed by way of a new statutory arrangement, which would ensure the setting of interchange by a transparent and objective process involving the participation of all stakeholders. The outcome would be binding on all issuers and acquirers to which the regulatory arrangement applies, including those participating in the Visa scheme.

6.4.4 The MasterCard advisory opinion


 Id., pp 6-7.

 Id., Annexure A, p 2; also Annexure B.

 According to the document Visa Inc. Corporate Overview, available to the public at www.corporate.Visa.com, Visa has completed its corporate restructuring. The company’s world-wide operations are carried out by Visa Inc. itself through regional divisions, except in the case of Visa Europe, which is a separate entity operating under licence. This may mean that the business previously conducted in South Africa by Visa International Service Association Inc. is now conducted by Visa Inc. – which is described as “a new global corporation” (p 8).

 Whether a scheme’s interchange methodology may – quite independently of the question of multilateral setting – involve a contravention of section 4(1)(b), or alternatively section 4(1)(a), of the Competition Act is considered below.
The South African Competition Commission has endorsed, by way of an advisory opinion in 2005, MasterCard’s Plan to set default interchange rates unilaterally.

The background to MasterCard’s request for an advisory opinion was its intention of commissioning EDC to conduct in South Africa a new interchange analysis similar to that which had been conducted in 2002/2003. This time, however, in place of a multilateral agreement between the participating banks, MasterCard itself would set the default rate. Issuers and acquirers of MasterCard transactions would be required to cooperate in the process, but could then reach bilateral agreements on different rates if they so chose.

MasterCard argued in its request that the proposed method would comply with the Competition Act, inter alia because the participating banks would not be setting the interchange themselves and so there would be no horizontal coordination of conduct.

In its initial response the Commission noted that the Act may nevertheless be contravened where an umbrella body sets a price to be applied by members in a horizontal relationship.

Nor would it make a difference that the price set was only a default price from which the issuers and acquirers could depart bilaterally if they so chose.

Following this, MasterCard met with representatives of the Commission and then set out further arguments on the issues in writing.

The independence of MasterCard from its participating institutions in the proposed process for setting interchange was emphasised.

Default interchange, it was pointed out, should not be characterised as restrictive of competition per se, as is contemplated by section 4(1)(b) of the Competition Act. It was not intended to eliminate competition but was necessary for the survival of a four-party scheme, and moreover facilitated the entry of new issuers and acquirers.

In a letter dated 4 October 2005, the Competition Commission stated that it now appeared that the proposed multilateral interchange fee would not contravene any per se prohibition in the Act. Whether it might have anti-competitive effects in a market had not been evaluated, and accordingly no opinion on that was expressed.

We note that advisory opinions are non-binding on the Competition Commission. We are at liberty to consider and express our own views on the same issues. For reasons expounded:

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335 MasterCard, October 2006, First Submission, p 103; see also pp 110-112 and Annexes G-J to the submission.
337 Id., p 7.
339 Id., p 4.
341 Id., p 5.
342 Id., pp 6-9.
343 Id., Annex J.
in this chapter, we agree that the default or multilateral setting of interchange fees for purposes of a four-party card scheme would not, in and of itself, amount to a contravention of the Competition Act. However, in our view, the methodology used may be such as to set interchange for illegitimate anti-competitive purposes – an aspect of the problem which was not raised in the advisory opinion, but which debate during the Enquiry has helped bring into relief. We deal fully with that aspect below.\textsuperscript{344}

6.4.5 The current MasterCard / “Edgar Dunn” process

(FNB declined to take part in the process, partly on account of unhappiness with the methodology\textsuperscript{345} – but in view of the bank’s own subsequent submissions to the Enquiry regarding appropriate interchange methodology it seemed uncertain whether this standpoint would be maintained.\textsuperscript{346})

It appears likely that, as in the past, Visa will await the outcome of the process and allow its participating banks to agree on multilateral interchange fees corresponding to those applied in the MasterCard scheme.

We have been asked in various meetings with interested parties to give our blessing to the new process, and thereby give comfort to the participants that they would not thereby be regarded as contravening the Competition Act. We have declined to do so; our remit extends only to making recommendations to the Commissioner. In this chapter, and in making our recommendations on interchange, we draw attention to unsatisfactory features in the current methodology and propose a regulatory scheme which would eliminate those features while giving practical recognition to the necessity of interchange wherever such necessity truly exists.

6.5 Revenues and profitability in issuing and acquiring

6.5.1 Banks’ revenue from card issuing and merchant acquiring

The table below assembles the information received from the big four banks in respect of

\textsuperscript{344} See the section 6.7.

\textsuperscript{345} Transcript 19 April 2007, pp 153-154. FRB, in its First Submission, October 2006, p 71, indicated that it would be willing to commit itself to abide by the findings of a study such as that previously conducted by EDC provided that, \textit{inter alia}, there was consensus reached on the costs to be included in the assessment, and the Competition Commission also committed itself to abide by the findings “so that even greater uncertainty is avoided”.

\textsuperscript{346} See especially FRB, Second Submission, March 2007, Section 8, Position Paper 3: Interchange., p 10. At the time of that submission FRB stated only that it “would be open to a third party study” to re-evaluate whether the prevailing levels of interchange remain appropriate. (\textit{Id.}, p 7.) Also see FNB, March 2008, Response to request for additional information, p 5, where they confirmed this stance.
their turnover, revenue, costs and profits in the issuing and acquiring markets in 2006. For ease of reference, card issuing totals are imported from Table 1 and aggregated for each bank, while figures for the number of merchants acquired are imported from Table 3.

Table 7 Turnover, revenue, costs and profits from issuing and acquiring in 2006

<table>
<thead>
<tr>
<th></th>
<th>ABSA</th>
<th>SBSA</th>
<th>Nedbank</th>
<th>FNB 348</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Issuing</strong></td>
<td></td>
<td></td>
<td></td>
<td>Confidential:</td>
</tr>
<tr>
<td>Turnover (R)</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>FRB</td>
</tr>
<tr>
<td>Total Revenue (R)</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>Absa</td>
</tr>
<tr>
<td>Total Costs (R)</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>SBSA</td>
</tr>
<tr>
<td>Profits before tax (R)</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>Nedbank</td>
</tr>
<tr>
<td>Total Credit Cards</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>MasterCard</td>
</tr>
<tr>
<td>Total Debit Cards</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td></td>
</tr>
<tr>
<td>Total cards issued</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td></td>
</tr>
<tr>
<td><strong>Acquiring</strong></td>
<td></td>
<td></td>
<td></td>
<td>Confidential:</td>
</tr>
<tr>
<td>Turnover (R)</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>FRB</td>
</tr>
<tr>
<td>Total Revenue (R)</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>Absa</td>
</tr>
<tr>
<td>Total Costs (R)</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>SBSA</td>
</tr>
<tr>
<td>Profits before tax (R)</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>Nedbank</td>
</tr>
<tr>
<td>Number of merchants</td>
<td>[ ]</td>
<td>[ ]</td>
<td>[ ]</td>
<td>SBSA</td>
</tr>
</tbody>
</table>

Source: Banks’ submissions, March and April 2007, Second submissions, Issuing and Acquiring

In the next table, the average interchange revenues receivable by an issuer on card transactions of average value are set out.

347 N/A indicates information not supplied.
348 Confidential: FRB
349 Originally, SBSA submitted a value of R443,302,000,000. When the order of magnitude was questioned, a revised figure of R443,302,000 was submitted. Neither of these figures appears to make sense, so neither is shown.
Clearly the average credit card transaction brings to the issuer significantly more interchange revenue than does the average debit card transaction – R8.72 per transaction as opposed to R1.24.

The same interchange fees are currently applicable for both MasterCard and Visa transactions in South Africa. This is referred to as blending and constitutes a process of treating all card brands like a single card and charging identical fees. This also has the consequence that merchants face the same fee for accepting cards from different schemes. We deal later in this chapter, in the section on the potential for abuse of interchange, with the question whether competition between schemes over interchange fees leads to beneficial or harmful results.

The total interchange fees received and paid on card transactions for the big four banks are depicted in the following table. From this it appears that Standard Bank is the only net receiver of interchange. Nedbank, ABSA and FNB are net payers.\(^\text{350}\)

Table 8 Average revenue from interchange per transaction

<table>
<thead>
<tr>
<th></th>
<th>Average credit card transaction value</th>
<th>Average cheque card transaction value</th>
<th>Average debit card transaction value</th>
<th>Average interchange fee received by the issuing bank per credit card transaction (1.71% of ATV)</th>
<th>Average interchange fee received by the issuing bank per cheque card transaction (1.09% of ATV)</th>
<th>Average interchange fee received by the issuing bank per debit card transaction (0.55% of ATV)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>R 510</td>
<td>R 380</td>
<td>R 225</td>
<td>R 8.72</td>
<td>R 4.14</td>
<td>R 1.24</td>
</tr>
</tbody>
</table>

Source: Banks’ submissions, October 2006, First submissions.

The fact that the aggregate of interchange fees paid away does not correspond with the aggregate of interchange fees received by these banks, is explained by the existence of transactions with other banks, including international banks, not reflected in Table 9.

Table 9 Gross and net revenue from interchange fees: the big four banks

<table>
<thead>
<tr>
<th></th>
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<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>C</td>
<td></td>
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</tbody>
</table>

A = Interchange fees received  
B = Interchange fees paid away  
C = A-B, or Net interchange fees received

Source: Banks’ submissions, March and April 2007, Second submissions

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350 The fact that the aggregate of interchange fees paid away does not correspond with the aggregate of interchange fees received by these banks, is explained by the existence of transactions with other banks, including international banks, not reflected in Table 9.
Revenue from the merchant service charge

The total revenue earned from the merchant service charge (MSC) by the big four banks is presented in the table below.

### Table 10 Revenue from the MSC: the big four banks together

<table>
<thead>
<tr>
<th></th>
<th>Total 2005</th>
<th>Total 2006</th>
<th>% Change</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total MSC received</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- from Debit &amp; Cheque card transactions</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>- from Credit card transaction</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td><strong>Interchange fees paid away</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- re Debit &amp; Cheque card transactions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- re Credit card transactions</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Net MSC received by acquiring banks</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>- from Debit &amp; Cheque card transactions</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>- from Credit card transactions</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Banks’ submissions, March and April 2007, Second submissions, Acquiring

While the total (i.e. gross) MSC received by the big four banks for all types of card transactions grew by per cent between 2005 and 2006, the gross MSC received for debit and cheque card transactions grew considerably faster in the same period, by a rate of per cent. This may be as a result of the increased volume in point of sale transactions on debit cards, which grew by per cent between 2004 and 2005 and by per cent between 2005 and 2006. These figures are also indicative of the increased acceptance and use of payment cards at point of sale terminals.

In respect of net MSC revenue – i.e., the MSC remaining in the hands of the acquiring bank after interchange has been paid away – at least two features appear from the table. First, the growth in net MSC revenue has been even faster than the growth in gross MSC revenue. Secondly, as in the case of gross MSC revenue, net MSC revenue for debit and cheque card transactions outgrew that for credit card transactions over the period. Net MSC revenue grew by almost per cent, compared with approximately per cent for gross MSC revenue, with net debit and cheque card revenue growing by per cent and net credit card revenue growing by per cent.

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351 Bankserv, November 2007, Data Submitted to the Enquiry.

352 Generally, when considering the revenue derived by banks from the MSC, it should be borne in mind that in on-us transactions (transactions in which the acquiring bank is also the issuer), the component of the MSC which would otherwise be paid away as interchange is retained and is thus available to contribute to the bank’s costs of issuing. (In the context of three-party schemes, such a notional in-house transfer of revenue has been referred to as “intrachange”.) In the last analysis, therefore, the interchange component of the MSC could just as well be treated as forming part of the issuing rather than the acquiring revenue of banks in on-us transactions as well. To the extent that profitability in acquiring would be reduced by such an allocation, profitability in issuing would of course be increased by a corresponding amount.
6.5.2 Growth rates in costs, revenues and profits

The table below indicates the growth rates of revenues, costs and profits in the acquiring business of major banks. With a revenue growth of 44 per cent and growth in costs of 29 per cent, profits before tax in the acquiring market grew year-on-year by 80 per cent. The slower growth in costs relative to the growth in revenue and profits, indicates the existence of economies of scale resulting from the increased volumes of transactions. This also signifies the need for review of the interchange fees on card transactions.

<table>
<thead>
<tr>
<th>Acquiring Business</th>
<th>Indication of growth between 2005 and 2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td></td>
</tr>
<tr>
<td>Total Revenue</td>
<td></td>
</tr>
<tr>
<td>Total Costs</td>
<td></td>
</tr>
<tr>
<td>Profit before tax</td>
<td></td>
</tr>
</tbody>
</table>

Source: Banks’ submissions, March and April 2007, Second submissions, Acquiring

The ratio of total profits to total costs in the acquiring business indicates a very profitable business with a ratio of 60.2 per cent.354 The European Commission’s Interim Report on Payment Cards (2006) stated that high profitability in these markets is often correlated with high fees charged to merchants and cardholders.

The issuing market also seems buoyant, with an indication of a profit growth rate over 43 per cent between 2005 and 2006. Total costs increased by approximately 79 per cent followed by an increase in revenue of just over 62 per cent.355 Even though costs increased substantially more than revenue and profits, profits before tax of 44 per cent and a ratio of total profits to total costs356 of 49.4 per cent indicate that this is a very profitable business.

353 Only ABSA and Nedbank provided us with data for 2005 and 2006, allowing for the calculation of percentage changes. This can be used as a proxy for the industry, seeing that South Africa has only four acquiring banks. The data is also representative of a large and a smaller bank among the “big four” in the market.

354 This calculation was done through the use of data submitted to the Enquiry in response to the Acquiring Questionnaires in March 2007 for three of the big four banks in South Africa (FRB, Absa and Nedbank). This calculation can also be weighted according to turnover indicating a ratio of 63.4%.

355 A breakdown in the components of costs was not provided to the Enquiry, but given the increased number of cards in circulation and the increase in the number of co-branded cards and loyalty programmes, these figures seem likely.

356 This calculation was done through the use of data submitted to the Enquiry in response to the Issuing Questionnaires in March 2007 for three of the big four banks in South Africa (FRB, Absa and Nedbank). This calculation can also be weighted according to turnover indicating a ratio of 40.7%.
6.5.3 Profits in card issuing without interchange

Evidence suggests that despite the healthy growth rates in the acquiring business, profits generated in the issuing businesses continue to be more lucrative than profits generated in acquiring.358

Data submitted in response to the issuing questionnaires, sent out to banks participating in the Enquiry in February 2007, also demonstrate that issuing revenue without interchange revenue also generates positive profits for the issuing banks. In the section of this chapter on the necessity of interchange in principle, we discuss the challenge to the legitimacy of

357 See footnote 353 above.

358...
interchange inherent in these facts.

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</thead>
<tbody>
<tr>
<td>Profits before tax</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>without interchange</td>
<td></td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>

Source: Banks’ submissions, March and April 2007, Second submissions, Issuing and Acquiring

6.6 The necessity of interchange in principle

6.6.1 Competition policy and joint ventures

The general approach of competition policy internationally towards joint ventures is to recognise the productive efficiencies and consumer welfare that can result when resources are combined by firms which could not achieve similar results independently – but to recognise at the same time the dangers of anti-competitive harm which associations of actual or potential competitors entail.

American antitrust scholars Sullivan and Grimes say:

The joint venture concept is of interest to antitrust because whenever two or more firms cooperate in a business activity there may be competitive harm and because whenever there is integration of these firms’ activities (one of the hallmarks of a venture) efficiencies may result. …

It must be stressed at the outset that arrangements called joint ventures do not avoid, but are strictly subject to, conventional antitrust analysis. The joint venture label is no antitrust shield. All such activities, whether or not meeting any scholar’s definitional norm, may involve or facilitate collusion, may reduce, discipline or inhibit actual or potential competition, or may foreclose rivals from inputs or outputs. Any activity that has such tendencies should be scrutinized in the conventional way.

Hovenkamp, rejecting the argument that joint ventures should be subjected to no higher scrutiny than single firms, says that the economic arguments for closer scrutiny of joint venture activity are overwhelming. Among these arguments is the fact that

…the participants in joint ventures are private actors seeking private gains. The gains from joint ventures come from two sources: efficiency gains, which result from reduced costs or

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improved products; and market power gains, which result from the fact that the venture has sufficient power to cause market wide output reductions and price increases. One important reason for looking more closely at joint activity is that agreements creating significant market power can be formed very quickly... All it takes is firms who collectively dominate a market and agree to do something jointly.361

Payment systems, as we have seen, are an example of a network industry. The establishment of common standards for interoperability contributes to efficiency and is one of the recognised benefits of joint ventures in network industries.362 Such ventures may also facilitate innovation, enable the entry of additional new players, promote scale economies, and reduce transaction and management costs.363 At the same time, the interaction of competitors in a joint venture provides the opportunity for them to–

widen the venture in ways that may intensify their interaction, homogenize their conceptions about market conditions, and provide new channels and incentives for explicit collusion, oligopolistic interdependence, or soft, live-and-let live pseudo-rivalry.364

Writing in the November-December 1995 Review of the Federal Reserve Bank of St Louis, Carlton and Frankel said:

Joint ventures, particularly those involving networks that contain many industry participants, present some of the most interesting and difficult antitrust issues. Modern payment and electronic funds transfer networks are technologies that have greatly benefited consumers and the economy by reducing transaction costs and allowing consumers to economize on their holdings of non-interest bearing forms of money. Payment networks, however, may also be able to engage in collective actions that allow their members to exercise market power... If members of a payment network exercise market power, the effects can be equivalent to a privately imposed sales tax on all network transactions.

In our view, for reasons given above, the progressive, pro-consumer, cost-reducing and output-enhancing potential of the network effects of four-party payment card schemes should be acknowledged. It does not follow, however, that we would accept that the manner in which these schemes are operating simply fulfils that potential and avoids anticompetitive harm. Among the critical issues is whether the setting of interchange within these schemes, as well as the methodology used and the levels of interchange applied, can meet the tests of legitimacy which competition law and policy prescribe.

6.6.2 Origins of interchange in card payment schemes

The origins of interchange are expounded in the 1984 judgment of the United States District Court, S.D. Florida, in National Bancard Corporation (NaBanco) v Visa U.S.A., Inc.365

361 Id.
363 Id, pp 690-696.
364 Id., p 697.
365 596 F.Supp. 1231; affirmed 779 F.2d 592 (11th Circuit, 1986). According to Visa, interchange was first introduced in 1974 (Second Submission, June 2007, document S, p 8.), but the account given by the court in NaBanco shows that it arose earlier.
First the bank draft, and then the cheque, had previously developed as the means by which banks’ customers could safely effect payments over long distances. About a century after the cheque gained common acceptance in the United States, the bank credit card was introduced.

The bank credit card provides many of the same services as the personal [cheque], but, in addition, provides retailers of goods and services an extra measure of protection from the risk of default.366

Describing the typical credit card transaction when it was still paper-based,367 the court said:

Once a potential consumer has opened a bank credit card account with a particular issuing bank, he or she may use that bank credit card in lieu of cash to purchase goods and services from any merchant participating in that particular bank credit card system. The merchant, after a sale, then transmits the consumer/cardholder's draft evidencing this transaction (referred to in the parlance of the industry as “paper”) to its merchant bank, this sum being immediately credited to the merchant's account minus a small charge agreed upon earlier by contract (called the “merchant discount”). If the merchant bank happens to be the same bank which issued the card, the consumer/cardholder's account in the bank will be processed “in-house” in what has been described as an “on-us” transaction. When the issuer bank differs from the merchant bank, the process becomes more complicated. First, the merchant bank sends the transactional paper to the issuer bank. The issuer bank then will either send the merchant bank the requisite sums due and owing from its cardholder, or will directly credit the merchant bank's account at the issuer bank, if the merchant bank has such an account. In either case, the issuer bank is ultimately responsible for the sums due and owing from its cardholders, and thus, absent a breach of agreed procedure by the merchant or merchant bank, the issuing bank bears the risk of default by the cardholder.

The process by which transactional paper is moved from the merchant bank to the issuer bank involves certain costs. In the system at issue here, the issuer bank withholds a small amount (called the “interchange fee”) from the monies due and owing the merchant bank to cover the costs of this processing. Even more simply stated, the merchant bank (if not the issuer of the card used in a sale) must process the paper generated by the sale to realize both the small profit hopefully provided in the merchant's discount charge to the retailer and reimbursement for the sale amount credited to the account of the retail merchant. The paper then goes to the issuer bank which reimburses the merchant bank but only after the deduction of the interchange fee.368

The plaintiff, NaBanco, was not a deposit-taking institution eligible for Visa membership. It performed processing activities similar to those performed by acquiring banks (“merchant banks” in the court’s parlance) on the latter’s behalf. Faced with having to discharge the acquirers’ burden of paying away interchange without the benefit of receiving any as an issuer, it complained that Visa’s “Issuer Reimbursement Fee (IRF)” – i.e. the scheme’s default interchange – was prohibited price fixing by Visa for its member institutions and that it was in any event set intentionally high to discourage competitors such as NaBanco.369 The claim was rejected by the court. NaBanco’s appeal failed.

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366 596 F.Supp. 1231, 1237. The debit card, which was developed subsequently, likewise provides this facility.
367 By the time of the case, however, the majority of credit card transactions were automated, “so that the banks’ and merchants’ computers actually credit each other’s computerized accounts.” 779 F.2d 592, 594.
368 596 F.Supp. 1231, 1238.
In pursuit of its claim of price-fixing, Nabanco argued that interchange was essentially a price fixed for the discounting ("factoring") of transactional paper within the scheme. On that basis, the acquirer would be seen as giving a discount to the issuer when on-selling to the latter the claim for payment against the cardholder, based upon the "paper" which it had purchased from the merchant. The court did not adopt that analysis – in our view correctly. The term "merchant discount" – although widely used – is itself liable to confuse. The merchant, when accepting a credit card and a signed slip from the cardholder in lieu of payment, does not itself extend credit to that customer. It acts rather from the outset entirely in reliance (indirectly) on the payment guarantee from the issuer to the acquirer, and (directly) from the acquirer to itself (the merchant), provided by the rules of the scheme and underwritten by the latter. Interest is charged solely by the issuer. The merchant may not add interest to the retail price, and then discount the interest-bearing paper to its acquirer. Indeed, scheme rules prevent any surcharge to the cardholder – a rule which we discuss below. At no stage in the integrated combination of transactions within the scheme does the acquirer appear to obtain a claim for payment which it could choose to assert directly against the cardholder, but which it elects to on-sell to the card-issuer instead. The artificiality of the "discounting" analysis is thus apparent. There is no sequence of truly independent discounting transactions which the scheme merely co-ordinates.

### 6.6.3 Interchange is not a price for service

Just as the nature of interchange is not well analysed by treating it as an issuer’s discount on its purchase of a payment claim from the acquirer, so too interchange is not properly to be regarded as the issuer’s price to the acquirer for a service supplied to the latter.

The European Commission noted in its 2002 decision concerning Visa:

> Visa does not consider its MIF [multilateral interchange fee] as a price for specified services provided by issuers to acquirers or merchants. Rather it considers the MIF as a transfer between undertakings that are cooperating in order to provide a joint service in a network characterised by externalities and joint demand. The MIF is, according to Visa, necessary as a financial adjustment to the imbalance between the costs associated with issuing and acquiring and the revenues received from cardholders and merchants.

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370 Even if it were accurate to see the process as one of “discounting” (which it is not), the expression “merchant discount” would be misleading: the more appropriate expression would be “acquirer’s discount”. In our view the correct expression is rather merchant service charge. As explained above, this is the charge paid by the merchant for the acquirer’s service supplied under the auspices of the card scheme.

371 **A fortiori**, this must apply in the case of debit card transactions.

372 See e.g. MasterCard, First Submission, page 47: "...[T]he system provider, such as MasterCard, ... is not a party to the payment transaction, but provides the framework of co-operation between the parties that permits the transaction to take place and, in certain circumstances guarantees the transaction."

373 Standard Bank initially submitted that interchange “is simply a price set in the market for issuer services.” (SBSA, October 2006, First Submission, p 54.) Cf also Nedbank, October 2006, First submission, Document 3, page 30. We do not consider it correct to characterise interchange as a price for services. Nor is it true that interchange is set in the market.

As the court in *NaBanco* concluded:\(^{375}\)

In the VISA “joint venture,” both issuer and merchant banks perform essential roles, and both perform necessary tasks for the benefit of each other, which must be performed if the basic payment service is to be offered.

The “services” within the scheme flow in both directions. Each participant depends upon the co-operation of the others. As Dr Koboldt put it, presenting for MasterCard at the hearing on 18 April 2007,

the notion of a payment for services provided to acquirers by issuers is meaningless and misses the point that the demand for the services of a payment [scheme] is determined by both customers, as cardholders, and merchants, and that the role of interchange is balancing that demand.\(^{376}\)

### 6.6.4 The nature of the joint venture in “open” (four-party) schemes

The true nature of interchange follows from the nature of the joint venture which a four-party card scheme entails. We accept the submissions to the effect that a four-party payment scheme is essentially a “co-operation enabling” joint venture.\(^{377}\) By virtue of the scheme, issuers and acquirers (together with the scheme owner) jointly provide interdependent services to cardholders on the one hand, and to merchants on the other.

Nevertheless the idea that there is “joint supply” and “joint demand” should not be exaggerated. Intrinsic to the operation of the four-party schemes is that there is – within and in conjunction with the co-operation enabling arrangement – a competition of independent suppliers. And in each inter-connected set of transactions, once embarked upon, there are distinct supplies.

The district court in *NaBanco* explained:\(^{378}\)

…[P]rofits and losses are not specifically shared among the various VISA members, nor is there any commingling of management functions. Furthermore, to the extent possible, each member engages as an independent unit in economic competition with other VISA members with respect to various aspects of their common venture. …

The fact that VISA members have integrated to the extent of agreeing on the terms of interchange, but have not fully integrated and still compete for cardholders and merchants, is typical of pro-competitive joint ventures and serves to maximize VISA’s competitive potential. …

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375 596 F.Supp. 1231, 1260.
376 Transcript, p 46.
377 See e.g. Von Weizsäcker, *Economic Analysis of the MIF*, 2004, MasterCard, October 2006, First Submission, Annex L. “I consider that the best way to view the relationship between the issuer and the acquirer is as co-operating members of a joint venture, since they both need to coordinate the input from the other to provide credit card payment services to their customers. On this basis the issuer and the acquirer are jointly providing a service to their customers, namely ‘enabling payment from the cardholder to the merchant’ and, as in the three-party example, there is both joint production and joint demand.” (P 4.)
And further.\textsuperscript{379}

Assuming that VISA cardholders want unplanned and rapid access to merchants anywhere, regardless of whether their own bank signed a particular merchant, and that VISA merchants want unplanned and rapid access to each cardholder who enters their shop, regardless of whether the merchant’s bank signed the cardholder, then some before-the-fact agreements must be made. The principal purpose of these agreements with member banks does not appear to be to improperly fix prices as NaBanco asserts but rather to provide a service which each member bank could not alone provide, namely, universal payments service which ensures that a VISA card will be honored by any merchant regardless of which bank issued it so long as that merchant displays the VISA logo on its door.

Although interchange is sometimes referred to as a mechanism needed in order to address a “market failure”, that might give rise to misunderstanding. The market cannot, by the independent action of the different players, bring about the co-operation for which a four-party card scheme exists. Interchange is necessary to such a joint venture. Only indirectly, therefore, can it be said to be connected with market failure.

\textbf{6.6.5 Rules to enable co-operation}

Mr Munson of MasterCard sought to explain the necessity of interchange by considering what a new four-party scheme, without any pre-existing “interchange", would have to determine in order to bring together separate issuers and acquirers in off-us transactions between cardholders and merchants. The first question a would-be issuer or acquirer would ask (so he argued) is what amount it would have to pay when settling a transaction. In respect of (say) a R500 purchase, the scheme would have to determine the amount payable by the issuer to the acquirer – the "settlement amount". This could be equal to, less than or more than the base amount of the transaction.

\ldots What is this differential between the settlement amount and the amount of the transaction which by the very nature of the business we easily see must be set. Well, frankly you can consider it just to be another definition of interchange. Interchange is a difference between the base amount of the transaction and how much the issuer pays the acquirer. If the issuer pays the acquirer the base amount [R500], that is the equivalent of a zero interchange fee. If the issuers pays the acquirer R495, that is the equivalent of [receiving] a 1 per cent interchange fee. And if he pays R450 that is the equivalent of a 10 per cent interchange fee. If he pays R505 that is the equivalent of a negative 1 per cent interchange fee and if he pays R550 that is the equivalent of a negative 10 per cent interchange fee.

So even without intending to set interchange fees, given that the issuer and the acquirer have to know what is their financial responsibility to the other side of the business, or what is the benefit there are going to receive from the other side of the business, we have to set this differential and frankly by definition, this differential is nothing more or less than the interchange fee.

There is no escaping this, it must be set, and if you say to issuers and acquirers nobody is going to set your interchange fee they would not participate in your business. \ldots After having \ldots understood it and decided that you are going to set this settlement differential, you have to ask yourself, what am I going to set it at? Am I going to set it at R495, R450, R505, R550, where do I set it?

\textsuperscript{379} 596 F.Supp. 1231, 1254.
In order to set that fee, first of all you are going to have to know something about the nature of the business. You are going to have to know things like, are you going to have a payment guarantee for merchants? How soon are merchants going to get paid, is it going to be immediate settlement with the merchants or is it going to be a delayed settlement? What are the benefits to the cardholder, what benefits [is] the cardholder going to get? Will the cardholder get an interest-free period? These things have to be established and have to be understood because they in fact are going to impact the initial allocation of costs as between the issuer and the acquirer. How much money it is going to cost the acquirer to participate in the system is going to depend on some things like, who has the risk for credit losses and fraud losses. Is there an interest-free period and a myriad of other things.

So the first thing you have to take into account is the initial allocation of the cost of the system on both the issuing and acquiring side. Moreover you have to also ask yourself, having set that fee at R495 or R450 or R505 or R550, is that proposition for the issuer, a viable proposition? Will the issuer be able to offer these products and services at prices that cardholders will be willing to pay, and will the acquirer be able to offer its services to merchants at prices that the merchant will be willing to pay?

Perhaps if you set the settlement differential at R550 as opposed to R500, perhaps it will be too expensive and cardholders would not want to use those cards and perhaps if you set it at R450 on the other side, merchants will not want to use the cards. So in setting this fee you are going to have to take into account the demand conditions that the issuer faces on its side of the business and that the acquirer faces on its side of the business.

So even though it was not your initial intention to balance demand you are in fact going to have to look at exactly the same kind of facts and circumstances. ... [A]t the end of the day you are going to engage in the very same decision-making process as if you started up intending to balance demand. So where does that leave us?

I would propose that even if you do not want to call this thing interchange, you still need to make a determination as to what is the obligation of the issuer to the acquirer and in effect you will have to set something that makes it very much like an interchange fee, and I would suggest further that even though it is not your intention to balance demand, if you are going to set this differential at a level that gives you a viable business and of course for your shareholders, you will want to grow this business as large as possible. ...

[Y]ou do not need to believe that an interchange fee is necessary because in fact it is absolutely incontrovertible if there needs to be some decision taken as to the relative obligations and benefits of the issuer and acquirer and whatever you call it, it is comparable to interchange, and even if you do not believe that we are about balancing demand, when you see what we do you will realize that we have to engage in the very same process that some of you claim to be balancing demand would have to engage in.  

The trouble with presenting the argument in this way is that it obscures a key analytical component which ought to be kept distinct, and so begs a question. A four-party scheme, in order to function, would indeed have to impose rules upon its issuing and acquiring participants regarding their respective rights and obligations in many respects – notable examples being the incidence of liability where fraud occurs, and the time for settlement. With obligations and risks come costs. Therefore rules determining the incidence of particular obligations and risks within the scheme also determine the incidence of costs. It does not necessarily follow from this, however, that the scheme needs to be able to determine a “settlement amount” that is greater or less than the cardholder’s payment obligation to the merchant (the basic transaction amount).

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Chapter 6 Payment Cards and Interchange

The assertion of the need to do so turns out to rest upon the unspoken assumption of an imbalance in the incidence of costs which the issuing and acquiring participants cannot be expected to recover simply by their own direct charges to cardholder and merchant respectively. This is the key element that has to be demonstrated in any analysis. If there were no need to achieve balance by a redistribution of revenue or a reallocation of costs between acquirer and issuer, there would be no need in fact either for “interchange” or for a variable “settlement amount.”

The case for interchange in four-party schemes, in order to be analytically rigorous, has to be based directly on the inherent need for a balancing payment between acquirers and issuers in circumstances where, without this payment, one or the other would in the ordinary course prove unable to meet its costs from its own direct revenues and make a normal profit.

6.6.6 Revenue allocation in a two-sided market

The case for the necessity of interchange rests essentially on analysing the four-party card payment model as an instance of a “two-sided” market. A number of participants in the Enquiry submitted helpful explanations of two-sided market theory.

Absa, for example, stated:

Two-sided markets are those markets in which businesses need to attract two distinct groups of customers in order for either set of customers to be willing to participate in the market. There are a number of different examples of such markets of which two are:

- Shopping malls (retailers and shoppers).
- Yellow pages or newspapers (readers and advertisers).

What is important to recognise about each of these markets is that the demand by one side of the market will be affected by the number of customers on the other side of the market. That is, the markets are characterised by “indirect network effects”. Network effects arise where the value of being part of the network varies depending on the size of the network. Typically they arise where the value of being part of the network increases as the size of the network increases. The “indirect” label indicates that value of being part of the network increases as the size of the “other side” of the market increases. For example:

- Shoppers prefer a shopping mall with more retail outlets and retailers prefer a
shopping mall with more customers.

- Both readers and advertisers prefer a newspaper with higher circulation: readers because then they can discuss the editorials with colleagues (direct network effects); and advertisers because then their advertisements are seen by more readers.

...[I]f prices on one side of the market are set only with reference to the customers on that side, and not with reference to the customers on the other side of the market, the overall market will be inefficiently small because the benefits from the first side that accrue to the second side are not taken into account.

Prices need to be set according to the overall market rather than to the two individual sides in isolation. The consequence of this is that prices are not necessarily symmetric and that the prices on one side of the market are not necessarily related to the costs incurred on that side of the market. Again, a series of examples from other markets makes this clear:

- Shopping mall owners might charge retailers for the cost of parking facilities (through their rent) rather than charging customers for parking so as to encourage lots of customers to come to the mall.

- Yellow pages or free newspapers are offered to readers at zero price while those who advertise in them have to pay. (Those who advertise are willing to pay to do so because they gain access to the readers and there are more readers when the price that readers face is zero.)

In each of these cases it is clear that the prices faced on one side of the market will not simply be determined by the cost incurred on that side of the market but rather the price will be determined taking into account the effects on both sides of the market.

In many of these cases, there is one provider who serves both sides of the market. For example, the newspaper owner can assess the relative values to readers and advertisers and decide upon the price to charge each side including whether there should be a subsidy or transfer from one ‘market’ to another.

*Payment cards as a two-sided market*

In the case of payment cards, the two sides of the market are represented by cardholders and merchants. The more merchants which accept a particular type of payment card, the more valuable it is to cardholders and the more cardholders that use a particular type of payment card, the more merchants will want to accept it.

The availability of debit and credit cards benefits consumers and merchants alike. If credit cards involve an interest-free period, credit cards provide cardholders with more flexibility to structure their repayments and thus enable them to make larger purchases from accepting merchants than would otherwise have been the case. Merchants also gain substantial benefits from the payment guarantee in respect of cardholders who take advantage of extended credit. They can sell goods to consumers who may not have funds in their current accounts (hence would be unable to pay with their debit cards), but without taking on the risk that these consumers would be unable to pay. This risk is taken by the credit card issuing bank. … Merchants rank the payment guarantee as one of the most beneficial aspects of accepting credit cards.

As in any two-sided market, there is a problem of allocating the costs of a card system across the two sides of the market (cardholders and merchants), to get the balance right in order to maximise the combined value to both sides. This is a problem faced by the three-party or proprietary schemes such as American Express and Diners International, but these schemes are free to decide how to set prices on either side of the market. In a four-party card system, the interchange fee is the tool that allows costs to be shifted from one side to the other, in order to get the right balance to maximise the combined value of the system to both sides.
Interchange fees of this type result in lower cardholder fees (and/or greater cardholder benefits) on the issuing side. Lowering cardholder fees and/or increasing cardholder benefits will increase the number of cardholders and the use of payment cards; the benefits to merchants from these effects can outweigh the effects of higher merchant service charges.

Although this explanation refers to the “shifting” of costs from one side to the other, what is in fact shifted by means of interchange is revenue. The costs stay where they arise or are allocated by specific rules of the scheme. Having regard to the revenues which participants on each side are able to raise by pricing to their own customers, the transfer of revenue from one side to the other by way of uniform interchange produces in effect an adjustment of average net costs – or rather of average net profit – between them.

Crucially, interchange has the purpose of affecting prices charged to end users on the acquiring and the issuing sides of the two-sided market, and thus to bring into balance the two separate supplies and the two separate demands. In this way, “optimal” output of the “joint product” of the scheme is sought to be attained.

There is “strict complementarity” of demand in a card scheme – i.e. two demands always have to be matched. It follows that the lower of the two demands always determines the maximum output of the scheme. Thus if, for example, customers in aggregate wish to use a scheme’s cards for purchases amounting to R200m in value, while merchants are willing to accept that payment method for only R100m worth, the actual usage of the cards is restricted to the latter quantum. If, on the other hand, merchants’ aggregate demand is higher than that of cardholders, it is again the lower demand which will govern usage and scheme output.

Because of the disparity in the demand of the end users, interchange – in order to be effective – will have to operate so as to place more of the burden on the less elastic side of the market. It appears that the bulk of the costs of a card scheme fall on the issuing

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384 “Interchange transfers revenues so that both issuing and acquiring are competitive businesses with incentive to attract more cardholders and merchants.” (Visa, June 2007, Second Submission, document B (third part), p 18.) “The role of the interchange fee in a four-party system is to allocate revenues between acquirers and issuers.” (Von Weizsäcker, op. cit., p 2.)

385 MasterCard explains the purpose of the interchange as “a transfer of revenue, an allocation of costs and a balancing of demand between the issuer and acquirer…” in the interest of achieving “optimal service delivery… to merchants and cardholders”. (MasterCard, October 2006, First Submission, p 7.) Dr Koboldt said: “Interchange is clearly affected by how costs are initially distributed between issuers and acquirers, but it is not linked to costs of services provided by issuers to acquirers.” (Transcript 18 April 2007, p 55.)

386 “[M]any businesses operating in two-sided markets charge prices that result in earning profits disproportionately from one side. Adobe for example gives away the Acrobat software for reading and charges for the Acrobat software that does the writing. Presumably, this maximizes deployment of the reading software, creating greater utility for those that create documents; which, in turn, results in more documents being created that can be read with the software, creating greater value for readers, etc. It is not a matter of fairness or cost recovery, but of maximizing output for the benefit of all participants – if each side in a two-sided market were restricted to pricing based on the direct marginal cost of providing the service, or inversely based on elasticity of demand on that side, the overall product usage would not be optimized and all participants would receive less value, or the product might not succeed at all. As a consequence social welfare also would be sub-optimal.” (Visa, June 2007, Second Submission, document R.)

387 See Transcript 18 April 2007, pp 47-48 (Dr Koboldt).

388 See e.g. Rochet and Tirole, 2001, The Economic analysis of the interchange fee in payment card systems. The optimal
At the same time, experience has identified the merchant as having a less elastic (i.e. a less fickle) demand, and thus being willing to bear a greater price burden – and so make a greater contribution to the covering of total costs – than the cardholder. Interchange serves indirectly, but nonetheless effectively, to regulate the distribution of the total price burden of the scheme between the two. This is one of the reasons why the schemes introduced their “no surcharge” rules: in order to prevent merchants in the scheme from reallocating their allotted part of the price burden over to the card user.

Dr Koboldt, drawing on a seminal 1983 analysis by Baxter, provided the diagram which is reproduced below. It illustrates at an abstract theoretical level how the maximum number of transactions in a card scheme is achieved by adjusting the prices charged to merchants and cardholders respectively according to their respective demand elasticities, within overall parameters determined by the point at which aggregate scheme costs intersect aggregate demand. Interchange in a four-party scheme, by transferring revenue from the suppliers on the one side to the suppliers on the other is intended to place each in a position to price its supply to the end user at a level which achieves the optimum balance and thus maximises total scheme output.

price structure in the system is determined by the transfer payment required between the suppliers in order to sustain the provision and demand for the service. The price structure thus refers to the division or distribution of the total costs and total revenues in the market. See Roson, 2005, *Two-sided Markets: A Tentative Survey. Review of Network Economics, Vol.4, Issue 2.*

In the *NaBanco* case the district court, after a trial of more than nine weeks, accepted that “up to 88% of total system costs” fell at that time on issuers. (596 F.Supp. 1231, 1260.) See also footnote 393 below. We do not have independent evidence of the current cost distribution in South Africa or anywhere else, and we do not accept that all the costs which are conventionally treated as issuing costs are truly integral or necessary to the functioning of a card scheme as a payment system (see further below). Nevertheless, the point seems uncontroversial at a general level. Wherever interchange operates in the card payment environment, it flows from acquirers to issuers.


"[F]rom the point of view of the four-party system, there is an optimal level of charges (which follows from an optimum level of interchange fee) which is business volume maximising." (Von Weizsäcker, op. cit., p 2.)
In the next part of this chapter we examine some limitations of the analysis presented in this model. For the moment, suffice it to say that it does demonstrate the inter-connected nature of the supplies and demands that come together in card payment schemes, and that the pricing on the two sides needs in principle to be capable of being adjusted so that both the supplies and the demands are effectively matched.

We accept that this matching cannot reliably be achieved by market forces operating independently on the two sides so as to render interchange unnecessary. The argument for leaving it to market forces alone would be that, if acquirers were simply left to recover their costs from merchants, and issuers their costs from cardholders, any resulting imbalance as between demand for card usage on the one hand and card acceptance on the other hand could be overcome by merchants either giving a discount, or charging a premium, to customers using cards. However, as Dr Koboldt observed,

... this requires that the merchant can differentiate those prices without great problems. Now in practice we observe that merchants do not differentiate prices. They do not surcharge widely, even where they are allowed to. They do not offer cash discounts even though they are allowed to, and that is to do with the fact that given the difference in the cost and benefits of accepting different forms of payment, it is simply not worth their while to do that.

In other words, it would require a considerable difference in the advantage or disadvantage to merchants in accepting a payment by card in order to trigger the mooted balancing
mechanism via the market. The dependence on such a considerable difference means that the needed balancing would not effectively be attained at all.

This point is reinforced (we would add\textsuperscript{392}) when – assuming the absence of interchange, and therefore the full cost burden of card issuing being passed directly to the cardholder – it is taken into account that cost differentials as between cards and cash may be relatively small for the merchant and relatively large for the cardholder.\textsuperscript{393} Thus the merchant might well be indifferent to the customer’s choice of payment medium, and so be unwilling to differentiate in price, while the cardholder might need to be offered a substantially lower price by the merchant in order to be willing to bear the added cost of using the card instead of cash. Therefore the market mechanism, operating purely on the outer ends of the two-sided market, would not in principle suffice to achieve the balance necessary for the viability of the scheme.

Absa testified:

Our economists tell us that it would be pure coincidence if the best allocation of cost for the system as a whole was one in which acquirers covered their costs ... only through merchants' service charges and issuers covered the full amount of their costs through cardholders' fees. \textsuperscript{394}

Dr Koboldt put the matter this way:

[It] would be pure co-incidence, it would be a fluke, if the ... initial allocation of issuer costs and acquirer costs would exactly correspond to the optimal structure of prices, and if it does not, you have a problem. \textsuperscript{395}

In a three-party scheme, as we have seen, the scheme owner (being both issuer and acquirer) can simply adjust the pricing on the two sides itself. In the case of an “open” or four-party scheme, however, the existence of a mechanism for revenue transfer – i.e. interchange – is in principle necessary in order to achieve the pricing adjustments. \textsuperscript{396}

In \textit{NaBanco}, in the USA, the court concluded that agreement on Visa’s interchange fee (referred to as the “Issuer’s Reimbursement Fee”, or IRF) was necessary for the scheme to market its product and be an effective competitor. \textsuperscript{397} It was

... necessary to achieve stability and thus universality; that to require exchange at par or

\textsuperscript{392} However, cf also Dr Koboldt, Transcript 18 April 2007, pp 62-63.

\textsuperscript{393} It has been suggested that issuing costs may make up as much as 95\% of total costs (before interchange), so that if they had to be fully recovered directly from cardholders this would make cards much more expensive for cardholders to use. See Transcript 18 April 2007, pp 90-92.

\textsuperscript{394} Transcript 17 April 2007, pp 69-70.

\textsuperscript{395} Transcript 18 April 2007, p 54.


\textsuperscript{397} 596 F.Supp. 1231, 1253. Visa, June 2007, Second Submission, document B (third part) p 3: “Properly we mean ‘Interchange reimbursement fees’ when we use the term ‘Interchange.’”
remove the fee to permit negotiations for interchange charges among issuer and merchant banks would result in loss of competitiveness and chaos with the eventual destruction of the enterprise.\(^{398}\)

During the present Enquiry, the view that interchange is necessary in the four-party card payment environment was confirmed in much testimony. Nedbank, for example, stated that while "in the ATM world one can see that direct charging appears to be a technically feasible alternative to interchange," interchange is essential as a balancing mechanism to ensure interoperability in the four-party payment card market generally.\(^{399}\) Standard Bank was of the same view.\(^{400}\)

According to the latter, not only would the elimination of interchange dramatically reduce cardholder demand and card usage in general and threaten the existence of the more desirable open schemes;\(^{401}\) the cost would become prohibitive for many debit card carriers.\(^{402}\)

MRS NYASULU: … We know for a fact that in the micro-lending environment, consumers have always been aware that they were charged much more than the average South Africans, but the Hobson’s choice comes in not having another choice. The question I am having is, are we assuming then that despite the crime, despite their knowledge of the charges, consumers would still decide not to go for payment cards?

MR FERGUS: I would say that many of them in the debit card environment, particularly, would not be able to afford the charges that would be allied to transactions and would then migrate to cash.\(^{403}\)

FNB likewise confirmed the necessity of interchange, saying that without it “we would not have had this interoperable system that we have in front of us today.”\(^{404}\)

While other mechanisms could theoretically be devised to achieve balance,\(^{405}\) no practical alternative was advanced which could function effectively in a truly open scheme.\(^{406}\)

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398 596 F.Supp. 1231, 1263.
400 “There is a fundamental difference between a three-party scheme and a four-party scheme. An open scheme demands an exchange of value between the participants, and a closed scheme, Diners or AmEx, is non-dependent in the same way.” (Mr Fergus, Transcript 19 April 2007, p 81.)
401 Standard Bank, Exhibit OO, slide 6.
402 Transcript 19 April 2007, p 99. “[I]t is obvious that a broader share of the population have debit cards than have a credit card, and many of those users would not be prepared to pay fees that would become necessary to fund the system if interchange was eliminated and the cost was moved solely to the cardholder, to one side of the value chain.” (Mr Fergus.)
403 Id., p 100. This particular testimony, however, while arguing for the necessity of interchange, could be taken to imply that current charges levied on cardholders for debit card transactions are themselves necessary. That is something we are unwilling to accept without clear proof, on the mere say-so of interested parties. Moreover, Standard Bank itself indicated that in view of increased scale efficiencies since 2002, a downward revision of interchange is probably warranted. (SBSA, First Submission, October 2006, p 60.)
404 Transcript 19 April 2007, p 112 (Mr Jordaan).
406 For example, an adjustment of cost allocations by the schemes would not seem to provide a satisfactory alternative.
Standard Bank defended interchange as “the most effective method of dealing with the complex relationships involved in four-party card systems.”\textsuperscript{407} This is in all probability correct.

It also seems clear that, in principle at least, the need for an interchange mechanism in the four-party payment card environment is not ended when the market becomes “mature” – when, in other words, just about everybody has cards and just about every merchant accepts cards. The widespread issuing of cards does not guarantee that cardholders will continue to use them. Likewise, the widespread acceptance of cards would not automatically be sustained. The market remains two-sided. There remains a need for revenue to be reallocated – or at least the possibility for it to be reallocated – so as to overcome disproportions in the incidence of costs, relative to the demand elasticities and pricing, on the two sides. Only in this way could the necessary matching of the two supplies and the two demands be reliably continued.\textsuperscript{408}

6.6.7 Default, multilateral and bilateral setting of interchange

We accept that – at least in the absence of regulated compulsory rates – it would not be possible to sustain a four-party payment scheme on a viable scale without being able to provide default rates of interchange for the settlement of transactions between acquirers and issuers within the system that would apply where there is no agreement.\textsuperscript{409}

This is the only way in which new participants could join without having to negotiate separate agreements with every other participant (of which there are today tens of thousands), and existing participants continue without renegotiations with all the others from time to time. It hardly needs stating that this would be utterly impractical and absurd.

Where interchange is set by agreement, the agreements are usually multilateral, applying a uniform rate to domestic card transactions of the same type, with default rates applying in international (including intra- or inter-regional) card transactions. Often, bilateral agreements between participants are permitted in place of the multilateral or default rates.

\begin{flushright}
\begin{itemize}
\item SBSA, October 2006, First Submission, p 55.
\item See Transcript 18 April 2007, pp 204-210; also Transcript 19 April 2007, p 105. FNB pointed out that the demand imbalances are different, depending on the immaturity or maturity of the market, but that even when the market matures there will still be (cost and) demand imbalances. (Transcript 19 April 2007, p 116.) See also Nedbank, March 2007, Second Submission, Access and Interoperability, pp 43-45; Absa, March 2007, Second Submission, Access and Interoperability, p 15.
\item Cf Visa, June 2007, Second Submission, document B (third part) p 17; document L p 1.
\item MasterCard, October 2006, First Submission, p 7.
\end{itemize}
\end{flushright}
SARPIF, representing the large retailers, argued for bilateral agreements on the grounds that by its very nature a uniform interchange rate between the banks is anti-competitive. “Banks that are more efficient should be able to offer lower rates to merchants and customers.” Plausible as it may seem, this approach to the setting of interchange levels between banks does not adequately comprehend the competitive dynamics that are involved. Indeed, in our view, it rests ultimately not upon the public interest but upon the self-interest of large merchants who would expect to gain an extra trading advantage over the small by having more scope to assert their countervailing power when negotiating merchant service charges with the big banks. We consider that the power of the banks in relation to interchange needs to be addressed in a different way in order truly to protect the consumer.

In March 2006 FEASibility reported to the Competition Commission that in general both the large banks and the smaller banks already in the system argued that interchange fees should be set on a multilateral basis. This has been amply confirmed during the Enquiry.

Absa argued cogently that a multilateral process for setting interchange fees has a number of definite advantages over bilateral agreements.

A reduction in transaction costs – Arrangements need to be in place between all acquirers and issuers. The number of arrangements that need to be agreed (together with associated costs) would increase exponentially as the number of issuers and acquirers increases. For example, the experience in relation to the recent negotiation of the AEDO / NAEDO agreements demonstrated the inefficiencies associated with bilateral agreements as these negotiations necessitated the individual negotiation of in excess of 72 individual agreements.

A reduction in barriers to entry – Because of these transaction costs, a system of bilateral arrangements would be likely to be a barrier to entry to new small players. Indeed, the FEASibility report notes that the burden of such negotiations would be particularly great on small players as they typically only have one payment system official rather than a fully staffed department. A multilaterally determined interchange fee removes the need for these additional transactions costs to be incurred.

A reduction in difficulties for small players with lower bargaining power – Setting interchange fees on a multilateral basis means that all players face the same conditions irrespective of their market strength or bargaining power. Setting interchange fees on the basis of bilateral agreements will inevitably mean that those firms that have bargaining power will negotiate better deals than firms that do not have bargaining power.

A reduction in time to market for new entrants – Where interchange fees are set on a bilateral basis and small firms do not have bargaining power, the negotiation process of agreeing the interchange fees may prevent new entry. This would not be a deliberate decision but an inevitable consequence of the time and resource constraints imposed by the need to make hundreds of bilateral agreements across all of the payment systems. From Absa’s perspective

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411 As at 06 January 2007, according to information submitted by SARPIF, its members were BP (with 600 retail outlets), Caltex (1,100), Clicks (665), Edcon (998), Foschini (1,300), Massmart (706), Metro (495), Mica (SuperGroup) (186), Pick ‘n Pay (576), Shoprite Checkers (850), Spar (1,250) and Woolworths (275).


413 The National Payment System and Competition in the Banking Sector, p 30. See also p 174: “In general, smaller players indicated support for the multilateral approach, especially if it could be based on some fair evaluation of costs. The big banks also favoured this approach for practical reasons.”

Promotes efficiency – depending on the methodology used to calculate the multilateral interbank fee (for example costs only captured from the most efficient banks)\(^\text{415}\) it may promote less efficient banks to become more efficient.

Standard Bank argued on similar lines that, where interchange is bilaterally negotiated, this allows greater scope for “the undue negotiating power of the large volume players”. On the other hand, a multilateral approach –

... is a “small volume” and “new bank” friendly model in that an average industry price is set which incentivises players with economies of scale without excessively penalising small volume banks, thereby maintaining interoperability and promoting competition.\(^\text{416}\) …

In the case of card interchange, a bilaterally determined interchange level runs the risk of discouraging new entrants and/or small players, for at least two reasons. Firstly, there is the likelihood that the differences in volumes will result in small banks having to pay higher interchange than the larger banks and discourage new issuers from entering the market.\(^\text{417}\) Secondly, the complexity and large number of negotiations required would pose a significant barrier to entry into the card market. In a single interchange model, small players effectively enjoy the benefits of the negotiating power of the larger players, and new entrants can enter the market without having to engage in a wide range of costly and time-consuming bilateral negotiations.\(^\text{418}\)

Standard Bank also submitted that a multilateral implementation of interchange is “the only workable approach”.\(^\text{419}\) Bilateral arrangements are “a very complicated and ineffective way of reaching agreements,” says Absa’s Mr Volker.\(^\text{420}\) In Nedbank’s view, a bilateral fee-setting process in which every issuer and every acquirer agrees the principle/scope and the level of the interchange fee on a separate basis with every other issuer and acquirer “is not feasible for maintaining the necessary balance within payment systems.”\(^\text{421}\) In the view of FNB, “bilateral negotiations of interchange fees are not sustainable.”\(^\text{422}\)

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\(^{415}\) For reasons dealt with below, we consider that an interchange methodology which takes into account average costs is more likely to promote competitive efficiencies.

\(^{416}\) SBSA, October 2006, First Submission, p 20. FNB agrees that bilateral processes “can threaten the interoperability of the payments system.” FRB, October 2006, First Submission, p 70.

\(^{417}\) Cf also FRB, October 2006, First Submission, p 70: “In its UK inquiry the Office of Fair Trading accepted that MasterCard’s multilateral interchange arrangements are preferable to bilateral arrangements as they increased the ease, and reduced the costs, of entry into the MasterCard scheme’ and ‘reduced transactions costs as compared to a situation where every acquirer and issuer had [to] come to agreements on interchange fees bilaterally’ (Investigation of the multilateral interchange fees provided for in the UK domestic rules of MasterCard UK Members Forum Ltd, Companion Paper to the decision, 6 October 2005.”

\(^{418}\) SBSA, \textit{id.}, p 62.

\(^{419}\) \textit{id.}, p 59.

\(^{420}\) Transcript 17 April, p 141.

\(^{421}\) Nedbank, March 2007, Second Submission, Access and Interoperability, p 63, read with p 60.

\(^{422}\) FRB, October 2006, First Submission, p 69.
MasterCard agreed:

Bilateral interchange fee setting has onerous time and cost considerations. It is, from a practical perspective, virtually impossible for each bank in South Africa to enter into bilateral negotiations and reach agreement with every other bank in the country in order to set the applicable interchange fee.\(^{423}\)

The flexibility of the four-party model and its ability to develop across national boundaries depends precisely on participating issuers and acquirers not having to negotiate and agree terms directly with each other. And if only bilateral agreements on interchange were to be permissible, then what would justify the myriad other terms and conditions essential to the viability of these schemes being set on a uniform basis?

Standard Bank observed:

Given technological advances and scale efficiencies that have accrued since 2002, we would expect that a revised calculation would recommend a further downwards revision of card interchange. Banks however face the dilemma that the co-ordinated effort required to conduct a revised study may be viewed as a contravention of the Competition Act, and so the industry has been reluctant to do the study on a joint basis, even though it may lead to a reduction in card interchange.\(^{424}\)

However, that view was evidently based on an interpretation of section 4(1)(b) of the Competition Act that was not endorsed by the Supreme Court of Appeal in *American Natural Soda Ash Corporation and another v Competition Commission and others* 2005 (6) SA 158, decided in May 2005. In light of that judgment, if the multilateral setting of interchange within a four-party scheme is reasonably necessary for the viability of the joint venture, then in our view it should be regarded as legitimate.

We have concluded that interchange is indeed necessary and legitimate, at least in principle. Likewise necessary and legitimate in principle would be a multilateral process designed to arrive rationally at the levels of interchange reasonably necessary for effective functioning of the scheme.\(^{425}\)

But is our conclusion regarding the necessity of interchange in principle sustainable in view of the fact that payment card systems evidently operate successfully in some countries without interchange, and the fact that banks have been making profits on card issuing in South Africa even without taking into account interchange receipts?

### 6.6.8 The absence of interchange in some countries

The EU Interim report on payment cards stated that “POS interchange fee arrangements between banks in open payment card systems are not an intrinsic feature of these

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\(^{423}\) MasterCard, October 2006, First Submission, p 8. See also pp 101-102.

\(^{424}\) SBSA, October 2006, First Submission, p 60.

\(^{425}\) We deal in due course with the question of appropriate methodology for such a process.
The report referred to four countries which do not have any interchange fees for debit card POS transactions – the Netherlands, Denmark, Finland and Luxembourg. The European Commission, in its December 2007 decision concerning MasterCard, also mentions Norway in this regard, arguing that “today the highest card usage per capita exists precisely in those EEA Member States where card schemes operated without a MIF for decades (Norway, Finland and Denmark).”

The contention therefore is that interchange is not in fact necessary for the successful operation of “open” or four-party payment card schemes. If this were true as a general statement, then it would refute the conclusion reached in the NaBanco decision in the United States and would warrant a full formal investigation by the South African Competition Commission into whether existing default or other multilateral interchange arrangements between issuing and acquiring banks contravene section 4(1)(b) or alternatively section 4(1)(a) of the Competition Act.

On closer examination, however, it appears that the absence of interchange fees in the European domestic debit card schemes referred to can be explained by unique acquiring arrangements set up historically in each country, whereby revenues raised on the acquiring side are nevertheless able to be applied to support card issuing. While it is beyond the scope and resources of the present Enquiry to delve fully into the facts concerning the operation of card schemes in those countries, the information made available to us or gleaned from public sources does indicate that the general case for the necessity of interchange (and thus its legitimacy in principle) in open card schemes is robust enough to survive the examples given.

In Finland the Pankkikortti debit card scheme provides a card that is uniquely co-branded with an international credit card logo, such as Visa or MasterCard. This allows cardholders to choose whether to use the Pankkikortti debit card function or the branded credit card function.
function when making a purchase. Issuing banks are required by law to operate as acquirers for the Pankkikortti debit card scheme. So far as the credit card aspect is concerned, there is only one acquirer in Finland, namely Louttokunta, which pays a commission to the issuing bank for every co-branded card issued. Thus the issuing banks receive a share of acquiring revenue, and at the same time the issuing of Pankkikortti cards is subsidised. Thus the Pankkikortti example does not provide persuasive support for the argument that truly open four-party schemes can develop commercially without interchange or an effective equivalent.\footnote{432}

In Denmark, the Dankort debit card system was developed by the banks in a joint venture.\footnote{433} The majority of Dankort cards are co-branded with Visa, enabling them to be used outside Denmark.\footnote{434} Historically Dankort has been based on a single acquiring institution, namely Payments Business Services (PBS) which was set up by the Danish banks. Via PBS (subsequently converted into PBS Holding A/S), the banks own Dankort. In addition to being the sole acquirer for the Dankort system, PBS is the main acquirer for the international card brands. The fact that the issuing banks own PBS and Dankort would enable acquiring revenue to flow by way of profits to the issuing side.\footnote{435} However, according to MasterCard, Dankort operates at a loss because regulation has unduly limited the amount of the merchants’ annual subscription (there being no transaction-based merchants’ service charge).\footnote{436} In the view of MasterCard the Dankort scheme is not sustainable commercially and survives as a national debit card scheme by virtue of regulatory pressure on the banks. While we are not in a position to comment on this evaluation, it does seem clear that it would be unsound to rely on the Danish case as disproving the need for an interchange mechanism in commercially viable open, i.e. four-party, schemes.

Norway is a world leader in the use of payment cards. In 2006, more than 200 transactions per Norwegian were conducted using payment cards issued in that country.\footnote{437} Norway is also notable for its early and widespread preference for debit cards. Debit cards are used for around 94 per cent of transactions concerning cash withdrawals and POS purchases.\footnote{438}
How did this come about? The development of the card payment system, together with the coordination of issuing and acquiring, was evidently highly centralised from the outset. Oil companies were the first to introduce payment cards. The first bank-operated card payment project took place in 1983/84, after the Norwegian Banking Association had entered into framework agreements with oil companies on the use of banks’ cards (ATM cards) in the oil companies’ terminals.439 The Norwegian Savings Banks Association also entered the picture. In 1986, the banking associations and the retailer organisations entered into an agreement of intent concerning the installation of point-of-sale terminals in shops, leading to signed agreement in 1987.440 Norges Bank engaged actively in the work to increase coordination.441

In 1990 the banking associations established a single domestic debit card scheme under the name “BankAxept”. According to Norges Bank, “BankAxept is the Norwegian debit card solution.”442

5.5 million BankAxept cards have been issued .... These are often combined with international cards with a debit function, often Visa. A total of 4.6 million BankAxept cards in Norway have a debit function linked to an international card system. A VISA part and a BankAxept part of a card may be regarded as two functions. Therefore, the number of functions … will be higher than the physical number of debit cards.443

Today, BankAxept is run by BBS,444 which is the Norwegian banks’ payment clearing house, and is a joint venture, wholly owned by the savings and commercial banks.445 All cards in the BankAxept system operate on-line to the issuer.

There is no explicit interchange, the system being based on direct pricing to cover costs on the issuing and acquiring sides.446 Card users in Norway have evidently been prepared to shoulder the issuing costs, despite the alternatives of cash and cheques. Crucial in this regard has been the planned and centralised nature of the system.

Extensive integration as a result of the merging of previously separate card networks, and

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439 Enge and Owre, op. cit., p 167.
440 Id., p 167.
441 Id.
443 Id., 2006, p 14. About 3.5 million cards with credit functions are registered in Norway. (Id.) Their usage, however, is obviously very limited by comparison with debit cards.
444 Bankenes BetalingsSentral AS.
445 The shares provide equal rights to dividends. The company’s after-tax results for 2006 show a surplus of NOK 80.7 million. It is proposed to allocate NOK 66 million to dividends. BBS, Annual Report, 2005, p 24.
446 See Enge and Owre, op. cit., p 169. A deliberate decision was made not to have merchants subsidise cardholders. “Cost surveys carried out by Norges Bank in 1994 and 2001 showed that a substantial share of the total costs associated with the BankAxept system have been covered through prices charged to consumers. In most other countries, the bulk of the costs associated with card systems is borne by merchants.” See also ESA – Response case 52824 – ESA retail banking sector enquiry - card payments. Available at Norwegian Financial Services Association (FNH): www.fnh.no.
expansion of the range of services to include cash withdrawal have paved the way for economies of scale and network economies in the card payment system. Norges Bank regards this coordination as the deciding factor behind the high use of cards in Norway.447

Nevertheless:

In order to encourage the use of services in a two-sided market, banks may choose to charge one side of the market less than its share of actual costs would imply. This may be used strategically, and the pricing may be varied over time in order to achieve growth in the side of the market that is most important for the further growth of the network. The appropriate price structure in the years ahead will therefore depend on the price sensitivity of the various services offered by banks, and what is regarded as most important for further growth in the use of cards.448

It thus appears that the Norwegian success was not brought about simply or even essentially by market forces, but that market realities may nevertheless in future lead to revenue transfers within the system in order to cater for cost and demand imbalances on the two sides of the market. The Norwegian example, instructive though it is, would therefore not seem to refute the case in principle for the existence of an interchange mechanism in a truly open four-party scheme.

In the Netherlands, the debit card system named PIN, together with electronic purses (named Chipknip) and credit cards are the electronic payment instruments most generally used. Consumers are, as a general rule, not charged for POS transactions, and direct charging is limited to annual contributions for the possession of a debit card. Merchants, however, charge a small fee (a surcharge) for small debit card transactions. The only national payments facility, Interpay, owned by the eight major banks that are both shareholders and customers, offers virtually all payment processing services. Interpay’s primary function is processing customer transfer orders and computing the resulting interbank positions (clearing). It also switches, authorizes and processes all debit card transactions.449

The CEO of Interpay has explained that, while interchange fees for Interpay’s debit card transactions were set at zero, the shareholder banks were paid yearly dividends from Interpay, based on the number of debit card transactions undertaken by them annually, to reimburse them for their authorization costs – i.e. as if interchange fees were paid to them as issuers. Interpay in turn charged merchants for the acquiring services, taking into account the costs incurred by issuers.450

447 Enge and Owre, op. cit., p 168.
448 Enge and Owre, op. cit., p 170.
449 Roundtable on Competition and efficient usage of payment cards, The Netherlands, 6 June 2006.
450 “Interchange on debit and credit cards – What role do authorities play?” Kansas City conference, 2006. Interpay was the sole acquirer of merchants for the acceptance of PIN. From March 2004, Interpay’s contracts with merchants have been transferred to the banks. Banks have requested an exemption from the Dutch competition authorities with respect to the introduction of a multilateral interchange fee. It is not known whether it has been approved. In 2005 Interpay transferred the ownership of the payments products, PIN and Chipknip, to a new company called Currence, owned by the same eight banks. Since its establishment, banks must obtain a license from Currence in order to issue and acquire collective payments products. Currence is the sole institution in the Netherlands that can grant access to new
Thus, once again, the example of the Netherlands would not seem to support the view that interchange would be unnecessary for the commercial development and functioning of an open four-party scheme.

In Luxembourg the local debit card scheme, Bancomat, has a single acquirer – Cetrel – which is wholly owned and controlled by the banks in that country. According to MasterCard, Cetrel performs all of the acquiring processing, issuing processing and switching services on behalf of the banks. Under such an integrated structure, the role played by interchange fees in an open four-party payment system is performed by the “revenues” distributed by Cetrel to its shareholders, which are the issuing banks. Consequently, the “revenues” distributed to shareholders constitute de facto interchange fees and are in fact similar to the “dividends” distributed under the Interpay scheme of the Netherlands. Therefore, here too, although ostensibly operating without interchange fees, the same financial result is achieved, albeit on a far less transparent basis, and at the expense of banks which are not owners of Cetrel.

Furthermore, as MasterCard explains, the costs borne by banks are allocated within the Bancomat scheme in such a way that two-thirds are borne by acquiring banks and one-third by issuing banks. This allocation evidently redistributes costs from the issuing to the acquiring side, in place of the reallocation of revenues from the acquiring to the issuing side which would be achieved by interchange.

6.6.9 The profitability of issuing without interchange

Earlier in this chapter, figures were presented showing that – at least in the case of major banks providing data, and at least in recent years – issuing would have remained profitable even without interchange revenue. On the face of it, this might seem to refute the conclusion that interchange is necessary for the viability of four-party card schemes.

There are at least two reasons why such a view would not be sound. First, the data is insufficient to enable any clear conclusion to be drawn regarding the longer-term probabilities for rates of return on investment in this regard, in which the position of smaller issuers would also have to be considered. Therefore it cannot be concluded that, in the absence of interchange arrangements, the banks concerned or other banks would have engaged in issuing (or acquiring) under the four-party schemes, either to the extent that they have done so or at all, or that they would continue to do so in future.

participants. Since 2005, merchants pay acquiring banks a transaction fee and cardholders make annual contributions for the use of PIN cards, while banks pay Currence a licence fee for the participation in the system. Switching and clearing are solely carried out by Interpay and participating banks pay issuing and acquiring fees for these services. (Roundtable on Competition and efficient usage of payment cards, The Netherlands, 6 June 2006.)

451 MasterCard, October 2006, First Submission, p 88.
452 Id., pp 88-89.
454 See Table 14 above.
Secondly, and more fundamentally, the profit figures for issuing would not in themselves weaken the general case explained above for a balancing mechanism within an open or four-party system. They might go to show that prices on the issuing side have in fact been sustained by the banks at an excessive level, despite the claims that competition between issuers coupled with demand elasticity holds these prices down. The figures might also show that the level of interchange has been excessive, given the revenues which issuers have been able to extract independently of interchange (and the underlying merchant service charge). Nevertheless, in our opinion, the cogency of two-sided market theory is such that it justifies a permanent mechanism for the determination of interchange, notwithstanding that the particular determination at a particular time could result in a zero – or theoretically even a negative – interchange rate.

6.6.10 Conclusion on the necessity of interchange

Based on everything put before us, and in the absence of any other evidence, we are willing to accept the necessity of interchange in principle in four-party schemes. While interchange has been shown to be necessary, and a mechanism for interchange accordingly legitimate, it does not follow that every methodology for determining interchange, and every level of interchange consequently arrived at and implemented, would be justified also. It is important to ensure that the theoretical case for the necessity of interchange does not serve as a smokescreen for an impermissible exercise of market power, whether by the schemes or by their participating institutions.

FNB, in arguing the need for interchange, stated:

Economic theory teaches that where externalities or spill-over effects occur, these should be compensated for by a subsidy or a tax, in order to internalise the externality. For example, inoculation against a contagious disease benefits not just the individual but also society, which is a spill-over benefit. If some individuals cannot afford the inoculation then they should be subsidised to take account of the spill-over benefit. Similarly, in the case of card payment networks, the main spill-over benefit is that merchants benefit from increased numbers of cardholders, and accordingly would be prepared to pay a portion of the issuing costs in order to internalise these benefits. That is exactly what the interchange fee accomplishes, thereby improving net welfare within payment systems.

Subsidies and taxes are not the legitimate domain of the market; they belong in the domain of public power. The argument so formulated does not show the necessity of interchange, and thus its legitimacy. What it advances is the alleged legitimacy of four-party schemes – these mighty combinations of financial institutions, issuing, acquiring and profiting for themselves as best they can – using their power to the full to determine the “tax” which should be imposed on merchants for receiving the benefits of the scheme, and the “subsidy” which should consequently flow to issuers to support their issuing businesses. It is an

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456 This would be the “privately imposed sales tax” against which Carlton and Frankel (supra) warned.
argument for pricing the acquiring services to merchants up to the maximum which the degree of market power exercisable by these schemes and their participating institutions can sustain. We cannot endorse such an approach.  

While accepting the necessity of interchange in principle, we nevertheless consider the setting of interchange to be open to the danger of abuse which may harm competition and the consumer. It is rightly a focus of public concern, and of scrutiny by public authorities.

6.7 The potential for abuse of interchange and the need for regulation

In this chapter we do not analyse card pricing to consumers. Cards are in many instances bundled with other banking products. If there is market power in relation to the pricing of the bundles, then that power extends to the included cards. Indeed, the network effects generated by payment card systems may serve to enhance the degree of banks' market power in respect of the bundles in which the cards are included.

6.7.1 The non-neutrality of interchange

"Neutrality" would imply that changes in interchange fees have no real effect on social welfare. In particular, if interchange fees were neutral, then it would not be possible for card associations to increase their profits on an uncompetitive basis by collectively increasing interchange fees. There would then be no reason either for competition authorities to be concerned, or for any other regulatory intervention to occur.

Von Weizsäcker (in a paper submitted by MasterCard) argues that the level of interchange applied in a four-party scheme cannot influence the level of the total service charge (the acquirer's merchant service charge plus the issuer's cardholder service charge) because of the competition between the members of the scheme on the acquiring and issuing sides. Accordingly, interchange would be "neutral" in its ultimate effect on prices. However, this is contrary to the view of other experts on the subject and is contradicted by the evidence of Dr Koboldt – who testified for MasterCard at the hearing on 18 April 2007 – as well as by common sense.

Rochet and Tirole say:

Neutralities in payment systems. The choice of an interchange fee paid by the merchant's bank,

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457 We discuss this further in the next section of this chapter, where we deal with unsatisfactory aspects of the current methodology of interchange.

458 Von Weizsäcker, op. cit., p 19. Carlton and Frankel had argued on similar lines in their 1995 article, "The Antitrust Economics of Credit Card Networks," Antitrust Law Journal, 68, pp.643 – 668. Using the idea that interchange is price-neutral, they contended that interchange is consequently unnecessary in four-party payment card schemes. We have dealt with this notion above, showing why market forces operating independently on the two sides of the market cannot in fact be relied upon to match the different supplies and demands.
the acquirer, to the cardholder’s bank, the issuer, is irrelevant if the following conditions are jointly satisfied: First, issuers and acquirers pass through the corresponding charge (or benefit) to the cardholder and the merchant. Second, the merchant can charge two different prices for goods or services depending on whether the consumer pays by cash or by card; in other words, the payment system does not impose a no-surcharge-rule as a condition for the merchant to be affiliated with the system. Third, the merchant and the consumer incur no transaction cost associated with a system of double prices for each item.

In South African conditions, none of these conditions is satisfied. First of all, the competition between acquirers is oligopolistic – and so is the competition between issuers. Accordingly, we can have no confidence that benefits are or would be fully passed through to all consumers of the card payment services on each side. Second, the schemes do operate a "no surcharge" rule to prevent merchants from charging cardholders more than the ordinary advertised price, or more than the price charged to customers using other payment methods. Third, even in the absence of such a rule, the added costs to merchants of having to differentiate in price would deter them from doing so, with the result that there would in any event be scope for interchange, and hence merchant service charges, to be raised above the level warranted in a notionally competitive market.

To support the case for the necessity of interchange, Dr Koboldt argued that merchants do not adjust prices for customers using different means of payment even when they are free to do so. International experience has confirmed this: “merchants typically do not pass through differences in costs and benefits of accepting different forms of payment in the form of different retail prices.” The “coherence” of merchant prices as between different means of payment rests primarily on the added cost of administering price differentiation. In our view it must also involve to a significant extent the fear of the merchant of alienating and losing customers by such differentiation, with possible consequences going far beyond the loss or gain of the immediate sale. The same arguments in this regard that support the necessity

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461 Indeed, the “neutrality” model assumes perfect competition in both the issuing and acquiring markets, as well as in all the markets in which merchants compete for cardholding customers. In fact, perfect competition exists nowhere.


463 To the extent that some consumers – notably the better-off – are more assiduously courted by the banks in their competition for customers, the likelihood is that the benefits flowing to the issuing side as a result of interchange, to the extent that such benefits are passed on, would be disproportionately passed on to those consumers, thus leaving the effect on aggregate consumer prices resulting from interchange to be borne disproportionately by the poor.

464 We consider separately below whether such a rule is legitimate, and we conclude that it is.

465 Gans and King have argued that the mere removal of restrictions such as the “no surcharge” rule would be a sufficient condition to avoid any regulatory concerns about the setting of interchange fees. “For there to be such concerns, regulators must also believe that there are restrictions binding cash and credit prices together. There is no social gain to having specific price regulation of the interchange fee if constraints that bind cash and credit prices are eliminated.” Op. cit., p 12. This argument seems naïve. It fails to appreciate that the coherence of cash, debit card and credit card prices would be sustained by factors independent of card scheme restrictions.

466 Exhibit MM1, slide 7.

467 ld., slide 8.

468 In Australia, where the rule against surcharging was abolished in 2003, only 12% of very large merchants and only...
of interchange go to show the potential for its abuse.

6.7.2 Do market forces limit card interchange so it cannot be abused?

In Figure 5 above, the “Baxter model” showed that maximum card scheme output would occur at a point where the aggregate costs of the scheme coincide with the aggregate demand of cardholders and merchants for scheme card transactions, and that this outcome can only be achieved by adjusting prices to cardholders on the one side and prices to merchants on the other so that their respective demands are indeed matched at this optimum point.

However, the graphic illustration is static, and it merely assumes the slope and position of the various demand curves. Dr Koboldt acknowledged that there is not a single, static point of balance at which scheme output is maximised through interchange in order to allocate net costs within the scheme in correspondence with the demand elasticities on the two sides. Network effects are dynamic effects, and the result is that the demand curves on the two sides would change. Thus, for example, as more cards are issued and cardholders seek to use them at merchants, the merchant demand curve would change in response. It must follow in our view that there is scope for manipulating interchange, albeit within limits, so as to bring about a sustained increase in the price burden which merchants are willing to bear, and thus maximise revenue to scheme participants who are both issuers and acquirers, as well as to the scheme itself.

It has been shown above that interchange effectively sets a floor for price competition in the acquiring market. At the same time, thanks to “price coherence” – thanks to the non-“neutrality” of interchange, in other words – competition from other means of payment (such as cash) would not adequately prevent the abuse of interchange by four-party schemes and their participants. The question therefore turns to whether (a) divergent interests of issuers and acquirers within the schemes or (b) competition between the schemes themselves would have this preventive effect.

Because interchange provides a stream of revenue to issuers, issuers have an obvious interest in maximising interchange. There is, of course, a constraint on this – namely that interchange, by affecting the service charge payable by merchants to their acquirers, must not so curb merchants’ willingness to accept payment by card that the overall negative impact on issuers’ revenue would be greater than the per transaction gain.

around 2% of small merchants applied surcharging for card over cash transactions according to a report of the RBA in 2006. See Payment System Board Annual Report, 2006, p 13. See also Transcript 17 April 2007, p 55.


469 Cf Transcript 17 April 2007, pp 51-53. Thus “higher is not always better for banks.” Absa (Mr Stillman), Transcript 17 April, p 138. There “can well be the case where you hit the spot where the interchange fee is too high, because ... you give up what you lose on the merchants’ side”. Id., p 140.
Merchants’ willingness to accept payment by card can be increased – the elasticity of their demand can be lowered – by network effects. These network effects follow upon an increase in the relative number of cardholders, an increase in the number and value of transactions in which cardholders wish to pay by card, and an increase in the number of customers that might otherwise shop elsewhere or forego the purchase should their wish to pay by card fail to be facilitated. The pressure upon merchants generally to accept cards can thus be increased by the manipulation of factors which incentivise the take-up and use of payment cards by cardholders – factors which incentivise the customers of issuers, in other words.

The card schemes (including the three-party and the four-party schemes) have an obvious interest in maximising the issuing and use of cards, as well as concomitant card acceptance.\textsuperscript{470} In the case of the four-party schemes, this interest is naturally shared by issuers and may extend to acquirers as well. Where an acquirer is not also an issuer, the acquirer’s interest would simply be in maximising transaction volumes and values while keeping to a minimum the burden in costs falling on the acquiring side and having to be passed through ultimately to merchants by way of the merchant service charge. The four-party schemes have taken care to avoid a conflict of interests between acquirers and issuers within their schemes, by ensuring that only substantial issuers are permitted to acquire. In South Africa, the main issuers are also the main acquirers: the big four banks.\textsuperscript{471}

In the development of the card schemes it seems to have been recognised that, generally and strategically, relatively more would be gained by an emphasis on incentivising cardholding and usage by cardholders than on incentivising merchant acceptance.\textsuperscript{472} The potential leverage throughout the network is greater where the incentives are applied on the cardholder side. Given a merchandise price that is ordinarily the same for card and cash transactions, the advantage of the card to the cardholder is essentially that of convenience and security – until other benefits for the cardholder are added. The convenience and security may itself be provided free of charge (or apparently so) by making the transaction costless to the cardholder. Other benefits, such as “loyalty” points or “rewards” for spending, may readily be added. The linking of these to the seemingly painless extension and take-up of credit through the issuing and use of credit cards, and a significant “interest-free period”, adds greatly to the attraction. By incentivising the take-up and use of cards by cardholders, the card schemes and their issuing and acquiring participants are able to enhance the network effect which renders merchant demand less elastic and increases the price-burden

\textsuperscript{470} Card scheme owners’ revenue is to a large extent related to transaction volumes through the scheme: Transcript 18 April 2007, pp 146-147.

\textsuperscript{471} Even where there is a divergence of interests between acquiring and issuing, international experience suggests that established levels of interchange would not be lowered as a result. Datamonitor says: “In theory issuers and acquirers in Europe can agree bilateral interchange fees. This seldom happens though because there is little incentive for an issuer to set a fee lower than the MIF [multilateral interchange fee] or for an acquirer to agree a fee higher than this level.” (Visa, June 2007, Second Submission, document T, p 49.)

\textsuperscript{472} There are occasional exceptions to this, as in the case of the South African banks’ decision over debit card interchange in 2003 (see above), when the main barrier to card usage was identified as reluctance of smaller merchants to accept cards.
which merchants are willing to bear. These are further reasons why we cannot accept that interchange simply settles, and must settle, at a level reflecting spontaneous competitive forces in the issuing and acquiring markets respectively.\footnote{Cf e.g. Von Weizsäcker, op. cit. p 20.}

In their competition to attract issuing institutions and expand their cardholder base, the four-party schemes have their own interest in seeing interchange at the highest sustainable levels. There is no reason to think that competition between schemes will tend to push interchange levels down.\footnote{It is sometimes argued that blending of interchange fees might weaken inter-network competition, which may also lead to higher acquiring fees. However, this argument fails to appreciate that inter-scheme competition over interchange paradoxically tends to raise rather than reduce the interchange fee.} If anything the incentive would be to compete them upwards, or at least hold them at established levels even as transaction volumes and values rise and unit costs fall. This conclusion is supported by the view of Frankel and Shampine in “The Economic Effects of Interchange Fees”, 73 Antitrust Law Journal (3/2006), 627-673. Dealing with the effects of inter-system competition on the level of interchange, they observe at 651-652:

> Competition between card brands is ineffective at constraining interchange fees because a network with lower fees gets fewer sales. If one network were to set its interchange exactly at a theoretically efficient level while its rival offered a slightly higher interchange fee, issuers would prefer the network with the higher fee unless the fee was so much higher that merchants refused that brand. Consumers would have no incentive at the point of sale to avoid the more expensive brand if price coherence prevailed, and the issuer would have an incentive to market more heavily or enhance rebates for consumers using the more expensive brand. Ultimately there is little to prevent each network from increasing the interchange fee to the same level that a monopoly association would choose if consumers are loyal to particular cards.\footnote{As Dr Koboldt correctly pointed out (Transcript 18 April 2007, pp 149-150), one would not know how much above the theoretically efficient level the interchange level could be set before it reached the level at which even a notional monopoly association would lose more than it gained. Nevertheless that caveat only serves to confirm the general statement. Frankel and Shampine note that “a network may have to increase its fee only in modest increments so it does not get too far out in front of other brands and risk losing merchants.” (P 652.) In this way, competition between networks would tend gradually to raise interchange to the point at which further increases became unprofitable. We do not accept the assertion of Dr Koboldt that there “are equally incentives downwards” (Transcript 18 April 2007, p 152). However, he is surely right in observing that “competing three-party systems would have the very same incentive to set merchants’ charges too high and reduce cardholder charges.” (Transcript 18 April 2007, p 171.) “We would not expect three party schemes to price significantly lower to the merchants, and if they do not, they price higher, despite not having an interchange fee.” (Id., p 172.) This seems to us all the more reason to be concerned about the potential pricing effects of interchange setting within four-party schemes.}

It is significant that Mr Munson of MasterCard – bringing all of that scheme’s international experience to bear – was unable to maintain a consistent argument to the contrary. Having at first emphasised that issuers themselves would not want interchange to be “too high” because they know that by so doing they would shrink the size of the system,\footnote{Transcript 18 April 2007, p 22.} he went on to admit that there is “short term pressure” in the competition between schemes for issuers’ business for them to give issuers higher interchange.\footnote{Id., p 25.} Indeed, he added:

> I can tell you in personal experience that, when issuers tell us what they think interchange...
should be in those circumstances in which we set interchange fees, they rarely say "please reduce my interchange", and they frequently say "I need more interchange to have more competitive products, to lower prices to card holders to help you grow your business". So yes, there is a short-term pressure and an intense pressure to raise interchange fees.\footnote{478}

He then sought to counter-balance this by emphasising again the issuers' need to be able to offer their cardholders a card which enjoys merchant acceptance. This is so especially when new cards are issued. Thus MasterCard – and the argument would apply likewise to other schemes – has an interest in not giving in to the pressure from issuers to raise interchange too high.\footnote{479}

Nevertheless, Mr Munson acknowledged that MasterCard had gained an advantage in Australia, where a regulatory intervention by the Reserve Bank initially produced a result which permitted a slightly higher rate of interchange for the MasterCard scheme than for Visa.\footnote{480}

Quite frankly we were thrilled with this. It was about a two basis point [0.02 per cent] differential, but I can tell you that a two basis point interchange differential over a sustained amount of time is a competitive advantage, it helps you win business. And so, in the first couple of years of this process, MasterCard had a slight, but significant competitive advantage, based on the way that the Reserve Bank had set up this system.

Despite all this, says MasterCard, the fact is that interchange levels have tended to come down internationally.\footnote{481} This may be true of absolute levels – we do not have adequate data to confirm it\footnote{482} – but the real question is whether interchange has come down relative to reductions in issuing costs.\footnote{483} Without a positive answer to this question, the fact that some

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\hspace{1cm} \cite{478} Id.
\hspace{1cm} \cite{479} Id., pp 25-27.
\hspace{1cm} \cite{480} Id., p 32. See also \textit{id.}, p 147. This important admission radically undermines Mr Munson’s earlier protestation (\textit{id.}, p 28) to the effect that, if MasterCard were to set a higher interchange level than Visa's, it would simply lose merchants and so also cardholders to Visa.
\hspace{1cm} \cite{481} This was asserted, for example, by Dr Koboldt, Transcript 18 April 2007, p 151. Mr Fergus of Standard Bank went so far as to state: "In the last 20 years that I have been involved in interchange, it has only gone in one direction, downwards." Transcript 19 April 2007, p 77.
\hspace{1cm} \cite{482} We have some evidence to the contrary. Visa International’s main default interchange rates (1.6\% electronic and 2\% paper) “have not changed for a number of years from being set in the early 1990s.” (Visa, Second Submission, June 2007, document K.)
\hspace{1cm} \cite{483} As Mr Fergus put it, "If you have greater volume going through the scheme, ... you would expect that the scheme would become more efficient and over time the costs would reduce." (Transcript 19 April 2007, p 78.) A greatly over-simplified hypothetical example should suffice to illustrate in an elementary way the consequent effect that should be expected on the absolute level of interchange. If, in an average transaction, total costs of 100 are incurred in the proportions 20:80 on the acquiring and issuing sides respectively before interchange, an interchange fee designed (say) to balance those costs evenly would amount to 30, leaving each side with net costs of 50 to recover from its own customer. If, say, through automation and increases in transaction volumes, total costs of an average transaction were halved to 50, and the proportion between acquiring and issuing costs remained the same, then interchange having the same simple purpose would fall to 15, leaving each side with net costs of 25. If we assume instead that, given different demand elasticities, the level of interchange is designed to load the cost burden disproportionately onto (say) the acquiring side, and if that disproportion were to remain unchanged while average transaction costs came down, interchange would still come down correspondingly. The mere fact that interchange has come down would tell us nothing about the presence or absence of disproportion in the net cost allocation itself, or the extent of it. It would not assure us that there is no distortion in the market produced by the manipulation of interchange. Furthermore, if interchange were to fall at a lower rate than the rate of fall in average transaction costs, interchange in relative terms would be rising not falling. Thus the mere fact that interchange rates may have come down would in no way refute the analytical argument which suggests a tendency for interchange to rise to its sustainable maximum.
interchange levels may have come down would not refute the argument that inter-scheme competition will tend to hold interchange to the maximum levels which a monopoly association could theoretically sustain.

6.7.3 The nature of the potential abuse

Dr Koboldt argued that

…increasing interchange can either reduce or increase total demand for the services of payment system …. [For example], as the interchange fee increases, total system output increases if previously cardholder demand was less than merchant demand and therefore there was merchant demand that eventually went unsatisfied. So [in that case] the transaction volumes increase if you increase interchange fee. You get to the point where you have got it right, that is where the demand is balanced. If you increase interchange fees further, total system output would fall. 484

At a general theoretical level this is unexceptionable, but it says nothing about the potential to manipulate upward the point at which the “balance” of cardholder demand with merchant demand is achieved at the expense of the latter. More telling is Dr Koboldt’s further explanation that it is wrong to look at interchange fees in the same way as you would look at a price.

Increasing the price normally, unless we have really perverse demand conditions, reduces demand. Increasing interchange fees may increase demand, depending on what the original starting point is. If you have a situation where there is insufficient cardholder demand, increasing interchange fees will lead to an increase in total system output. 485

It must follow that, provided the limits of merchants’ endurance are not exceeded, it would pay schemes to maximise interchange and utilise the extra revenues to expand cardholder demand. Because of the scope for manipulation of interchange, and for raising the floor for merchant service charges in this way, we have to be very wary of the idea that “optimal” (i.e. maximum) card scheme output is the same as the output which would be optimal for society, or indeed that which a notionally competitive market would allow.

Capitec submitted:

Interchange should ideally be at a level which is sufficient to cover the processing cost. It should not be the main driver behind the acceptance of a new product as it should be as price neutral as possible (not be the main area of income) and not be treated as a profit centre in its own right. 486

Mr Stassen confirmed this position during the hearings. In his opinion interchange on credit card transactions in South Africa is relatively high and is being treated as a profit centre – i.e. as a main area of income by other providers. 487 In our view, if interchange functions in this

484 Transcript 18 April 2007, p 57.
485 Id., p 58.
486 Capitec Bank, October 2006, First Submission, p 11.
way it will constitute an abuse of the power that is facilitated by the four-party joint venture. That should not be allowed.

The schemes and several banks participating in the Enquiry naturally placed emphasis on the positive benefits for all participants in a payment card network. Clearly if the benefits to a merchant of accepting payments by card were to be eclipsed by the cost incurred in doing so, then the merchant’s acceptance of cards would cease. But to price the benefit to the merchant up to that point is to price at a level which even a monopolist could not breach. Within limits set by the inequalities of property in a market system, the point of competition is to enable resources to be allocated through a price mechanism which matches production and distribution to wants. The “value proposition” (utility) of payment cards to the merchant provides no justification for pricing the acceptance of cards above an optimally competitive level.\footnote{488}

Even if it is so that merchant service charges in South Africa are comparable to those paid in other countries,\footnote{489} this would not dispose of the question whether, either here or in other countries, interchange arrangements are nevertheless serving, or may in future serve, to keep these charges above their potential competitive minima.

It was suggested by Mr Jordaan of FNB that the public, as consumers, would have no more interest in interrogating the level of interchange than in interrogating the level of (say) the rental costs incurred by Pick ‘n Pay.\footnote{490} If consumers did not like the prices they were being charged, for example for soap powder, they could always switch to buying it from Checkers. Competition in the retail market thus adequately protected consumers, and it was unnecessary for them to concern themselves with the costs incurred by the supplier in making the supply. However, this is not an apt comparison, as was observed at the time.

ADV PETERSEN (of the Panel): I have a problem with the comparison between the consumer’s interest or lack of interest in the rental paid by Pick ‘n Pay, or the costs that have gone into producing a packet of soap powder, and the issue of interchange in this network. … Let me [accept] for argument’s sake that interchange is necessary and that all that we are concerned about is how it is arrived at and perhaps by whom. Now, the theory behind it is the balancing of demand in a two-sided market where independent market forces on those two sides will not produce a proper harmony.

The first point of distinction with Pick ‘n Pay’s rental or the soap powder is that this is going on within a massive, very important network – an unusual joint venture which is not a fully integrated joint venture, but one which allows competitors, independently providing part of the combined product to be linked up. Where all of us – and it is at an immature stage, [so it] is going to be more the case [in future] – are affected by this network several times a day, the interchange that has been set … is entering as a uniform cost into acquirers’ costs and would logically find its way down into merchants’ costs and ultimately into consumer prices. … [S]o something that is agreed by many enterprises or set in common for many enterprises is

\footnote{488} Cf in this regard the argument advanced by FNB (FRB, March 2007, Second Submission, Position paper: Interchange, pp 8-9).

\footnote{489} Transcript 18 April 2007, p 9 (Mr Munson).

\footnote{490} See Transcript 19 April 2007, p 133.
finding its way into the price paid by the consumer.

At the same time you have the theoretical possibility which we have explored over the past days that it could be manipulated – one of the parties presenting was unhappy with my use of the word “manipulate” so let me say it could be delicately adjusted – so as to make it painless for example for a credit card holder to take up and use a credit card. Painlessly initially, not painless later when the interest has to be paid on the credit debt, but painless to take it up and use it – so much so that you can boost demand on the issuer side, the cardholder side, and then exploit the network effects, making it more and more difficult for merchants to refuse, in other words increase the inelasticity or captivity of merchants on the acquiring side and thereby jack up the aggregate revenue to the optimal point [for the scheme].

No effective answer to these points has been provided. Indeed, there was significant support for the view that interchange can be manipulated by or within a scheme in order to maximise the aggregate revenue of its participants, and that this should not be left to happen. In this regard the following was said during the hearing of Absa:

MR VOLKER: I think that the principle sounds right. I think that is why we in our presentations did say that we would support an independent methodology in structure to determine that. I think if the system is left to its own devices … it could open itself to abuse and misuse.

MR STILLMAN: If I may just add to that. I mean I think it is well recognised in the economic literature that the use of the interchange fee can have very strong pro-competitive beneficial effects. It is also noted in the literature and I think it was picked up by the European Commission in its review, that in some circumstances interchange fees could be used also … as a means of shifting revenues from one side to the other to enhance the profitability of the banks. So there are different possible effects of interchange fees and I can appreciate your desire to try to figure out how to sort through them and see what the drivers are. … I do not want to anticipate questions …, but I think if one does think about that issue of shifting costs from one side … to the other, it is very important to take on board differences in levels of competition in acquiring and issuing, in which direction those differences in levels competition might point to in terms of the implications of interchange fees, and I …. (indistinct) … that it is probably the opposite of the implication that the Technical Team suggested in its earlier presentation, i.e. under circumstances in South Africa if anything I would think [that] … the competition considerations, the differences in degrees of competition might argue in favour of lower interchange fees.

…

MR NORTON: … What has been called into question is the level of interchange and I think the Absa proposal is one which says we are very happy for the level of interchange to be interrogated thoroughly and for an independent third party to do a thorough and detailed analysis of the levels of interchange and if post that analysis the nett result is that interchange levels should come down as was the case in [2003] when interchange levels were reduced post the Edgar Dunn study, then Absa is more than happy to accept that position, and I think we are very much in favour of an objective independent assessment, to [address] your concern which is, as I understand it, that interchange is effectively a mechanism for concerted practice by banks to ramp up revenue. We are very happy for an independent third party to have a very cold hard look at that issue and make sure that that concern is not one which

491 Id., p 136-139.
493 See also id., pp 173-174 (Mr Volker): “I think if we can agree on an objective set of criteria that address the fundamental requirement for balancing the two sides of the market and have a mechanism as well to ensure the effective and objective and transparent implementation of that methodology, we should hopefully minimise misuse or manipulation to a large extent.”
494 It is not clear precisely what Mr Stillman was referring to here.
comes into question.

... [T]he concerns that were expressed in Australia were the lack of a regular review of interchange levels and the lack of a full methodology and I think absolutely from an Absa perspective we are in favour of both of those in relation to interchange.

Standard Bank also acknowledged that the setting of interchange could potentially be abused, although with some qualification.

MR BODIBE: I am asking you ... to what extent can the scheme abuse the [in]elastic demand from the side of the of the merchant?

MR FERGUS: I think that is why you actually do need an independent expert who is controlling the process and you need some regulation from within the country to ensure that this does not happen. ... [I]f you had issuing and acquiring balance between the banks the risk would be there. If you have got big differentials in issuing volumes and acquiring volumes there is no logical economical argument that I can think of why that would happen, and I really do not think Nedcor are going to agree blindly to give Standard Bank significant sums of money because they think it is good for Standard Bank, which is what they would be doing in agreeing to a high interchange.

An important element in the potential for abuse of interchange lies in the fact that, in South Africa, large issuers also dominate the acquiring market. The effect of disproportions between banks' issuing and acquiring businesses is an aspect which deserves exploring.

To understand the dynamics involved, it is best to begin with a notional firm whose issuing business is small relative to its acquiring business. The larger a firm’s acquiring business relative to its issuing business, the greater will be the proportion of its own cardholders’ transactions that are likely to be “on-us”. On-us transactions are comparable to transactions in a three-party scheme: no interchange is payable to any other firm. Since, in these transactions, the firm qua acquirer receives the interchange component contained in the merchant service charge and retains it qua issuer, it will have no interest in a lower interchange so far as these transactions are concerned. However, its relatively large acquiring base will also mean that it is engaging as acquirer in a relatively large proportion of transactions involving other issuers’ cardholders, and in doing so will be obliged to pay away interchange to those issuers. Its relatively small issuing base means that its interchange receipts from off-us transactions by its own cardholders will be relatively few, and so it will probably be a net payer of interchange. This could well give it, on balance, an interest in keeping interchange down. The alternative of enlarging its relative cardholder base by

495 Transcript 19 April 2007, pp 78-79.
496 Cf the 2000 report by the Reserve Bank of Australia (RBA) and the Australian Competition and Consumer Commission (ACCC), “Debit and Credit Card Schemes in Australia – A Study of Interchange Fees and Access”, which pointed out that banks had no incentive to lower interchange fees because they were both issuers and acquirers. See Visa, Second Submission, June 2007, document T, p 17.
497 Nedbank is a notable example of such a firm (Transcript 19 April 2007, pp 6-7); hence the mention of it by Mr Fergus in the passage quoted above.
498 Transcript 17 April 2007, p 34, pp 51-52.
499 Cf Transcript 19 April 2007, p 7, p 32.
aggressively competitive issuing would be retarded by the relative lack of interchange
revenue with which to sustain such a drive. Its competitive position is disadvantaged when
compared with large issuers having relatively smaller acquiring businesses.

In the case of large issuers with smaller acquiring businesses the dynamics of advantage
are the converse. A relatively greater proportion of their cardholders will be entering into off-
us transactions, and thus generating net interchange revenue for the issuer. Meanwhile the
issuer’s on-us transactions generate internal “interchange” revenue as well. If interchange
is a source of profit to the issuer – i.e. not merely a necessary means of cost redistribution
and recovery – the result would tend to chill competition in the supply of acquiring services
and raise merchant service charges above a notionally competitive level. Moreover, the
profit component in interchange would tend to reinforce big-player advantages also on the
issuing side.

If (as we think probable) there is any significant degree of market power over merchants in
the supply of acquiring services, generated in particular by network effects, then a higher
than necessary level of interchange could readily be sustained to the advantage of the big
issuers. Because the profit component in such a level of interchange would flow to the big
issuers in on-us as well as off-us transactions, and because of the disincentives to growing a
large acquiring base without a corresponding issuing base, there would be a tendency for
big issuers to increase their hold also on the acquiring market and narrow the scope for
profitable acquiring by independents. Thus interchange, in particular when taken together
with scheme rules weighted against non-issuers or smaller issuers acquiring, has
considerable potential to restrict and distort the market for acquiring services.

The non-transparency of interchange is itself a crucial reason convincing us that interchange
cannot safely be left to market forces, or to setting by private interests alone. The applicable
level of interchange in respect of any particular card payment is only partially known to
merchants; it is experienced only indirectly through the merchant service charge. In that form
it is passed on into consumer prices. It is unknown to the cardholder, yet enters into
consumer prices which the cardholder also pays. The supposedly “free” service to the

500 Transcript 17 April 2007, p 34, pp 51-52.
501 The argument that margins are tight in the market for acquiring services has previously been addressed by showing
how interchange operates as a floor for price competition anyway. The argument based on “tight margins” is further
weakened when it is observed that that market is dominated by firms which are also major issuers. For them, in on-us
transactions (as is the case with three-party schemes), there is ultimately no separate “margin” on the acquiring side. In
off-us transactions they are the recipients, as issuers, of the interchange component of the acquirer’s merchant service
charge. In on-us transactions they are the recipients of the interchange component of their own merchant’s service
charge. Any element of profit in this component is a profit which they extract and retain in their dual capacity as acquirer
and issuer.
502 Transcript 17 April 2007, p 47, pp 109-112. “I think the perception from a credit cardholder is such that he perceives a
transaction to be free, where most consumers are not aware that there is a charge to the retailer”. Absa (Mr Volker), id.,
p 112. Since a lot of the effect of interchange is concealed, it does not advance the case of the card schemes to refer to
contented consumers.
cardholder is subsidised by the merchant\textsuperscript{503} – but ultimately at the consumer’s expense.\textsuperscript{504} By way of interchange arrangements, a non-transparent element of profit is being extracted by the issuing bank from the customer (or from the particular customer along with all other customers, whether they use cards or not) via a component of a “merchant’s fee” that is funded ultimately through a hidden increment in the purchase price of the merchandise.\textsuperscript{505}

6.7.4 Unsatisfactory methodology

The \textit{Nabanco} court in 1984 found that Visa’s credit card interchange fee was reasonably cost-related, and approved the methodology used as being “careful, consistent, and within the bounds of sound business judgment.”\textsuperscript{506} There appears to have been no consideration, however, of the appropriateness or otherwise of the cost elements included in the setting of interchange, from a competition policy point of view, or of the precise role of the business judgment concerned.

Visa and MasterCard have each developed their own methodology for the setting of interchange and generally describe their processes in different ways. Both employ costing studies, but differ as to the identification of relevant costs and the use made of them in arriving at interchange levels. It must be borne in mind that interchange has to reconcile not only imbalances in cost on the two sides of the market, but also imbalances in the elasticity of merchant and cardholder demand – i.e., in the different ability or willingness of the end customers on the two sides to bear the costs of the co-operation enabling service which the joint venture provides.

In the case of credit cards, MasterCard’s costing study is “really a proxy for measuring merchant demand.”\textsuperscript{507} This proxy is created by selecting certain costs on the issuing side. Visa evidently uses a more comprehensive costing methodology.\textsuperscript{508} MasterCard’s debit card

\textsuperscript{503} As Mr Volker acknowledged in answer to Mr Bodibe, interchange is a mechanism to subsidise cardholders. (\textit{Id.}, pp 81-82.) One may add that it is not only the cardholding customer that is subsidised by interchange, but also the business of the bank issuing cards. Moreover, the subsidy to cardholder tends to go to those least needing it – the credit-card holders whose spending is supported by a component of the merchants’ service charge, paid for ultimately by all consumers.

\textsuperscript{504} “I think irrespective of which payment instrument is used, the consumer does ultimately pay. So I think our view is that there is a variety of payment instruments that can be selected by the consumer and whether it is cash or cheques or credit or debit card there is a cost associated with that instrument to the merchant and to the cardholder so none of those options are free in themselves.” Absa (Mr Volker), Transcript 17 April 2007, p 82.

\textsuperscript{505} There is an inherent non-transparency in interchange. In addition, there may be actual secrecy. In its decision on the Visa exemption in 2002, para (15), the European Commission noted (\textit{OJ L} 318, p 19, 22.11.2002, para (15)): “Visa has in the past considered the level of the MIF and the way in which it is determined by the Visa EU Board as a business secret, not to be disclosed by the Visa members to their clients. Therefore, acquiring banks which in practice pass on to merchants the interchange fee that they have to pay to the issuing bank in part or in whole, were not permitted to inform merchants about the level of the MIF. Therefore, merchants have not been made aware of the exact components of the MIF in their merchant fee.”

\textsuperscript{506} 596 F.Supp. 1231,1261-1262.

\textsuperscript{507} Transcript 18 April 2007, p 27.

\textsuperscript{508} However, in terms of the exemption negotiated with the European Commission in 2002, and which expired on 31 December 2007, Visa agreed to limit interchange on a basis which applied a costing methodology essentially

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Contains confidential information
costing methodology is also more comprehensive. Both schemes, however, ultimately apply a business judgment to the setting of the resulting interchange levels. In Visa’s case, merchant demand is evidently assessed solely by way of this business judgment.\textsuperscript{509}

A remarkable thing, however, is that the proxy methodology takes into account only certain of the issuer’s costs, while ignoring the acquirers’ costs altogether. Thus, where credit card interchange is concerned, no attempt is made to actually assess the imbalance of costs on the two sides of the market. Nor is the elasticity of cardholder demand ever established.\textsuperscript{511}

It seems clear that the object of the exercise is simply to estimate the maximum share of total scheme costs which merchants can be expected to bear, and – subject to the cautionary judgment which comes from business experience – to arrive at a maximum interchange rate which as nearly as possible will exploit this limit without breaching it.

In its very origins, credit card interchange was based upon information regarding the merchant service charge which acquiring banks were able to levy. In the \textit{NaBanco} case, the US Court of Appeals noted that when, in 1966, Bank of America expanded its three-party system nationwide by licensing local banks, and thus becoming a four-party system, a variable interchange fee system was created.

Each merchant-signing bank was required to inform the card-issuing bank of either the actual or average merchant discount it charged. The fee was based on this information.

After the original BankAmericard network expanded, the variable interchange fee system did not work effectively. A for-profit nonstock-membership corporation, NBI, was therefore formed in 1970. NBI’s board of directors adopted a new uniform fee system, the IRF, in late 1971.

corresponding to the “proxy” approach used by MasterCard. Visa has not disclosed much specific information about its cost studies where its own preferred methodology is concerned. Visa’s Interchange rates are set at a level “to optimise the payment service”. (Visa, June 2007, Second Submission, document B (second part) p 3.) They take account of cost studies, market review, product development, and incentives. (Id.) There is activity-based costing at the member and country level. (Id., p 4.) A sample is used to represent the entire payment system (issuing and acquiring). A consistent framework has been applied globally for over 25 years. (Id.) The cost studies isolate Visa payment cards from others (Id., p 5), by which we understand that the costs specific to the Visa scheme are able to be identified. Visa seems to use regional data for costing studies, which are related to historical and projected costs and revenues of member institutions in that region. Through this the “cost imbalance” on the issuing and acquiring sides respectively are calculated, and subsequently a “cost calculated rate” necessary to redistribute the costs between issuers and acquirers is arrived at. This rate is then used as one of the inputs into the setting of interchange fees by means of a business judgement. (Visa, June 2007, Second Submission, Annexure L.)

\textsuperscript{509} “There is a misconception in the market that Visa’s methodology solely comprises a cost study. Looking at a member’s input costs is only a small part of the review process, if at all where data is unreliable, prohibitively expensive to collect or unobtainable. This is where a market review is used to determine how to structure the Interchange rates in order to encourage the fullest use of the system. Market forces play their part...” (Id.)

\textsuperscript{511} MasterCard, March 2007, Second Submission, p 22. MasterCard normally employs EDC to conduct the costing exercises.

\textsuperscript{511} “We don’t actually do a comparable study on the cardholder side”: Transcript 18 April 2007, p 27 (MasterCard).
NBI became VISA in 1977.\textsuperscript{512}

Visa has evidently been refining its business judgment on this matter ever since.

\textsuperscript{513} Visa has evidently been refining its business judgment on this matter ever since.

\textsuperscript{514} The theoretical rationale provided for the MasterCard proxy is that, if it were not for the scheme, merchants would have to bear the cost of extending credit themselves to their customers through an in-house card scheme. The idea is that they should accordingly be willing to bear the comparable costs within the scheme. Thus the proxy, in broad terms, includes three main components: the issuer’s processing costs, the issuer’s payment guarantee (against cardholder default or fraud), and the interest-free (or “free funding”) period granted by the issuer to the cardholder.

\textsuperscript{515} We shall consider these elements further below.

\textsuperscript{516} MasterCard’s debit card cost study is fundamentally different from that of credit cards, and uses a more comprehensive approach to calculate the costs involved in the provision of debit card services to the two sides of the market. It is said that this approach is more closely aligned with the theory justifying interchange, but requires a considerable amount of expense, time and commitment of resources to carry out.

\textsuperscript{517} Because the debit card is integrally related to the provision of banking services, more costs and functions need to be taken into consideration. Credit cards are typically viewed as a product in their own right, whereas debit cards are seen as a generally used device to obtain access to the customer’s bank account.

\textsuperscript{518} These points are not without merit, yet presented simply in this way they tend to give the subject of interchange setting an exaggerated appearance of objectivity. Ultimately, the key reason for the more comprehensive cost study adopted for debit card interchange seems to be that there was no accumulated business experience regarding the extent of the price burden that merchants would be prepared to bear in the debit card stream, and (as

\textsuperscript{512} 779 F.2d 592, 595.

\textsuperscript{513} See e.g. Von Weizsäcker, op. cit., p 19.

\textsuperscript{514} Visa says that the merchant receives a ‘payment guarantee’ from the acquiring bank. (Visa, Second Submission, June 2007, document S, p 6.) However, the issuer guarantees payment to the acquirer. Thus when the cost of the payment guarantee is considered it refers to “the promise of the issuing bank to honour payments made by the acquiring bank”. (Id.)

\textsuperscript{515} MasterCard, March 2007, Second Submission, p 24.

\textsuperscript{516} This is called a full cost or “Baxter” approach or an end to end cost study. (MasterCard, Second Submission, March 2007, p 23; Transcript 18 April 2007, p166.)

\textsuperscript{517} MasterCard, March 2007, Second Submission, p 23.

\textsuperscript{518} MasterCard, October 2006, First Submission, p 106. Thus the cost to the customer of other means of accessing the account also have to be considered.
MasterCard put it) “a proxy for merchant demand is not easily identifiable”. Accordingly, business judgment as to sustainable interchange has required a more extensive cost study as an input into decision-making.

The fact that the credit card proxy is designed to identify an “upper bound” for merchant service charges was explicitly acknowledged by Dr Koboldt:

In practice directly measuring merchant demand is very, very difficult and proxies can be used, and a suitable proxy for an upper bound of what merchants should be expected, reasonably be expected to be prepared to pay for cards is essentially what it would cost the merchant to self-provide a similar payment system, noting of course that only the very largest merchants would be able to do that.

So it’s the cost of self-providing a card payment system that the merchant would have to incur, which is what the cost study is measuring. It is measuring issuer cost but by doing that it is not measuring costs of services provided by issuers to acquirers, it is rather trying to figure out what it would cost merchants if they were to provide a similar card payment system to their customers, so if merchants became issuers what costs would they have to incur? They would have to incur funding the interest-free period, they would have to incur some processing costs, they would have to write off fraud losses, they would have to write off credit losses and so forth, and those are the cost components, issuer cost components which essentially proxy the willingness to pay of merchants, the amount that merchants can reasonably be expected to be willing to pay for the services provided by the card payment system.

Although Mr Munson denied that the goal of MasterCard in setting interchange was to find “the maximum point at which merchants will continue to take the card”, he was obliged to concede as “a fair point” that the methodology used was to establish an upper bound on what merchants would bear. This was plainly stated in Dr Koboldt’s Exhibit MM1, slide 11. Not surprisingly, therefore, MasterCard would usually set interchange at or below this upper bound.

It was suggested to Mr Munson that, by setting interchange at or near the “yellow line” of what merchants would bear, the schemes were not promoting cards as replacements for cash as vigorously as they might. In his answer he indicated that while cash and debit cards could be considered true substitutes, cash should not be seen as a good comparison with the credit card. “One of the important differences between credit cards and other forms of payment, especially cash and debit, is the availability of long term revolving credit line and

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519  MasterCard, March 2007, Second Submission, p 76.
521  Id., p 157.
522  Id., pp 157-158.
523  Mr Munson said he would not necessarily use the same language, “but nevertheless, you are attempting to establish a number at or below which, you were comfortable that your acceptance will not suffer.” (Transcript 18 April 2007, pp 159.)
524  The approach with new card technologies, where the immediate aim might be to secure merchant acceptance, the approach could well be different and interchange could be set significantly lower. (Id., p 160.)
525  Id., p 162.
in some cases the availability of the short term or the interest-free period. Dr Koboldt pointed out that anyway the proposition involved “a rather one-sided view of a two-sided problem”, in that a drive to replace cash by increasing card usage would still require balancing the price to cardholders and to merchants, and not simply applying all the incentives on the merchant side. This latter answer seems correct.

Nevertheless, the use of a proxy in the cost calculations of credit card interchange fees raises several concerns. Whatever may have been its justification at the outset of credit card issuing, the idea that merchants would instead have to provide their own in-house store card and credit system is now surely quite artificial. Dr Koboldt himself stated that this would be realistic only for very largest merchants. Yet merchants of all sizes are being induced, via interchange and the resulting merchant service charges, to bear such a burden. Nor is the benefit to merchants of an increased turnover thanks to credit cards really pertinent to their willingness to pay. As Pick ‘n Pay submitted, virtually all merchants nowadays accept plastic generally because to refuse to do so would lead to a loss of turnover. From the merchant’s perspective the debit card now functions in large measure indistinguishably from the credit card.

FNB submitted:

The correct methodology for calculating interchange is that both demand and supply (cost) factors should be taken into account, as this appears to be correct according to economic theory. The use of the MasterCard “proxy” approach does however yield comparable results, as it implicitly accounts for demand-side factors.

We are unable to accept that view.

It is stated in theory that interchange fees can be positive, negative or zero. The proxy specified in the MasterCard / EDC cost studies is predefined and identifies several issuing costs upfront, not allowing for negative or zero outcomes to occur. The development of a comprehensive costing methodology for debit cards shows that it is feasible to measure all relevant issuing and acquiring costs. In our view the specification of a proxy, whether as a representation of the imbalance of costs or of the imbalance in demand elasticities in a payment card system, lacks coherent justification.

As Capitec pointed out:

Debit cards have better risk management features than that of credit cards; credit cards

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526 Id., pp 163-164.
527 Id., pp 165-166.
528 Id., p 69.
529 Pick ‘n Pay, October 2006, Submission of information, p 5.
531 Roche and Tirole (2001), An Economic analysis of the interchange fee in payment card systems.
normally offer better fee structures to its users. Client fees could possibly start reflecting the true cost of transacting and risk, which could see an increase in credit card fees. Individuals may lose the marketing benefits on their credit card purchases if that cannot be funded from interchange.\footnote{Capitec Bank, October 2006, First Submission, p 12.}

Put differently, the question to be addressed is why credit card interchange should not be limited essentially to what is needed to enable it to function as a means of payment (like the debit card), leaving the costs of credit extension to be charged directly and competitively to the borrower.

The vast majority of South Africans holding credit cards – some 80 per cent – do pay interest on their transactions.\footnote{Transcript 17 April 2007, p 62.} The remaining minority make use of the “interest-free period” and discharge their debt to the issuing bank before that period expires. Where the debt is not discharged in time, there is no interest-free period: the cardholder is treated as having drawn on the revolving credit facility from the outset and interest is charged from the date of the transaction.\footnote{Id., p 64.} In the vast majority of cases, therefore, the issuing bank receives revenue through a high rate of interest as well as receiving interchange.\footnote{See id., pp 62-63.} At the same time, the interest-free period for the remainder (the “transactors”) is being funded by merchants, willingly or unwillingly via interchange. Like a mirage, the interest-free period also serves as an attraction to those credit card users who prove unable to repay timeously (the “revolvers”), and who are thereby more easily drawn into high-interest bearing debt. Merchants derive increased turnover from all forms of credit extended to retail customers, not merely from credit on credit cards. No adequate justification has been advanced for imposing on merchants this cost of credit extension by banks, or for permitting this particular form of credit extension to be privileged in the market-place in this way.\footnote{Absa observed that the removal of interchange would (inter alia) reduce the availability (i.e. the issuance) of credit cards particularly for higher risk consumers.\footnote{Absa acknowledged that credit cards compete with all lending products. (Transcript 17 April 2007, p 114, Mr Sweeney).} This is because the lenders’ costs would have to be recovered directly from the borrowers themselves. By logical extension, the same must apply if the level of interchange were to fall relative to the cost of extending the credit. The implication is clear: under the present arrangements merchants are being required to pay, by way of interchange, towards the cost of extending credit to bank customers in various categories of risk, without having any part in assessing and deciding whether they would themselves wish to assume that risk. The artificiality of using the

\footnote{Nedbank acknowledged that the 55 days’ interest free credit on credit cards “is a real saving in comparison to cash or debit card because the money stays in the account and if you are a borrower you save interest and if you are a depositor, you would earn it.” (Transcript 19 April 2007, p 21, Mr Shuter.)}
interest-free period as well as the full cost of the payment guarantee (i.e. including the cost of debtors’ defaults) in determining the level of credit card interchange is, in our view, manifest. Moreover, since credit card interchange – like all interchange – enters ultimately into consumer prices, it must follow that cash and debit card customers are being compelled to shoulder part of the banks’ costs of lending to the better-off, and so subsidising the latter.\footnote{Concerning the “payment guarantee”, the EC noted in 2002 (OJ L 318, p 20, 22.11.2002): “In the present decision [concerning Visa], this term is used to describe the promise of the issuing bank to honour payments to the acquiring bank, even those which turn out to be, \textit{inter alia}, fraudulent or for which the cardholder ultimately defaults, on condition that the merchant undertakes all the security checks necessary to enable the issuing bank to promise payment. As concerns default losses, only losses occurring during the free-funding period are to be included in the MIF cost study.”}

According to Visa, its interchange fees internationally address only the “payment service." \footnote{The “subsidy” or “tax” issue is not disposed of by arguments over the relative social cost of cards and cash. The costs of money-lending are not to be confused with the costs of the payment medium. In any event, the full social benefits of innovative products depend upon their being made available, as soon as is reasonably possible, at the lowest prices that a truly competitive market can secure. As we have noted earlier in this chapter, it is the monopolist who can continue pricing up to the cost of the old substitute when the costs of the new product fall and a lower price would thus be possible.} A distinction is specifically drawn between the “payment service” and the “financing service”. \footnote{Visa, June 2007, Second Submission, document B (second part) p 7.} This would suggest that the interchange fees do not address the costs of credit extension – but on closer examination that appears not to be so. Visa says that revolving loans and cash advances are excluded from the scope of interchange.\footnote{\textit{Id.}, document R, p 5.} It goes on to say, however, when dealing with the interchange exemption granted to it by the European Commission in 2002, that the permitted “benchmark” costs which have formed a ceiling for its average interchange have included not only processing and the payment guarantee, but also the free funding period.\footnote{\textit{Id.}, document B, p7.}

Under Visa’s own methodology the study of issuing costs identifies the costs of processing, of the payment guarantee, and of “funds”. \footnote{\textit{Id.}, document B (second part) pp 9-10. Visa was permitted freely to set interchange rates within the cap. (\textit{Id.}) The free-funding period in respect of credit cards is described by Visa as “the time between when the acquirer is paid [by the issuer] and the time when either the cardholder pays the bill in full, or the bill is rolled over into the credit card facility.” For debit cards the free-funding period is “the time between the actual purchase and when the amount is debited to the cardholder’s account.” (Visa, June 2007, Second Submission, document S, p 6.) The “free funding period for cardholders” was defined in more detail by the EC in its 2002 decision as follows: “This corresponds, for deferred debit cards, to the cost of any time difference between payment to the acquirer and debiting of funds from the cardholder's current account. For credit cards, it corresponds only to the cost of any time difference between payment to the acquirer and the time when either payment must be made by the cardholder, or the balance of the credit card bill rolled over into the extended credit facility, to which a rate of interest is applied (that is, it does not include any costs arising from the granting of extended credit to cardholders). For debit cards, it represents only the processing time necessary to debit the transaction to the cardholder account; for deferred debit and credit cards it represents also the extra interest-free period before which payment must be made or extended credit used.” (OJ L 318, p 20, 22.11.2002.)} Visa says that “finance charge revenues, as well as the underlying cost to fund revolving cardholder receivables, clearly go with the financing service”. \footnote{\textit{Id.}, p 11.} But it seems arbitrary to limit in this way the allocation of costs to the

\footnote{\textit{Id.}, document R, p 6.}
financing service, thus treating the costs of the interest-free period enjoyed by non-revolving cardholders as if they were intrinsic to the “payment service” and not to the “financing service” at all.\footnote{Moreover, the interest-free or “free funding” period should not be regarded as if it were an unalterable fact of nature. We note that in Australia the period is much shorter than in SA, averaging between 16 and 23 days for various types of cards compared with our 50-55 days. See id., document U, p 34.}

Included in Visa’s study of issuers’ costs will be the costs of applications, marketing, clearing, risk, fraud, authorisations, “etc”.\footnote{Id. Marketing would appear to include “Loyalty and incentives programmes: see id., document B (third part) p 18.} Nothing is said about acquirers’ costs at this point.\footnote{Id., document B (second part).} Later, however, it appears to be recognised that relevant acquirers’ costs will include communications and terminal, processing, merchant customer service and merchant “affiliation”.\footnote{Id., document B (third part) p 18.} As a description of a methodology, all this is far from clear.

We do not doubt that interchange in order to balance cardholder and merchant demand, might legitimately – both in the debit and credit card streams – factor in some part, not only of issuers’ processing costs where these exceed what cardholders may be expected to bear, but also of the savings to merchants through certainty of payment and protection against cardholder fraud.\footnote{We note, however, that merchants in South Africa argue that there is in effect no unconditional payment guarantee given the acquiring bank’s right to make charge-backs directly to the merchant’s account. This, so it is said, leaves the dispute resolution to take place between merchant and the cardholder, which results in huge fraud costs to merchants every year. It is also suggested that the “payment guarantee” on debit cards is irrelevant, since debit card transactions involve direct access to pre-funded accounts. (See SARPIF, October 2006, South African Retailers Payment Issues forum Submission of Information, p 2 and p 4; Pick ‘n Pay, October 2006, Submission of information, p 3 and p 5.) Given our recommendation of an independent, objective and transparent interchange setting process under regulatory supervision, we have not considered it necessary to pursue these and other issues of detail.} Nevertheless, lack of transparency in the whole process, coupled with the scope for abuse, mean that the public is not adequately protected by the current methods of setting interchange.

In assessing merchant sensitivity to the cost of accepting cards, Visa recognises an increasingly complex segmentation between, for example, groceries, fuel, airlines, other travel and entertainment, and “card not present” (as in internet) transactions. In other words, the elasticity of merchant demand is assessed according to market segment.\footnote{See id., pp 24-25. Cf also id., document R, p 4. Interchange will also vary, for example, according to the card technology and its effect on volumes, risks and costs. (Cf id., document B (third part) p 27.)} MasterCard similarly has a variety of interchange rates internationally. This degree of sophistication in interchange setting has not yet come to South Africa, but could be expected to do so as the payment card market matures.

The degree of market power over merchants already attained by the four-party schemes can be expected to grow. Currently, ultimately, everything comes down to a judgment call by the schemes or their participating banks collectively regarding the extent of the costs which can
be loaded, via interchange, onto the acquiring side and thus onto merchant service charges. In our view this is a far from satisfactory state of affairs.

6.7.5 Illegitimate benefits would extend to three-party schemes

Most of the first submission by American Express to the Enquiry consisted of an eloquent defence of interchange within the four-party schemes, and a warning against interfering with it. This seemed somewhat curious, considering that American Express, like Diners Club, is a three-party scheme in which interchange plays no direct part. Nevertheless the three-party schemes do have a distinct interest in the level of the merchant service charges that are levied in the four-party schemes, and thus indirectly an interest in the level of four-party interchange too. Their interest would be in their rivals’ merchant service charges being high rather than low.

In the first place, the four-party schemes’ merchant service charges provide a benchmark in relation to which the three-party schemes’ own competing merchant service charges can be set. Thus, where a premium card is offered, the merchant can more readily be persuaded to pay a premium service charge as compared with the four-party “norm”.

Secondly, to the extent that high interchange fuels four-party card issuing, there is a general expansion of the market within which the three-party schemes can promote their cards as a second card for the convenience of the better-off.

It follows that, if interchange in the four-party schemes is set at higher than necessary levels, then the illegitimate benefits would flow – indirectly – to the three-party schemes as well.

6.7.6 The need for regulation

In our view interchange has the character of a necessary evil. Where its necessity is shown to exist, it still needs to be kept as low as is reasonably possible. The difficulty is to find the means of securing that outcome in the public interest in a way that does not compromise the effective functioning and further development of card and other non-cash and paperless payment systems.

Interchange arrangements, as we have seen, are themselves a substitute for a market mechanism. As Dr Hawkins expressed it during the hearings,

... if you are replacing a mechanism or perhaps substituting a mechanism that the market

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552 American Express, October 2006, Comments in response to the South African Competition Commission Enquiry into Banking. We have dealt with the substance of the arguments at various points in this chapter with reference to other sources, and it is unnecessary to repeat them.

553 See also footnote 475 above.

554 Transcript 17 April 2007, p 43.
itself does not naturally appear to generate, then the question is begged as to who should be making decisions about what those replacement fees should be, and is it appropriate that it is actually left to those who benefit from the scheme to do that setting?

For the reasons set out above, interchange should clearly not be left to be set privately by those actually or potentially benefitting from it.

Mr Munson of MasterCard – while opposing any regulatory intervention – acknowledged that, generally speaking, there are three possible ways of setting interchange.

The banks can set the fee themselves, the scheme operator (MasterCard in our case) can set the fee, or some third party either appointed or approved by a regulatory agency or the regulatory agency itself, could set the interchange.\(^{555}\)

In the next part of this chapter we consider the problem of appropriate regulation of interchange – a subject on which a great deal of constructive input was made by a number of participants in the Enquiry.

Here we would merely note that competition law is obviously not designed for such purposes. A specific statutory framework to enable and enforce the envisaged regulatory process will be required. That is a matter for the Competition Commissioner to take up with other appropriate authorities in the light of this report.

However, competition law is not left impotent in the face of the challenge posed by interchange. Accepting the necessity of interchange in principle does not mean that any particular methodology of arriving at interchange is justified. If the methodology actually employed can be shown to have an illegitimate purpose, then in our view there would probably be the setting of a restrictive trading condition in contravention of section 4(1)(b) of the Competition Act. It might also be possible to demonstrate anti-competitive effects, and a consequent contravention (in the alternative) of section 4(1)(a). Although the issues are complex, an investigation with a view to such enforcement should be considered if the regulatory remedies which we propose are not adopted or are inordinately delayed.

6.8 Interchange in other payment streams

6.8.1 Introduction

In South Africa we have 16 payment streams governed by the applicable PCH agreements. Of these, six payment streams necessitated attention during the Enquiry with respect to the interbank arrangements that are in place. Prime among them has been interchange in the payment card environment – the one to which the preceding sections of this chapter have been devoted. Although many other payment streams may also utilise interbank fees,\(^ {556}\)

\(^ {555}\) Transcript 18 April 2007, p 20.

\(^ {556}\) According to Standard Bank, “… certain payment streams in South Africa (e.g. EFT) exhibit interbank
Chapter 6 Payment Cards and Interchange

particular concerns arise in the electronic funds transfer (EFT) and early debit order (EDO) streams which warrant attention in this chapter.\textsuperscript{557}

6.8.2 Electronic funds transfer (EFT)

In the realm of interbank EFT, interchange makes its appearance under the name of a "homing fee". The justification for a homing fee in an EFT transaction is said to be based on the two-sided nature of the market for such transfers, which in principle may require a balancing payment in off-us transactions.

The direction in which interchange flows in EFT transactions differs according to the type of EFT transaction initiated. There are two types of EFT transactions: EFT credit transactions\textsuperscript{558} and EFT debit transactions.\textsuperscript{559} In the case of an EFT credit transaction, interchange flows from the paying side to the receiving side; in the case of an EFT debit transaction, it flows in the opposite direction. Stakeholder banks in both cases argue that interchange is vital for the viability of the payment stream.

In both instances, the market appears be truly two-sided, so that a balancing payment could in principle be necessary to reallocate revenue between the two sides. However, the need for a non-zero rate of interchange – the need for an actual flow of interchange in one direction or the other – must still depend on an inability of the service providers on one side or the other to collect sufficient revenue by independent pricing to end users who have a demand for the service.

If total revenues collected on either side were not sufficient at least to cover total costs associated with providing such a service, together with normal profit, the service would obviously not be provided. This then would necessitate a transfer of revenue from the side with a strong (or "inelastic") demand and subsequent surplus of revenue, to the side with an inability to cover costs due to a very elastic demand. If, however, the costs are sufficiently

\textsuperscript{557} The applicable PCH agreements with respect to the clearing of these transactions are those relating to: Authenticated early debit order payment instructions (AEDO), Non-authenticated early debit order payment instructions (NAEDO), Credit card debit payment instructions, Debit card payment instructions, EFT credit payment instructions, and EFT debit payment instructions.

\textsuperscript{558} The definition for an EFT credit transaction in the EFT credit payment instruction PCH agreement is given as: "... a payment instruction issued by the payer to the paying participant to transfer funds from the account of the payer to the account of a beneficiary at the beneficiary participant, and which is delivered for clearing to the PCH system operator.” (P 6) The paying participant and the beneficiary participant are the two relevant banks.

\textsuperscript{559} The definition for an EFT debit transaction in the EFT debit payment instruction PCH agreement is given as: "... an electronic payment instruction to a paying participant to make a payment, issued by the collecting participant or by its customer on behalf and ostensibly under the mandate of the customer of a paying participant.” (P 6) The collecting and paying participants are the two relevant banks.
covered through the extraction of revenue on either side without rendering demand ineffectual, the flow of revenue or the balancing of interests would not be required. If interbank interchange arrangements are not strictly necessary for the functioning of the market, they ought not to be allowed, because they involve agreements between competitors which entail inherent dangers for competition.

If, apart from such a strict necessity, it would be socially beneficial and welfare maximizing to support and increase by collective measures the demand for a particular means of payment by manipulating the basis for the prices charged on the different sides of the market, then this needs to be done by incorporating that payment stream into the regulated structure and methodology for the setting of interchange fees which we have proposed in Section 6.9 of this chapter below. It should not be left to be determined by the banks (or other possible future clearing house participants) among or between themselves.

According to the information submitted to this Enquiry, interchange (“homing”) fees in the EFT payment streams were uniform at least until 2006. How exactly such uniformity was arrived at is unclear. The uniform interchange fees for EFT debit and EFT credit transactions agreed and applied as between participating banks in the past, are set out in the table below.

<table>
<thead>
<tr>
<th>Date</th>
<th>EFT debit</th>
<th>EFT credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>R0.115</td>
<td>R0.225</td>
</tr>
<tr>
<td>2002</td>
<td>R0.135</td>
<td>R0.275</td>
</tr>
<tr>
<td>2003</td>
<td>R0.19</td>
<td>R0.34</td>
</tr>
<tr>
<td>2004</td>
<td>R0.23</td>
<td>R0.36</td>
</tr>
</tbody>
</table>

*Source: Banks’ Submissions in response to a request for information on 8 October 2007*

It is clear that there has been a consistent increase in the interchange fees paid on EFT transactions over time. Yet it is far from clear that, as transaction volumes have increased, average transaction costs would have warranted the fee increases. As with payment card interchange, agreed charges which enter into the cost structure of service provision ultimately find their way into consumer prices. Any unnecessary sheltering of costs

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components from effective competition needs to be eliminated.

We now move on to discuss EFT credit and debits transactions in turn.

**EFT credit transactions**

An EFT credit transaction is an electronic transfer of funds, initiated by the paying customer, instructing the paying bank to transfer funds from the account of the payer to the account of a beneficiary at the beneficiary bank. These transactions are mainly salary payments.

In an EFT credit transaction, the beneficiary of the transfer is ordinarily unwilling to pay a fee to his or her bank (the beneficiary bank) for the receipt of payment, or at least to agree in advance to be debited a fee for such receipts. There is said to exist a very elastic demand for the service, indicating that an increase or an introduction of a fee might drastically decrease the quantity of the service demanded. In this instance, the inability of the beneficiary bank to charge its client necessitates the extraction of revenue from the client initiating the transaction (i.e., the paying client) and a consequent transfer from the paying bank to the beneficiary bank in order to cover the costs associated with the beneficiary side.

We accept that there would be customer resistance, and probably rightly so, to the levying of a fee on the beneficiary side. We doubt, however, that the problem is essentially one of "elastic demand", since increasingly employees are required by their employers to have bank accounts into which their wages and salaries may be electronically paid. Once they have a bank account, and especially if they are required to have one, there will be a significant degree of customer captivity. It might well be inappropriate on those grounds too for the beneficiary bank to charge the customer for such receipts. We would accept that in these circumstances an interbank payment of interchange (a "homing fee") from the paying bank to the beneficiary bank is legitimate.

However, as with all interchange in our opinion, the process and methodology for the setting of this fee warrants incorporation into the transparent and objective regulatory scheme which we propose.

Figure 6 and Figure 7 illustrate the flows involved in an EFT credit transaction and EFT debit transaction respectively:

562 Transcript 3 November 2006, p 102 (Financial Sector Campaign Coalition; Mr Kholisile).
563 The general basis for this conclusion is analysed in the chapter of our report dealing with market power in retail banking.
In an EFT credit transaction (see Figure 6), funds are “pushed” by the payer (with the help of the paying bank), to the beneficiary (with the help of the beneficiary bank). A typical example of an EFT credit transaction is where an employer pays salaries into the accounts of its employees. Here the paying client (the employer) pays a per transaction fee plus the value of the transaction to its bank (Bank A) and the value of the transaction plus the interchange fee is paid to Bank B. The full value of the transaction is reflected in the account of the receiving client (the employee).

**EFT debit transactions**

In the case of an EFT debit transaction, the beneficiary “pulls” or draws the funds by prearrangement with the payer (again on each side assisted by the relevant bank). An example would be a debit order obtained by a corporation from its customer for payment of services such as a cell phone contract. In this case, the paying client agrees that the value of the debit order will be pulled from his or her account periodically.

Each month (say), the value of the debit order and the transaction fee will be drawn from the customer’s account at Bank B. In turn, Bank B pays over the value of the debit order to Bank A, where the cell phone company has its account. Bank A ensures the value is paid into the cell phone company’s account, and would typically charge a transaction fee for doing so. Bank B (the paying bank) receives an interchange fee while also charging its own customer for its trouble (see Figure 7).
An EFT debit transaction takes place when the beneficiary bank (technically called the collecting participant) issues an electronic instruction to the paying bank (the paying participant) to transfer funds to it, for the credit of the beneficiary’s account and for the debit of the payer’s account. In doing this, the collecting bank acts upon an instruction from its account-holder, the beneficiary, relying on an authorisation which the payer has provided to the beneficiary to serve as an order to the paying bank.

Typical examples of this would be the debit orders obtained by corporations from their customers for payment of services such cellphone contracts, life insurance and medical scheme contributions. In many instances these corporations require their customers to have a bank account and to sign a debit order on the account as the obligatory method of payment. Accordingly, once again, we have a reinforcement of the general basis for a significant degree of captivity of the ordinary individual customer in the retail banking relationship.564

It is argued that the paying customer and bank are usually far more resistant to the use of this payment method (i.e., the debit order) than the beneficiary customer and bank.565 That may well be so, but it does not follow in the circumstances that customer demand is elastic, given the degree to which customers of big corporations have no choice but to sign debit orders or forego crucial services. There has been an increased uptake of EFT transactions, evidently fuelled by the requirements of the corporate clients initiating the transactions.

According to data submitted by Bankserv, the volumes of EFT debit transactions from 2003

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564 See footnote 563 above.
to 2006 increased as follows:

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>Volume</td>
<td>7.57%</td>
<td>6.34%</td>
<td>9.94%</td>
<td>10.43%</td>
</tr>
</tbody>
</table>

Source: Bankserv, submission 27 November 2006

The interbank homing fee (interchange) is said to be necessary to balance the interests in the services provided to the different end users, and transfer revenue in order to cover the associated costs. We do not consider this contention to have been proved. In contrast to an EFT credit transaction, the banks on both sides of the transaction can and do charge their customers for the service which they provide. Higher transaction volumes should have caused average processing costs to fall. Yet charges levied on those paying by debit order have risen. The graph below illustrates the increase in the debit order fees applied by the big four banks to entry level savings accounts – i.e. to the customers on the paying side.

Figure 8 Debit order fees on big four banks’ entry level savings accounts

Source: InfoChoice data

Why then have an additional flow of revenue across from the collecting to the paying side? Why, at least, has this flow not diminished? In fact, as we have seen, the interchange or “homing” fee paid from the beneficiary bank to the paying bank has increased steadily – by 100 per cent per transaction over nine years.566

Clearly, we would have to be concerned that the elimination of the homing fee (interchange)

566 See Table 15 above.
on EFT debit transactions might translate simply into lower bank charges for the corporations requiring payment by debit order and correspondingly higher charges being levied on customers on the paying side as banks continue to utilise their market power over the latter. However, the latter charges may well be kept at or near the bearable maximum anyway, and it cannot be assumed that banks would be able simply to raise their processing charges for paying debit orders without limit or resistance. An investigation in any event into excessive pricing or, failing that, a regulatory intervention might then be warranted.

It would be naïve to suppose that customers on the paying side are currently being helpfully subsidised by fees charged by banks to the corporations in whose favour these customers sign debit orders. Those corporations are generally able to recover their costs by their own charges to their customers. Thus if the corporations’ bank charges are inflated, the ultimate customer ends up paying anyway. The key difference is that it is non-transparent. If the paying banks are able – by agreements on interchange – to extract additional revenue from the collecting side, it is very doubtful that this is or would be used to ameliorate the position of the paying customers. The paying banks and the collecting banks are the same institutions. They have a mutual interest in creating a common cost-floor for their charges to corporate customers on the collecting side, which cannot readily be competed away in the face of those corporations’ countervailing power, and which transforms itself into revenue in their own hands as paying banks. By means of this interchange, a partial shelter against price competition is created. We have analysed this dynamic earlier in this chapter when dealing with merchant service charges. The same logic applies here.

Having this uniform and common cost component on the collecting side has the related effect of privileging the collecting banks in competition with bureaux for the provision of debit order processing services to corporate clients. In this way they further distort the market. The banks are already at an advantage in being able to bundle their processing services with the actual payment-collecting service that is unique to them as banks. In accepting debit orders via bureaux for collection, the banks are able to charge a fee including the interchange (or homing fee) component. In offering their own processing services directly to the collecting customers (the corporations), the banks (which are also paying banks and thus retain the homing fees in all on-us transactions) have a revenue stream denied to bureaux, and which they can use to discount their processing charges to the corporations. If interchange (and thus the homing fee) is to be seen as providing a subsidy, then in all probability it is the banks which are being subsidised in the EFT debit stream.

Thus, in our view, even though EFT debit transactions meet the basic criterion of a two-sided market, the actual necessity of interchange in this payment stream has not been demonstrated. We are not in a position to say conclusively, on the basis of the information voluntarily submitted to us, that it has been proved not to be necessary. Consideration should therefore be given by the Competition Commissioner to initiating a complaint with reference to section 4(1)(b), and alternatively section 4(1)(a) of the Competition Act, in order
formally to investigate a possible contravention or contraventions arising from the past and current interbank arrangements in respect of interchange in this stream.

As regards to the future, if interchange is to be levied in relation to EFT debit transactions, then it ought to be included within the regulated process which we recommend for interchange generally, and so be subject to the participatory procedures involved in arriving at and implementing an appropriate level of interchange. The first step in this process would be to establish whether interchange in this stream is necessarily at all.

6.8.3 Early debit orders (EDO)

The introduction of the early debit order (EDO) system in 2006 has created two new payment streams – authenticated early debit orders (AEDO) and non-authenticated early debit orders (NAEDO). These are governed by two separate PCH agreements.

AEDO and NAEDO transactions function like EFT debit transactions, but get processed early in the morning on the designated date or dates. As FNB explains, the EDO system “services a niche of debit order payers and beneficiaries who require a debit order which runs immediately after the salary or income credit is received into the account.” The AEDO system was designed for micro financiers and requires the authentication of the debtor and the debit order through the use of a card and PIN. The NAEDO system in comparison was designed for banks’ own payment collections and for those of large corporations, including insurance companies, and requires no authentication because of the mandate obtained in the agreement with the borrower. However for a number of reasons enumerated below, it appears that the NAEDO stream is favoured by most users.

The South African Reserve Bank’s National Payment System Department stated in its Directive No. 1 of 2006:

1.3.3 In the recent past banks have allowed, for collection purposes, practices whereby certain persons’ payment instructions have been granted preferential treatment over others. These preferential practices have taken place using various mechanisms

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567 The definition for an AEDO transaction in the relevant PCH agreement refers to: “… a payment instruction issued by the cardholder which payment instruction is to be processed at a future date.” (PCH agreement, Authenticated early debit order payment instructions (AEDO), p 3.)

568 The definition for a NAEDO transaction in the relevant PCH agreement refers to: “… a payment instruction authorised by the payer to be issued on his instruction for payment on a future date or dates.” (PCH agreement, Non-authenticated early debit order payment instructions (NAEDO), p 3.)

569 FRB, Response to request for information, EDO and EFT Debit Order Rules, August 2007, p 2. “Credit tracking”, which allows for extended re-processing of these “early debit orders” where credits to the payer’s account have been delayed, is described in the section on Penalty Fees in the chapter of this report on Costing and Pricing.

570 Presentation on EDO by Mr de Swardt, CEO of Intecon / ALLPS, furnished by PASA on 5 September 2007. Slide 5 and 6.

including sorting-at-source\textsuperscript{572} and the abuse of the ATM system.\textsuperscript{573}

1.3.4 The Reserve Bank considers the above preferential practices as contrary to the efficiency, effectiveness and neutrality of the NPS. Therefore, the Reserve Bank, in conjunction with the banking industry and relevant stakeholders, has agreed on the principles for the collection of debit payment instructions in EDO PCHs.

Micro-lenders, who provide small loans to lower-income clients, prefer repayment through debit orders because of the increased risk in this segment of the market.\textsuperscript{574}

AEDO transactions are debit card-based,\textsuperscript{575} and are authenticated at the time of electronic contract registration by production of the card and entry of the cardholder’s PIN. In this way the borrower’s debit card is used to issue a series of future dated electronic payment instructions.

NAEDO transactions, in contrast, are based simply on a signed mandate from the debtor, authorising the future-dated payments. The NAEDO user (the creditor) applies for and obtains a user code.

Acquiring in the AEDO stream is done in conjunction with a Customer Service Provider (CSP).\textsuperscript{576} Three service providers, appointed by the participating acquiring banks, are prominent in the provision of EDO services: NuPay facilitates transactions for Absa,\textsuperscript{577} Information Technology Consultants (Pty) Ltd (“Intecon”) for Mercantile and Mycomax for Bank of Athens.\textsuperscript{578} The CSPs ensure that the micro lender is equipped with a POS device and that the payment instructions are routed through the system.

According to information published by Mycomax, the main practical differences between AEDO and NAEDO are as follows:\textsuperscript{579}

\begin{itemize}
  \item AEDO and NAEDO each have its own niche in the market..
\end{itemize}

\textsuperscript{572} “Sorting-at-source” is defined in the directive as “the process whereby the beneficiary of payment instructions sorts each paying bank’s payment instructions together and then submits those payment instructions directly to each paying bank, where the proceeds of such payment instructions are credited to an account in the name of the beneficiary.” See the chapter on Access to the Payment System.

\textsuperscript{573} The reference to the abuse of the ATM system is evidently a reference to the practice of some micro-lenders taking possession of borrowers’ debit cards and PINs in order to make ATM withdrawals themselves on the borrowers’ bank accounts as soon as credits to those accounts came through.

\textsuperscript{574} Presentation on EDO by Mr de Swardt, CEO of Intecon / ALLPS, furnished by PASA on 5 September 2007.

\textsuperscript{575} According to information published by NuPay (https://www.nupay.co.za/np_aedo.html), credit card and combination cards are not accepted, and a maximum installment value of R5,000 is permitted.

\textsuperscript{576} SBSA, March 2008, Further questions for Standard Bank, p 3. This relationship between acquiring banks and CSP does not exist in the NAEDO stream (except for Absa, see next footnote).

\textsuperscript{577} Absa is a significant shareholder in NuPay. Until May 2008, NuPay also facilitates NAEDO transactions for Absa, after which acquiring will be done via Absa’s electronic banking (Absa, March 2008, Response to additional questions, p 3). NuPay clearly dominates processing in the AEDO stream with a reported 79% of all transactions passing through NuPay (PASA, March 2008, EDO Statistics).

\textsuperscript{578} Other service providers are also in the market.

\textsuperscript{579} www.mycomax.com:81/mycomax/edo.php
The general perception is that AEDO is more of a hassle because you need the client to be present with his Bankcard and PIN in your office at the time of granting the loan. On the other hand, the benefit is that the client mandates his transaction by swiping his card and entering his PIN. This brings a major benefit: the payment can’t be reversed by the client after you have received the funds in your merchant account.

In contrast to the “more of a hassle to load” AEDO transactions, NAEDO might seem more streamlined and effortless to implement. You don’t need additional computer hardware or terminals (Card readers) to load payment transactions. Your client authorizes the payment by simply signing a paper NAEDO mandate. The mandate includes the bank account number, branch code and deduction amount for a particular date. The major disadvantage of NAEDO is its reversibility. A payment can be reversed for a period of up to 40 days after it has been processed. This means the client can request his bank to reverse the payment after you have received it in your merchant account!

According to information published by service provider Intecon / ALLPS,580 the interchange structure in the EDO system is based on separate bilateral agreements between acquiring and issuing banks relating to so-called “billable components” of the interchange fees.

It appears that the interchange in the EDO market has been set at a much higher level than for EFT transactions (see further below). Interchange is payable by the acquirer (collecting bank) to the issuer (paying bank) in each case. The initial “contract registration” is billable in the case of AEDO only. “Successful transaction payment received”, “Unsuccessful transactions”, “Tracking per day” and “Recall of transactions in tracking” are billable in respect of both AEDO and NAEDO. A “Disputed Fee Charge” is billable only in respect of NAEDO.581

The participants in the EDO streams as furnished by the banks are contained in Table 17.

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580 “EDO Billing Principles”.

581 Id. One of the major differences between AEDO and NAEDO lies in the fact that on NAEDO, the payer has the ability to dispute the payment(s) received. In such instance payment(s) received will be reversed against the account of the micro financier.” A dispute fee per payment “will be an additional levy against the account of the micro financier.” AEDO, on the other hand, “does not entertain disputes or reversals on funds received.” Id.
### Table 17 Participants in the EDO streams

<table>
<thead>
<tr>
<th>Institution</th>
<th>AEDO Issuing</th>
<th>AEDO Acquiring</th>
<th>NAEDO Issuing</th>
<th>NAEDO Acquiring</th>
</tr>
</thead>
<tbody>
<tr>
<td>Absa</td>
<td>✓</td>
<td>✓</td>
<td></td>
<td></td>
</tr>
<tr>
<td>African Bank</td>
<td>-</td>
<td>-</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Bank of Athens</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Capitec</td>
<td>✓</td>
<td>-</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>FNB</td>
<td>✓</td>
<td>-</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Mercantile Bank</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Nedbank</td>
<td>✓</td>
<td>-</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>SBSA</td>
<td>✓</td>
<td>-</td>
<td>✓</td>
<td>✓</td>
</tr>
<tr>
<td>Teba Bank</td>
<td>In progress</td>
<td>In progress</td>
<td>In progress</td>
<td>In progress</td>
</tr>
</tbody>
</table>

*Source: Banks' Submissions, March 2008.*

In the AEDO stream, Absa, Mercantile and the Bank of Athens are the only banks offering acquiring (i.e. collecting) services; all the other participating banks are issuers only. In the NAEDO stream, more banks participate in both issuing and acquiring.

The interchange fees bilaterally agreed on for successful AEDO transactions have resulted in *ad valorem* fees being paid away by the acquiring (i.e. collecting) banks to the issuing (i.e. paying) banks. The applicable interchange fees on unsuccessful AEDO transactions are flat fees ranging from R1.00 to R1.50 per transaction.

The interchange fees paid for successful NAEDO transactions. Unsuccessful transactions in this stream, like those in the AEDO stream, attract a flat interchange fee ranging from R1.00 to R1.50.

The bilateral agreements in respect of all these components have resulted in a complex array of different interchange fees being paid by the acquiring banks to the issuing banks. As

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582 ABSA, October 2007, Response to data and information request, Annex B. Also see SBSA, October 2007, Information request regarding “Interchange fee data”, and FRB, October 2007, Data and info request.

583 *Id.* This depends on which issuing and acquiring banks are participating in the transaction. These fees also seem to take on various forms (either a flat fee, a stepped fee, an *ad valorem* fee, or a combination of both).
an example of this, the table below reflects the AEDO interchange fees negotiated by Absa with various other banks.

Table 18 AEDO interchange fees paid by Absa

<table>
<thead>
<tr>
<th>AEDO transactions</th>
<th>SBSA</th>
<th>FNB</th>
<th>Nedbank</th>
<th>Mercantile</th>
<th>Bank of Athens</th>
<th>Capitec</th>
</tr>
</thead>
<tbody>
<tr>
<td>Successful transaction</td>
<td>0.65%</td>
<td>0.60%</td>
<td>0.65%</td>
<td>0.55%</td>
<td>0.70%</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Min R1.50</td>
<td>Max R6.50</td>
<td>Min R2.00</td>
<td>Max R6.50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Unsuccessful transaction</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
| Source: ABSA, October 2007, Banking Enquiry – Response to data and information request.

Because of this interweave of bilateral interchange fees applicable to the EDO stream, we shall simplify the picture in order to facilitate a comparison between the interchange fees relating to the AEDO and NAEDO streams respectively. For purposes of illustration, SBSA is used as the paying bank (i.e. issuing bank), and Absa as the beneficiary bank (i.e. acquiring bank). This results in an interchange fee being paid from Absa to SBSA.\(^585\) As depicted in Figure 9, interchange fees in the NAEDO stream are clearly significantly higher than in the AEDO stream.

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\(^{585}\) All the other banks’ bilaterally negotiated interchange fees differ only marginally, but follow the same trend at approximately the same level as for the fees depicted in Figure 9.
The interchange fees charged on EDO transactions are thus significantly higher than the flat
applicable to ordinary debit order transactions (EFT debit transactions, see Table 15 above). This is puzzling as the processing required in both the EDO and EFT stream appears to be very similar and the value added services in the EDO stream – such as tracking – are all being charged for separately. Mercantile stated that:

The major issuers have contended these are justified based on the amount of development done to facilitate the EDO payment streams, and the additional overhead on systems due to the extra processing required dictated by the timelines involved in providing feedback to acquiring banks.\(^{586}\)

However, the “feedback” mentioned here evidently relates to the optional tracking service offered by the paying bank for which the beneficiary pays specially. It would therefore seem to be irrelevant to the basic interchange fees payable, and its inclusion in the alleged justification for those fees merely clouds the issue.

The standard two-sided market argument for higher interchange fees in a particular payment stream is that this will serve to enable the recipient of the interchange revenue to price in such a way to customers on its side of the market so as to attract them to the service. In the EDO streams both the recipient (user) – such as the micro lender – and the paying customer – whose account is being debited – pay for the service. So both sides of the market are charged for the service, as is the case for EFT debits. Despite higher interchange in the EDO environment than for ordinary EFT debit orders, the prices paid by paying customers to the issuing (i.e. paying) banks seem broadly to be the same, irrespective of the payment

According to Absa, the paying customer bears the same cost for regular debit order transactions as for successful NAEDO transactions, and is thus unaffected by the difference in the underlying interbank interchange fee structures applicable to the two payment streams. For AEDO transactions, the fees are set at the same level as for POS NuPay transactions and may result in a slightly lower fee paid by the paying customer than for a NAEDO transaction.

FNB, Nedbank, Standard bank and Mercantile submitted that the fees charged by them to paying customers for successful EDO transactions do not differ from the charges made for ordinary debit order transactions. Capitec submitted that its charge for successful EDO transactions is slightly more, at R3.50, compared to a successful ordinary debit order charge of R2.25.

The difference between charges for successful EDO transactions and ordinary debit order transactions, if there is any, is not disclosed in the banks’ pricing brochures provided to customers.

The only set of customers in the system that appears to be affected directly and substantially by the EDO pricing regime are the beneficiary customers – e.g. the micro-lenders – who bear the increased user fees, in part because of the increased interchange fee applicable. Currently, there is no transparent and objectively quantified basis for the interchange fees agreed between the banks, or for the user fees charged.

Micro Finance South Africa (MFSA) submitted to the Enquiry data reflecting user fees payable by the beneficiary customers in respect of successful AEDO and NAEDO transactions respectively.

Confidential: Absa

Confidential: Absa

Confidential: Absa

Confidential: Absa

Notes:


588 On the Silver current account the NAEDO transaction attracts the same fee as for internal debit orders on current accounts. For Mzansi, FlexiSave and Mega Save accounts this equals the fee set for regular debit orders. NAEDO transaction fees range between R4.50 and R4.75 per transaction on these accounts (Absa, March 2007, Second Submission, Part A Data Request, pp 18-23).

588 The payment stream used in the past for micro lending transactions and which has been replaced by EDO. For Mzansi and Flexisave accounts, the AEDO customer fee is lower than the NAEDO fee. However, for other types of accounts, an ad valorem component may result in the AEDO fee for a specific transaction size being greater than the NAEDO fee.

589 Absa, March 2007, Second Submission, Part A Data Request, pp 18-23. This is because the AEDO transactions replaced the POS NuPay transactions. The successful AEDO transaction fee is set between R2.30 and R2.50 for Mzansi, FlexiSave and Mega Save accounts and at R2.10/R0.58/R12 for the Silver current account.


In Table 19, the interchange fees used in the table are those payable by Absa to Standard Bank, in terms of the agreement between them, for AEDO and NAEDO transactions. The net revenue indicated is the net revenue on the acquiring (Absa) side.

<table>
<thead>
<tr>
<th>Transaction Value</th>
<th>AEDO interchange fee</th>
<th>NAEDO interchange fee</th>
<th>AEDO User fees for successful transactions</th>
<th>NAEDO User fees for successful transactions</th>
<th>AEDO Net revenue</th>
<th>NAEDO Net revenue</th>
</tr>
</thead>
<tbody>
<tr>
<td>R100.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>R200.00</td>
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<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>R300.00</td>
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<td></td>
<td></td>
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<tr>
<td>R400.00</td>
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<tr>
<td>R500.00</td>
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<td>R700.00</td>
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<td>R800.00</td>
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<tr>
<td>R900.00</td>
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<tr>
<td>R1,000.00</td>
<td></td>
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</tr>
</tbody>
</table>

Source: Banks’ Submissions, October 2007 and MFSA November 2007

Absa states that on AEDO transactions, the split of the user fees between Absa and NuPay is approximately 50/50. On NAEDO transactions, NuPay receives a rebate of R0.85 for successful transactions. The user fees paid by the beneficiary customers to NuPay range between 1.7 per cent and 2.2 per cent ad valorem for successful transactions, of which Absa receives 1 per cent and NuPay receives between 0.7 per cent and 1.2 per cent. Our calculations using this information result in the revenue per transaction received by the respective parties as reflected in Table 20.

Note that the outcome for Absa is understated in every case where the transaction is on-us. This is discussed further below (see Table 21).

593 The information provided to the Enquiry does not show a significant difference in the fees charged to the customers of the other service providers. In actual fact, user fees for RealPay and NuPay in the NAEDO stream are identical.

594 This is the interchange fee applicable to successful transactions.

595 Net revenue = user fee for successful transactions – interchange fee.

596 Absa, March 2008, Response to additional questions, p 3. No comparable information is available for Intecon and Mycomax.

597 Again, for purposes of illustration, the amounts of interchange payable by Absa are assumed to be those payable to Standard Bank.
Table 20 Share of user fees for successful AEDO transactions

<table>
<thead>
<tr>
<th>Transaction Value</th>
<th>AEDO User fees for successful transactions (charged by NuPay)</th>
<th>AEDO revenue per transaction retained by NuPay</th>
<th>AEDO revenue per transaction received by Absa</th>
<th>AEDO interchange payable from Absa to SBSA</th>
<th>AEDO net revenue per transaction received by Absa</th>
</tr>
</thead>
<tbody>
<tr>
<td>R100.00</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>R200.00</td>
<td></td>
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<tr>
<td>R300.00</td>
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<td>R400.00</td>
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<td>R700.00</td>
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<td>R1,000.00</td>
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Source: Absa, Response to additional, March 2008

It should be emphasised that the data in Table 20 exclude any amounts payable by users for credit tracking. Where the user opts for credit tracking, that could increase the total fees payable significantly.

In their submission MFSA stated that:

The banks determine the cost of EDO independently of the users, i.e. microfinanciers. Since EDO is designed to facilitate payments across the banking network, the banks – under the guise of the NPS – set the price and are not required to disclose the structure.  

As Table 19 reveals, typical user fees for successful AEDO transactions are much higher than those for successful NAEDO transactions. Thus, for example, where a transaction value of R1,000 is concerned, the AEDO user may well pay R22.80 when the NAEDO user is paying R7.98. For repayments greater than R350, NAEDO is better value. It is partly for this reason that micro lenders appear to be shifting to NAEDO.

FNB justified higher AEDO user fees as follows:

AEDO offers merchants additional value adds when compared to NAEDO, particularly the protection against repudiation of transactions, due to the authentication of the transactions and thus tends to be priced higher to merchants.

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Even at this general level the explanation is unsatisfactory, given that many of the users in the AEDO stream – i.e. smaller micro financiers and non-banks – appear to be opting for the less expensive NAEDO. Moreover, we have no reason to think that pricing by major banks in this area is any more cost-related than in others considered in this report. The levels of pricing, and especially the much higher prices charged to users without significant bargaining power – namely those in the AEDO stream – are most probably the result of banks’ ability to exercise market power. Additions of “value” (utility) for the consumer provide no justification for an above-competitive price.

At the levels of interchange and user fees now applied, especially in the AEDO stream, it is not surprising that acceptance of this new and clearly more advanced payment method on the beneficiary side has been retarded. Capitec submitted that with regard to the NAEDO stream, “Monthly EDO volumes are currently approximately 10 per cent of EFT volumes.”

The acceptance and response to the more expensive AEDO stream paints an even bleaker picture. According to PASA, in December 2007, only 3.744 million NAEDO transactions and 0.385 million AEDO transactions were processed through Bankserv. This is insignificant compared to the 28 million EFT debit transactions processed through Bankserv in October 2007.

Another factor hindering participation in the AEDO stream was mentioned by Mercantile:

- The reason why we participate in both the AEDO and NAEDO payment streams is that AEDO has limited access to accounts that can be accessed via the Bankserv debit card switch, whilst NAEDO allows for much broader access to accounts. This is a technical issue apparently not foreseen at the time of developing the AEDO stream.

In the AEDO stream, however, there is no identifiable relationship between the interchange fees and the substantially higher user fees charged.

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600 Capitec, March 2008, Response to further questions for Capitec, p 3.
602 Bankserv, November 2007, Data submitted to the Enquiry.
604 This fee ranges between R3.50 and R6 for the other banks that submitted user fees charged to beneficiary customers (SBSA, Absa, Capitec).
605 FRB, October 2007, FRB data and info request, p 10.
606 Confidential: FRB
The value added services that EDO offers beneficiary clients and the specialist support and infrastructure required to run the systems could well justify higher user fees compared to previously used systems. But the extremely high EDO user fees currently charged to the beneficiary customers (especially AEDO customers) compared to ordinary debit order user fees clearly impact on the success of this payment stream and the clear preference of customers for the latter. Capitec explained that:

The EDO service is deemed a value added service over EFT and a decision was taken to charge the EDO transactions at a slightly higher rate than EFT debits…

To be able to process these unique EDO features and to meet the tight Service Level Agreements for EDO places a burden on processing capacity at the bank.

EFT on the other hand carries a lower fee and is processed at the end of a business day where we have a little more time to complete processing. It is [a] simple process that is done in a batch processing mode during the night window of the bank. Much less strain is put on the operators.

A client has a choice of EDO or EFT mandates and the price differentiation is intended to act as a disincentive to issue EDO mandates when a normal EFT would suffice…

Users should use EDO selectively and use EFT for the more established consumers… the operational pressure on banks to complete processing on time is already high. Should the EFT users move large volumes to EDO it could create pressure on banks’ processing capacity and will require further investment in capacity to meet the early morning SLAs [Service Level Agreements].

It seems thus that the reluctance of banks to accept and use this more sophisticated payment system – which clearly contains significant benefits for consumers, and in which the banks have invested substantially – is reflected in the pricing to the end users, disincentivising the use of this payment method.

The pricing structures seem to only serve the best interest of the participating banks. but is required to pay away, in the form of the interchange, only a small part of the revenue extracted from the beneficiaries (users). It is unclear as to why no other participating banks have entered into the market in the provision of a competitive service. If effective competition existed in the provision of AEDO transactions, one would expect the high user fees to be undercut.

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608 Paying customers have hitherto not generally been charged for unsuccessful EDO debits and can thus save significantly on the penalty fees charged on rejected debit orders. See id., and also the chapter on Penalty fees; Absa, March 2008, Response to additional questions, p 4 and Nedbank, March 2008, Supplementary submission, p 4.) FNB charges an unsuccessful fee of R2.65, significantly lower than its dishonour fee for ordinary debit orders, while SBSA intends charging the standard dishonour fees to paying customers. See costing and pricing chapter on penalty fees.

609 See Table 19.

610 According to MFSA, all three of the participating acquiring banks and service providers charge very high user fees.

611 Also see the chapter on Market Power.
In contrast, payments between banks and users of the NAEDO stream seem considerably lower and less complicated,\textsuperscript{612} whilst participating issuing banks extract more revenue through higher interchange fees.

In the table below, the user and customer fees and the interchange are shown for both an AEDO and NAEDO transaction of R500, between Absa and Standard bank clients. In an on-us transaction where both end-users bank with the same bank, interchange would not be paid away, however, we have assumed in our example that two banks are involved. Total revenue extracted from both end-users in the AEDO stream is \[
\text{R16.70}
\] and increases with the value of the transaction, whereas for NAEDO, the amount is \[
\text{R13.33}
\], for all transactions up to R1000, whereafter the interchange increases by \[
\text{R5.00}
\].

The AEDO transactions require authentication, hence removing some of the risks out of the system. However, given the equality in the processing and functioning of the two EDO payment streams, the disproportionate revenue extracted in the AEDO stream on the acquiring side in comparison with the non-authenticated NAEDO transactions, seems unjustifiable.

The process of negotiating EDO interchange fees bilaterally seems not to have produced any pro-consumer competitive benefits. If anything, it tends to confirm the general analysis given above – namely that bilateral interchange setting serves to accentuate market power.

\textsuperscript{612} The user fee seems to be the same regardless of the value of the transaction.

\textsuperscript{613} E Plan account, 2008 pricing brochure
In our view, the interchange fees applicable to EDO transactions ought to be brought within the transparent and objective regulatory scheme which we propose for payment cards and other payment streams where it would be appropriate. Once again, establishing the necessity of interchange in the payment stream concerned would be fundamental to the process.

That process will also help clarify the extent to which banks’ pricing to users in these streams is in excess of costs, and whether a specific investigation into excessive pricing, either under the Competition Act or consumer protection legislation, is warranted.

6.9 Appropriate regulation of interchange

6.9.1 International experience

Where the setting of interchange is not regulated, competition authorities are left with an unending predicament in their attempts to address the abuses, or potential abuses, identified above. The point at which interchange ceases (or would cease) to operate purely as a legitimate balancing mechanism to enable the necessary co-operation in a four-party payment system, and begins to function as a centre for the co-ordinated extraction of excessive profits, is constantly shifting and is extremely difficult to pin down. While the public is entitled to protection against abuse, the card schemes and their participants are entitled to certainty so that they can get on with productive business, and in so doing expand the local and global reach of innovative and efficient alternatives to cash and paper-based payments.

The *Nabanco* decision in the United States in the mid-1980s seemed simply to give a green light to interchange – but, as we have seen, its analysis did not adequately distinguish and disentangle the necessity and legitimacy of interchange in principle from the reasonableness of the methodology and “business judgment” employed in setting it. In the latter respects the decision was merely case-specific. At that relatively early stage in the development of four-party schemes, the potential for systematic abuse was not identified.614 Everything was supposedly for the best in the best of all possible worlds. In other jurisdictions authorities have not accepted interchange so readily.615

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614 Even now it is not identified by some well-informed writers on competition in the United States. Cf e.g. Muris, T.J., “Payment Card Regulation and the (Mis)application of the Economics of Two-Sided Markets”, 2005 Columbia Business Law Review 515-560. However, despite *Nabanco*, there are evidently a number of pending cases brought by merchants in the US against MasterCard and Visa challenging the legality of scheme interchange rules. See: http://www.mastercard.com/us/company/en/newsroom/interchange_lawsuit.html. Moreover, a Bill has recently been introduced in the US House of Representatives (HR 5546) which would seek to impose a regulatory regime on interchange setting in “covered electronic payment systems”, being those electronic payment systems used for at least 20% of the combined dollar value of US credit, signature-based debit, and PIN-based debit card payments processed. The Bill is supported by the National Retail Federation, but opposed by card schemes and banks. See e.g. http://www.paymentsnews.com/2008/03/retailers-welco.html; http://www.electronicpaymentscoalition.org.

615 “Australian regulators are not alone in expressing an interest in interchange. Regulators in Europe, in the US and in Hong Kong have also recently introduced interchange reforms or are currently considering their introduction.” Visa, Second Submission, June 2007, document T (March 2005), p 7. “[A]uthorities in Austria, Portugal, Spain and Switzerland and Poland have also launched interchange focused investigations or have considered interchange in the context of broader payment system reforms.” Id., p 51. The *Financial Times* reports (19 December 2007): “Up to 12 EU
In Europe, for example, interchange has been a bone of contention since at least 1992. Back in 1977, the company which became known as Visa International had notified various rules and regulations governing the Visa association and its members to the European Commission, applying for negative clearance under Article 81(1) of the Treaty or, in the alternative, an exemption under Article 81(3). In 1992 the Commission withdrew a comfort letter previously given, and “re-opened” its investigation. In 1997 the re-opened investigation also took into account a complaint filed by EuroCommerce, a European retailers’ organisation, concerning various aspects of, *inter alia*, the Visa International payment card scheme, in particular interchange fees. On 24 July 2002, the Commission issued a decision relating to the intra-regional interchange fee scheme of Visa International for consumer cards, as applied to cross-border point of sale Visa card payment operations between EEA Member States. The effect of this decision was to exempt Visa’s intended multilateral interchange fee (MIF) from the prohibition under Article 81(1) until 31 December 2007, on the basis of certain proposals and undertakings from Visa. The undertakings included significant reductions in the prevailing levels of interchange for different types of cards – a reduction of more than 50 per cent in the case of average debit card transactions. The proposals involved the use of a costing methodology, subject to independent audit, which was designed to serve as a “proxy” for benefits received by merchants from cross-border card payments by retail consumers, and which would set a cap to the permitted level of

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616 The Treaty of Rome established the European Community. Its articles were amended and renumbered in terms of the Treaty of Amsterdam. Article 81 (formerly Article 85) provides as follows:

1. The following shall be prohibited as incompatible with the common market: all agreements between undertakings, decisions by associations of undertakings and concerted practices which may affect trade between Member States and which have as their object or effect the prevention, restriction or distortion of competition within the common market, and in particular those which:
   a. directly or indirectly fix purchase or selling prices or any other trading conditions;
   b. limit or control production, markets, technical development, or investment;
   c. share markets or sources of supply;
   d. apply dissimilar conditions to equivalent transactions with other trading parties, thereby placing them at a competitive disadvantage;
   e. make the conclusion of contracts subject to acceptance by the other parties of supplementary obligations which, by their nature or according to commercial usage, have no connection with the subject of such contracts.

2. Any agreements or decisions prohibited pursuant to this Article shall be automatically void.

3. The provisions of paragraph 1 may, however, be declared inapplicable in the case of:
   a. any agreement or category of agreements between undertakings;
   b. any decision or category of decisions by associations of undertakings;
   c. any concerted practice or category of concerted practices,
   which contributes to improving the production or distribution of goods or to promoting technical or economic progress, while allowing consumers a fair share of the resulting benefit, and which does not:
   a. impose on the undertakings concerned restrictions which are not indispensable to the attainment of these objectives;
   b. afford such undertakings the possibility of eliminating competition in respect of a substantial part of the products in question.


618 See id., para (18).
interchange for each card type.

In reasoning its way to its decision the Commission concluded that, while Visa’s MIF did not have the \textit{object} of restricting competition, it did have the \textit{effect} of appreciably restricting competition, and therefore required exemption from Article 81(1).\footnote{See \textit{id.}, paras (69) and (73).} It found that adequate grounds for such an exemption existed. The Commission’s analysis did not make a clear distinction between the necessity of interchange in principle, on the one hand, and a methodology of interchange setting which may unnecessarily restrict or distort competition (whether in object or effect), on the other. Indeed, the methodology which it approved for purposes of the exemption was essentially the same as the one used in South Africa, which we have found above to be inherently unsatisfactory.\footnote{The methodology approved in the EC’s Visa exemption used (a) the issuer’s costs of processing transactions, (b) the issuer’s cost of providing the “payment guarantee”, and (c) the cost to the issuer of the “free funding period” as an “acceptable proxy” for the average marginal utility of a Visa card to the merchant accepting it. (See \textit{id.}, especially paras (83) – (90.) At best the Commission could only say that these costs reflected the cost of services which issuing banks provide “wholly or partly” to the benefit of merchants. (See \textit{id.}, para (91).) In the case of the “free funding period”, this was “a feature of international charge and credit cards that partly benefits the merchant for cross-border transactions.” Why the whole of these costs should then simply be included in the approved interchange methodology (and no others), and why no attempt to assess and balance elasticities of demand on the two sides of the market was thought necessary to a rational outcome, remains a mystery. The likelihood is that the grant of the exemption relied less on systematic reasoning than on the promise that Visa’s interchange levels would actually come down.} Although mentioning the argument regarding the need in principle for a balancing mechanism in an open or four-party scheme, the Commission seemed to give it no weight. It concluded that interchange was not technically necessary since the Visa scheme could admittedly survive on a greatly reduced scale without it.\footnote{See \textit{id.}, para (59).} We are unable to follow this line of reasoning. By implication it acknowledges that interchange would have been necessary to enable the \textit{additional} transactions to occur, but the point at which “technical” necessity would be established in a two-sided market remains unclear. At the same time, so the Commission’s reasoning went, the necessity of interchange for optimising card usage was clear enough to warrant an exemption under Article 81(3) – subject to the provisos as to reduced levels and the “proxy” costing methodology.\footnote{See \textit{id.}, paras (98) and (99).}

The logical consequence of this approach would seem to be:

- that multilateral or other uniform interchange setting is always prone to prohibition in Europe under Article 81 unless specifically declared exempt;
- that exemptions would have to be periodically reconsidered; and
- that in this way regulation of interchange would in fact occur indirectly under the supervision of the competition authorities.

On 19 December 2007, the European Commission announced its decision on MasterCard which has been referred to earlier in this chapter. Still maintaining that open card schemes
“can operate without a MIF”, and that methods other than interchange can provide a balancing mechanism in a four-party scheme, the Commission nevertheless stated that it did not consider interchange as such to be prohibited. However, it found that MasterCard’s multilateral intra-EEA default interchange fees for debit and consumer credit cards did violate Article 81 of the Treaty. In its announcement, the Commission stated:

MasterCard has six months to comply with the Commission’s order to withdraw the fees. If MasterCard fails to comply, the Commission may impose daily penalty payments of 3.5 per cent of its daily global turnover in the preceding business year. MIF are not illegal as such. However, a MIF in an open payment card scheme such as MasterCard’s is only compatible with EU competition rules if it contributes to technical and economic progress and benefits consumers.

The criteria mentioned are ones applicable to exemptions under Article 81(3), thus suggesting that multilateral interchange is indeed to be treated as prohibited unless exempted. At the same time, the European Commission drew attention to the fact that the Visa’s 2002 exemption was about to expire.

[From that moment on VISA will be responsible to ensure that its system is in full compliance with EU competition rules.]

From our perspective, the EU approach lacks the clarity and certainty that we would be looking for.

624 Id., p 6. The alternatives are not specified and it is not clear why they would be less objectionable in principle or in fact if their object or effect would be to place a cost burden on merchants similar to that which interchange accomplishes. In the same explanatory memorandum in respect of its December 2007 decision on MasterCard, the European Commission also said that its Sector Inquiry of 2005/2006 into retail banking had found that in 22 of 25 EU member states credit card issuing remains profitable without interchange fees. See id., p 5, citing IP/07/114 (Brussels, 31st January 2007). Reference to the underlying analysis reveals a rather more qualified position. (See Report on the retail banking sector inquiry, Commission Staff Working Document accompanying the Communication from the Commission – Sector Inquiry under Art 17 of Regulation 1/2003 on retail banking (Final Report) [COM(2007) 33 final] SEC(2007) 106, 31 January 2007, pp 121ff.) It appears that, in the case of 62 out of the 100 issuing institutions that reported positive profits from credit card issuing, they would have remained profitable without the component of their revenues provided by interchange. In other words, 36 of the 100 would not have been profitable without interchange. As for the 62, the level of their residual profitability is not indicated, nor is there an examination of the extent of any likely exit on their part from credit card issuing in the event that interchange in respect of such cards were to be prohibited. (Mere profitability may not be enough to keep a firm in a market if the rate of profit is abnormally low.) The working document itself indicated a need for caution when it stated: “The aim of this analysis is not to argue in favour of a zero interchange fee for all networks. However, in the light of the results, it is legitimate to question the optimality of the current level of interchange fees in several countries. The inquiry’s findings seem to confirm some recent theoretical predictions of the two-sided market literature, which suggest that privately optimal interchange fees may be too high, notably if merchant fees increase with interchange fees but issuers do not pass the additional interchange fee revenue back to cardholders.” From the South African perspective, we have addressed all of these aspects in this chapter above.
625 Id.
626 IP/07/1959, Brussels 19th December 2007, p 1. On the same day, MasterCard Europe announced that it would appeal the decision to the European Court of First Instance. (MasterCard press release, 19 December 2007.)
627 According to a report in the Financial Times, 19 December 2007, this would amount to $316,000 per day.
628 Id.
629 “Far from providing clarity, today’s decision leaves MasterCard Europe and the entire payments industry in doubt as to what interchange fees the Commission will allow,” said the President of MasterCard Europe, promising to “continue to seek common ground with the Commission” while contesting the decision. (MasterCard press release, 19 December 2007.) To the extent that, in the Commission’s reasoning, there is an implied approval of bilateral setting of interchange, we consider this both impractical and (at least in South Africa) highly undesirable for reasons discussed above.
Like the European Commission, the South African Competition Commission has no direct regulatory powers. Unlike the European Commission, our Competition Commission lacks wide powers of exemption. The powers in terms of section 10 of the Competition Act to exempt a practice from prohibition are very limited indeed. Even if these powers were to be expanded – which may be warranted in any event – we do not consider that exemption under competition legislation provides a satisfactory framework for regulating interchange.

For the reasons explained above, an approach which assumes that multilateral or uniform interchange is prohibited unless exempted seems inherently flawed. At the same time, the constant resort to exemption in order to legitimise interchange would oblige the competition authorities to function in effect as price regulators. They are not cut out for such a role. Moreover, criteria for exemption under competition legislation – criteria which, by their nature need to be generally applicable across industries – could not be tailored adequately to the complex subject-matter of interchange and would thus not be sufficiently precise. The vagaries of official discretion would consequently reign at the expense of objectivity, clarity, business certainty and the rule of law.

In Australia, the Reserve Bank cut through these difficulties by imposing a regime of interchange regulation in respect of payment cards, standing independently of competition law. In an appendix to this report we have provided considerable detail of the Australian reforms for ease of future reference and comparison. While our recommended methodology differs from that adopted by the RBA for determining appropriate levels of interchange, we do recommend that South Africa follows their pioneering initiative in moving to the regulation of interchange on an independent, objective and transparent basis.

6.9.2 An independent, objective and transparent process

After the conclusion of the Enquiry hearings, the Panel asked the Technical Team to engage in a consultative process with banks and other relevant stakeholders in order to explore further the feasibility and practical implications of certain changes which had been mooted in the hearings. One of these was

the introduction of an independent, objective and transparent methodology and procedure for

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631 Section 10 (3) of our Competition Act limits permissible exemptions to those restrictive agreements or practices where the restriction concerned is required to attain (i) the maintenance or promotion of exports; (ii) the promotion of the ability of small businesses, or firms controlled or owned by historically disadvantaged persons, to become competitive; (iii) a change in productive capacity necessary to stop decline in an industry; or (iv) the economic stability of any industry designed by the Minister of Trade and Industry, after consulting the Minister responsible for that industry. Section 10 (4) further allows the possible exemption of agreements or practices relating to the exercise of intellectual property rights. The intended scope of this is not clearly indicated. It was under section 10 (4) that Visa sought and obtained – whether validly or otherwise is not a matter for us to address – an exemption until 2013 of its interchange arrangements in South Africa.

632 Obviously domestic regulation cannot affect cross-border interchange rates. There needs to be discussion between competition authorities internationally as to how to address this problem.
determining interchange in all payment streams in which interchange is necessary.\textsuperscript{633}

A series of exploratory meetings was then arranged. It was emphasised that nothing said at those meetings would be considered as being on the record of the Enquiry, unless specifically advanced and recorded as an on-the-record statement at the instance of, or by agreement with, the participant concerned. Moreover, participation in the exploratory process would not be taken to imply support for or endorsement of any particular change or measure that the Panel might ultimately recommend.

Three such meetings on interchange were held – on 15 August, 4 September and 30 October 2007 – which were attended by representatives of banks, card schemes and the larger retailers. The consultative process envisaged by paragraph 6(c) of the Enquiry terms of reference continued also in other ways. Valuable contributions to our further understanding of the subject were made in this way, both in oral debate and by means (for example) of working documents for discussion, and we have drawn on them to varying degrees in coming to our own conclusions. They are not specifically identified and acknowledged in what follows because they have remained off the record.\textsuperscript{634}

In our view, there is a need for the process of interchange-setting to be subject to regulation under specific statutory authority. This is necessary to ensure, \textit{inter alia}, that the global four-party card schemes are effectively subordinated to the envisaged process in so far as their operations in South Africa are concerned, and that their participating institutions here adhere to that process despite any provisions to the contrary regarding interchange that may exist or be adopted in the schemes’ own rules.

The regulator of the payment system – the South African Reserve Bank (SARB) – would appear to have the authority under section 10(1)(c) of its own enabling Act\textsuperscript{635} to devise and implement the necessary rules and procedures. That Act, however, has to be read in conjunction with the NPS Act. It should be noted that in the chapter of this report dealing with Access to the Payment System, we have concluded that certain fundamental changes to the NPS Act are required. Other, less fundamental changes may also be necessary. Currently section 12 of the NPS Act, which allows the SARB to issue binding directives regarding a payment system, does not apply to a “designated settlement system”. It will be important to ensure that a regulated process of interchange-setting which might be provided for by way of

\textsuperscript{633} Letters of invitation to stakeholders, July 2007.

\textsuperscript{634} The exploratory process on appropriate regulation of interchange went considerably beyond the on-the-record submissions of the various participants, and similarly beyond the questions asked and the answers given by them at the hearings in that regard. No purpose would be served by recapitulating those earlier submissions, questions and answers here. The record stands as a direct source of reference should it be needed. Occasional references are made to the record in footnotes to this section below, where that helps to elucidate certain issues not elaborated in the main text.

\textsuperscript{635} South African Reserve Bank Act 90 of 1989. Section 10(1)(c)(i) empowers the SARB to “perform such functions, implement such rules and procedures and, in general, take such steps as may be necessary to establish, conduct, monitor, regulate and supervised payment, clearing or settlement systems”. Section 10(1)(c)(iii) empowers it to “perform the functions assigned to the Bank by or under any law for the regulation of such payment, clearing or settlement systems”.

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Contains confidential information
a directive under section 12, is not able to be circumvented by the simple device of banks deciding to clear and settle their card transactions through designated off-shore systems of the card schemes.

The regulated process of interchange setting which we have in mind would not cast the SARB or its National Payment System Department (NPSD) in the role of having to establish the appropriate level of interchange itself. It would not become, in effect, a price-setter. Rather its role would be to confirm that the process provided for in the envisaged rules had been duly carried out by the participants and, on that basis, to declare the result binding. It would then have the role of ensuring compliance and dealing in the ordinary way with contraventions.\textsuperscript{636}

The basic elements of the envisaged regulatory process are set out below. Payment streams that should be included in the process at the outset are the credit card, debit card, electronic funds transfer (EFT) and early debit order (EDO) streams.

In our view, the regulator should have the authority to invoke the process also in respect of any other existing or future payment stream, or any means of payment in any stream, whenever satisfied that interchange in that connection (however it may be set or proposed to be set) may give rise to significant competition or consumer welfare concerns. (Advice from the Competition Commissioner from time to time could assist the regulator in being satisfied or otherwise in regard to the first of those criteria, at least.)

The advantage of such a flexible approach would be that, at least initially, where innovations occur in methods of payment, including the introduction of new types of payment cards, interchange could (where it is necessary) be established for them by private arrangements without immediately facing regulatory control. There should, however, be a requirement of public disclosure of all interchange arrangements at least twice a year, combined with frequent reporting to the regulator of all volumes and revenues connected with interchange, whether regulated or not. This would both enable compliance with the regulatory arrangements to be monitored and put the regulator in an informed position from which to investigate further and invoke the process once concerns over unregulated interchange setting arise.

The possibility of such flexibility follows from the conclusion that multilateral or uniform interchange in a payment stream, where it is necessary to balance the two sides of the market, is not unlawful \textit{per se} – but that it may nevertheless be abused.

\textsuperscript{636} This role appears to be in keeping with the responsibilities set out by the Bank for International Settlements (BIS) for overseers of Systemically Important Payment Systems, in its Core principles and Responsibilities of Central Banks. In particular Core Principle IX, which aims to address access and competitive aspects in payment systems, read together with the Responsibility C, which is designed to include overseeing compliance of other systems with the core principles, would apply.
6.9.3 Participation in the process

The process which we envisage would involve the establishment of an “Interchange Forum”, within which there would be a specific sub-forum for each payment stream where interchange is to be subject to regulation. The mandate of the combined forum would be to consider and reach a decision on the optimal (i.e., welfare maximising) level of interchange in respect of each of the relevant payment streams, having regard *inter alia* to the way in which different payment streams may compete with each other. The role of the sub-forums would be to consider and convey advice to the combined forum regarding the optimal level of interchange from the separate point of view of each particular payment stream and its stakeholders.

Decisions reached in the Interchange Forum need not set or modify the levels of interchange in all the relevant payment streams at the same time.

The SARB should appoint a chairperson and a deputy chairperson for the Interchange Forum. These persons would also be responsible for convening and chairing the sub-forums. A reasonable combination of independence and expertise or experience should be sought in these appointments.

Participation in the Interchange Forum and its sub-forums should be open to all relevant stakeholders, including, for example, merchants where relevant, representative consumer organisations, consumer protection authorities, payment schemes and scheme participants, and other relevant payment service providers. The NPSD of the SARB, as well as any payment system management body such as PASA, should be informed of all meetings of the Interchange Forum and its sub-forums, so as to be able to observe or participate in proceedings if it so wishes.

Working procedures for the Interchange Forum and its sub-forums would have to be drawn up, including provisions to ensure the submission of complete and accurate information together with the protection of business information that firms may legitimately need to keep confidential from their competitors. There should be no restriction, however, on the public airing of different views and motivations regarding appropriate criteria, methodologies and levels for interchange. A primary objective is to render the process of interchange setting as transparent as possible.

Since divergent interests would be represented in the Interchange Forum and its sub-forums, proceedings in each of the sub-forums could well give rise to conflicting advice to the combined forum, and consensus could well ultimately be lacking in the latter. In our view, the decisions in the Interchange Forum should be the decisions of the chairperson (or deputy in the absence of the chairperson), duly recorded with reasons.637 Where a

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637 Given that there will in fact not be democratic decision making in the Interchange Forum, the setting out of reasons is
consensus exists and is recorded, that would be reason enough: the decision would simply express the consensus. Failing consensus, the decision would have to be supported by adequate written reasons.

Clear governance procedures should thus be established, so as to allow for an orderly and expeditious process in the forums in which facts, views and arguments are properly recorded, and so that these can be adequately reflected in any reasons for decision which may ultimately have to be given.

There should also be an expeditious appeal procedure, to a tribunal appointed by the SARB but including at least one external independent adjudicator. An appeal should be possible on grounds that the decision made is insufficiently supported by the reasons given for it. In the interests of efficiency, the appeal tribunal should also have power to review and set aside procedural decisions, and correct procedural omissions, where a fundamental failure of due process would otherwise result. The appeal tribunal should be able either to remit an unsatisfactory decision to the chairperson for reconsideration or substitute its own decision (with reasons) where it has adequate information enabling it to do so.

At the conclusion of the process, the SARB would bring the relevant interchange levels officially into operation by confirming the decisions reached. In so doing, the SARB would satisfy itself that the process has been duly carried out in compliance with the regulations or directives concerned.

6.9.4 The methodology

General criteria

First among the decisions to be reached in the Interchange Forum would be the formulation of general criteria for the setting of interchange in payment streams which are to be subject to the regulatory process. There would be no need for sub-forums to debate this aspect separately, unless particular criteria are thought to be stream-specific. Draft criteria could be published to allow for comments to be more widely received. After consideration by the Interchange Forum, a decision on the criteria would be arrived at – again supported by reasons, subject to appeal, and subject to confirmation by the SARB.

Apart from the decision on the general criteria and final decisions on the levels of interchange to be applied, it should not be necessary for the SARB to have to confirm each step or decision taken in the course of the interchange-setting process as it occurs. Its ability to observe and participate in the process, should it so wish, would enable it to indicate dissatisfaction at an early stage and advise remedial steps should the need for that arise.

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essential. Moreover, it captures the spirit of the country’s constitution.
Among the general criteria should be the promotion and maintenance of effective competition, both within and between payment streams. For reasons extensively set out in this chapter above, we consider that the objectives of competition are generally best secured by levels of interchange no higher than is reasonably necessary to balance disproportions of cost and demand on the different sides of a two-sided market. Whereas hitherto a “business judgment” – a profit-maximising judgment – has been exercised in order to collectively “optimise” output by means of interchange in particular payment streams, it should now be expected that the optimisation of the output of one payment stream vis-à-vis other payment streams by means of uniform interchange would involve a social value-judgment aimed at welfare-optimising effects. Thus, for example, the replacement of cash with electronic and other paperless means of payment might legitimately be given weight as a general objective in the interchange-setting process. Likewise the promotion of the use of debit cards by consumers and ending the privileged position of credit cards in payment transactions, for may also be an identified aim. “Business judgment” would now have to defend itself openly in a forum concerned also with potentially divergent interests and wider social aims.

At the same time, efficiency, reliability, profitability and the encouragement of modernisation and innovation within existing payment streams would surely constitute general criteria to be applied in evaluating appropriate levels of interchange.638

The general criteria for the setting of interchange should be open to reconsideration, if called for, whenever the process of interchange-setting is repeated in any payment stream.

Uniformity

We have shown above why bilateral setting of interchange is in fact anti-competitive;639 and also why competition between card schemes would usually tend to raise or sustain high interchange levels rather than bring them down. Accordingly, in our view, there should be a uniform level (or levels) of interchange compulsorily applicable on the same basis to all participants within the payment stream concerned – save only that in the case of payment

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638 Visa, for example, has specifically put forward innovation as one of the strategic objectives involved in determining “the appropriate rate of interchange”. (Visa, June 2007, Second Submission, document B (third part) p 19.) However, the legitimacy of this where interchange is privately set by profit-making firms, such as the schemes and their participants, is open to question. In a competitive market, the entrepreneur must finance ongoing innovation through re-investment of profit. An ability to make the customer pay now for future innovation smacks of the existence and the exercise of market power. However, once interchange setting is moved into a transparent and objective process, with full participation of all stakeholders and subject to regulatory oversight, then the objection would fall away. The public interest in innovation could then be brought effectively into the balance. Cf also FRB, October 2006, First Submission, p 67; Nedbank, March 2007, Second Submission, Access and Interoperability, p 42 and p 53; Transcript 19 April 2007, pp 51-55. This aspect (the financing of innovation through interchange) is distinct from the importance of interoperability in facilitating innovation, and the role of interchange in enabling interoperability to develop in conjunction with innovations. FNB stated that the development of payments by cellphone has been held back by the absence of interchange and of a four-party model. (Transcript 19 April 2007, p 115. Cf also id., pp 178-180.) The development of the hybrid card, on the other hand, was facilitated by the existence of interoperability and interchange. (Id., pp 183-184.)

639 See section 6.6.
streams involving the cards of “open” or four-party card schemes (such as Visa and MasterCard) a lower uniform level or levels of interchange may, if they so wish, be applied by those schemes on a scheme-wide basis to the type of transactions concerned.

This approach would serve (a) to set a cap on permissible interchange levels, (b) maintain a prohibition against bilateral setting between individual participants, and (c) at the same time allow scope for the schemes to compete interchange levels downward across the board in the instances when it might be in their respective interests to do so.640

Costing methodology

Following a competitive tender process, the Interchange Forum should instruct an independent third party with relevant experience and expertise to draw up and submit a precise costing methodology in order to enable the disproportions in costs between the issuing and acquiring (or paying and collecting/receiving) sides of the market in each of the relevant payment streams, and for each relevant means of payment or transaction type therein, to be assessed.641

This draft costing methodology would then be considered and debated in the Interchange Forum, and could be referred back to the third party for further attention if necessary, before becoming the subject of a decision in the Interchange Forum. If (as seems likely) the appropriate costing methodology would differ (for example in its relevant cost categories) between different payment streams and means of payment or transaction types, then the need to involve particular sub-forums in considering and debating it would naturally arise.

In the event that the chairperson (or deputy) has to make the decision on the costing methodology in the absence of consensus, and where reasons accordingly have to be given, the decision would be subject to appeal.

We have indicated above why we consider that a sub-set of issuing costs is not acceptable as a “proxy” for use in the process of interchange setting (as has hitherto been the case with credit cards). First, it is altogether inadequate as a means of determining the true disproportions of relevant costs on the two sides of the market. Second, it subsumes into a partial costing exercise on the one side of the market an alleged measure of the elasticity of

640 To ensure a level playing field, our recommendation of a uniform “cap” on interchange in each card payment stream is subject to one potential qualification which is addressed below.

641 “Independence” here will obviously be relative. The crucial requirement is that the entity concerned should not be financially interested in the outcome of the process (Transcript 19 April 2007, p 58). It should be independent of the issuing and acquiring institutions involved so that it can be entrusted also with their confidential data in performing the costing exercise. Given the need for experience and expertise, it is probably inevitable that the entity concerned will have a history of providing services to one or other of the card schemes, and the expectation of continuing to do so, whether in South Africa or in other jurisdictions. In these circumstances transparency becomes all the more important, along with wide participation, proper reporting, open debate and informed decision-making in the Interchange Forum itself.
demand on the other side. Not only have we found the justification advanced for this to be unconvincing, and its true objective purpose to be objectionable; it also simply disregards the need to evaluate the relative elasticities of demand on both sides of the market, in order for the setting of necessary interchange to be properly carried out in any payment stream.

The costing methodology which is called for is one which assesses all relevant categories of costs incurred in supplying the payment service on both sides of the two-sided market in each stream. Which categories are relevant, and which are irrelevant, is a matter for recommendation by the independent third party and for debate in the Interchange Forum and sub-forums.

As we have explained above, we do not consider that the costs of credit extension – including the funding costs of the interest free (or “free funding”) period afforded to credit card transactors – are legitimately included in payment card interchange. Processing costs and the net costs of the payment guarantee (to the extent that this is a benefit truly provided by issuers and truly passed through to merchants) are a qualitatively different matter.\textsuperscript{642} In our view, it is the use of a card as an effective means of payment that gives rise to the necessity (and hence legitimacy) of interchange in principle where four-party schemes are concerned. While the relevant cost categories may differ in detail as between debit card and credit card interchange, the principles for determining relevance would seem to us to be essentially the same. It is as a means of payment and not as a means of credit extension that the credit card qualifies for interchange.

Issuers’ costs of providing “loyalty” or frequent-user benefits to cardholders would also seem not to be a legitimate component of interchange, and indeed such costs are conventionally excluded from existing interchange calculations.\textsuperscript{643}

\begin{itemize}
\item[642] We recognise that the payment guarantee is essential to the acceptance of a card as a means of payment, and could legitimately be included among the costs relevant to interchange. It is at least arguable that the cost of the payment guarantee would include the cost of cardholder default. This arises potentially when, in using the card to make payment, the cardholder draws on a credit facility of some kind. That is invariably the case with credit card transactions, but may also occur where a debit cardholder draws on an overdraft facility. In this connection, the question arises as to the period within which default (and with it the cost of default) might reasonably be regarded as relevant to interchange. A suitable period would need to be identified, in order to prevent interchange being used to finance what is essentially the issuer’s lending business. The cost of the payment guarantee in the case of credit cards is commonly taken to include the cost to the issuer of default by borrowers during whatever “free funding” period the issuer allows – but this period varies between countries and there is nothing logically sacrosanct about it. Clearly the longer the period, the less relevant the costs of the borrower’s default becomes where payment card interchange is concerned. Nevertheless, the inclusion of some part of the cost of cardholder default in interchange calculations would seem unobjectionable, at least when (as we go on to recommend) the merchant is free to accept a scheme’s debit cards or credit cards, or both, without being obliged either to accept its cards of all types or none at all. For reasons discussed above, however, qualitatively different policy considerations come into play when the inclusion of costs in interchange setting is extended to the funding costs incurred by the issuer-lender in providing to its customers a period of credit that is interest-free. We do not regard such lending costs as a legitimate component of interchange.

\item[643] It is instructive, nevertheless, to find in a 2005 study by Datamonitor on the effects of the Australian interchange reforms that lower interchange rates have been found to result in a cut-back of loyalty benefits, or higher charges for providing them. (\textit{Interchange in Australia – Global implications}, supplied by Visa, June 2007, Second Submission, document T.) “Card issuers have long used interchange revenues to fund loyalty schemes. It is therefore no surprise to see that the reforms have brought about a raft of loyalty scheme cut backs and fee increases.” (\textit{Id.}, p 34.) “Loyalty scheme access is now considerably more expensive.” (\textit{Id.}, p 43.) Datamonitor also says that one of the outcomes of the interchange reforms has been to expedite the trend towards low-rate cards which have limited or no loyalty schemes. “Consumers have lost out as a result of higher fees for loyalty but have gained from greater competition at the low rate end of the market.” (\textit{Id.}, pp 43-44.)
\end{itemize}
In drawing up an appropriate costing methodology for consideration, the independent third party should recommend the size and composition of the representative sample to be used for the cost study. In our view the advantage of establishing and utilising weighted average costs rather than the costs of the most efficient firm, on each side of the market, is that the competitive incentive for firms to reduce their costs would be more likely to be stifled if a firm could not retain the rewards of above-average efficiencies but instead were to lose those rewards automatically the next time interchange levels came to be evaluated.

We were informed that currently the costs incurred by card scheme participants, while they vary considerably as between the issuing and acquiring sides, do not vary significantly as between the two major card schemes. This is something the independent third party would have to confirm. If correct, it would mean that averaging of costing data as between participants in the two schemes would not give rise to major anomalies. If in fact there are significant differences – or if, for example, one scheme or both were to change appreciably the allocation of costs in terms of their rules as between the issuing and acquiring sides – then it might well be necessary to change or set different interchange caps for them in order to take proper account of this and level the playing field.

The consequent cost study

Once the appropriate costing methodology has been finally formulated and formally decided upon, the Interchange Forum, through its chairperson or deputy, would instruct the independent third party to carry out a cost study accordingly. Participants in the relevant payment streams would be required to submit cost data to the independent third party on a confidential basis. The latter would check and interrogate the data supplied by participants to ensure accuracy and consistency. Another independent entity should be engaged to audit the calculations that have been made with the collected data, as well as a random audit of data supplied.\footnote{Cf MasterCard, October 2006, First Submission, para 16.3: “One method adopted by MasterCard to verify the integrity of the data collected and utilised in the cost study, is to ensure that EDC maintain an audit trail of all documentation received. This audit trail makes it possible for participating members to trace the reported cost, revenue and statistical data back to their source. Detailed documentation of source data is developed by customer banks during the data collection process in order that reported cost, revenue and statistical data may be traced back to its source.”}

The independent third party which has conducted the cost study would then submit the results to the Interchange Forum. These would need to be accompanied by calculations showing the effect that different rates of interchange would be likely to have on ultimate average net costs on each side of the market, and advice as to whether interchange should be applied in each stream, or to each means of payment or transaction type, at a flat rate or on an \textit{ad valorem} basis.
All recommendations and calculations by the independent third party, once formally submitted to the Interchange Forum, should also be made available to the general public in the interests of transparency and to encourage public awareness of and confidence in the process.

**Assessment of demand elasticities and application of general criteria**

Objective methods of assessing demand elasticities on both sides of the market in each relevant payment stream, or for each means of payment or transaction type, should be adopted, if they can feasibly be devised, in order to assist the eventual judgment process in the Interchange Forum and its sub-forums. That judgment process, as already indicated, would be aimed at achieving optimal levels of interchange in accordance with the general criteria previously established.

Recommendations should be made by the independent third party in this regard, to the extent that it is possible to do so. Consideration could also be given to whether different interchange rates should apply to different types of merchants or segments of the market within a payment stream.

To the extent that it proves impossible or unreasonably difficult to establish objectively the relative elasticities of demand, the judgment process itself will have to suffice in this regard, guided mainly by experience. The Interchange Forum, in exercising its own judgment, would have to take carefully into account the implications of any shift from existing levels of interchange in any payment stream, and would need to consider calculations, estimates and recommendations by the independent third party in this regard. The Interchange Forum would not be bound by any recommendation of the independent third party. Where appropriate, the implications of a particular proposal arising in the Interchange Forum or its sub-forums could be referred by the chairperson or deputy to the independent third party for an assessment of its implications, before a decision is adopted.

**Decision on interchange levels**

As outlined above, the decision of the Interchange Forum would be made by the chairperson (or deputy, as the case may be), either on the basis of consensus or, failing consensus, on the basis of reasons given. The decision would then be subject to possible appeal and to ultimate confirmation by the SARB. Upon confirmation and publication of the decision, the interchange levels so determined would apply in the payment streams concerned until duly altered by a subsequent interchange-setting process conducted in due course.

The consensus during the Enquiry has been that a review every two or three years would be sufficient. In Australia, the costing process for the setting of interchange is carried out every
three years. In our view this seems adequate and could be laid down as the norm. In a particular case, if the independent third party has so advised and the Interchange Forum so decided, a shorter period could be determined at the time when the level of interchange is set. In any event, however, there should be a provision allowing the regulator to invoke a review at an earlier time in respect of any payment stream or streams if it appears that a material change in circumstances has occurred.

Cost of the process

It may be anticipated that the process outlined above will (especially at the outset) be intensive, time-consuming and costly. Once the relevant procedures have been laid down, the necessary appointments made and the methodology established and tested, the process can be expected to become more efficient and streamlined over time.

Subject to what is said below, stakeholders participating in the Interchange Forum and its sub-forums should bear their own costs incurred in doing so, including their own costs incurred in any appeal. Participants in payment streams who are required to submit cost data to the independent third party should likewise have to bear their own expenses in doing so.

However, the costs of establishing and operating the Interchange Forum and its sub-forums, the costs connected with the appointment of the chairperson and deputy, and the costs of engaging the independent third party and auditor should, in our view, be seen as a public expense. If these costs were to be borne directly by banks, card schemes, or other powerful participants, then the suspicion would inevitably arise in the public mind that “he who pays the piper calls the tune”. Whether public funds duly expended for this purpose could and should be recovered by levies on participating entities which are involved in receiving or paying interchange revenue is a matter for consideration by the authorities concerned. Moreover, it may be necessary to fund the participation of appropriate and relevant consumer bodies.

6.9.5 Avoiding negative consequences of regulation

We appreciate – and this has been emphasised especially by MasterCard – that the regulation of interchange can potentially have negative unintended consequences. Two categories of possible consequences require particular consideration: the effect of regulation on competition between three-party and four-party schemes, and the effect of regulation on

645 And for example, administered by the SARB or the National Treasury
646 See e.g. Transcript 18 April 2007, pp 35-38; Exhibit MM, slide 18; Exhibit BBB, Slides 12 &13; and also MasterCard’s published critique on the RBA’s regulatory intervention in Australia: Insights (MasterCard Worldwide), First Quarter 2007. Although it would not be directly affected by the regulation of interchange, American Express likewise warned in its Submission, October 2006, p 9, against regulatory intervention.
innovation.

The effect on competition between three-party and four-party schemes

It is suggested that three-party schemes such as American Express and Diners Club, in respect of which there is no explicit interchange and which would thus be unaffected by the regulation of interchange, could gain an undue advantage over their four-party rivals. If, for example (so the argument goes), interchange levels affecting the four-party schemes were to be brought down as a result of the regulatory process, the three-party schemes could still maintain their “intrachange” or implicit subsidy from the acquiring side to the issuing side at existing levels, and so provide greater benefits to cardholders for comparable issuing fees than the issuing participants in the four-party schemes could afford. More banks would be inclined to become issuers of the three-party cards under licensing arrangements. The three-party schemes would therefore be able to grow their market share at the four-party schemes’ expense—a “perverse” and anti-competitive consequence of regulation.

In order to address the problem rationally, it is necessary first to examine its assumptions and also strip away the elements of special pleading which overlay the manner in which it is expressed.

Just as the interchange in four-party schemes is financed ultimately by the merchant service charges levied by the institutions participating on the acquiring side, so the “intrachange” of the three-party schemes is financed by the merchant service charges which these schemes themselves levy. Our analysis earlier in this chapter has shown that the premium benefits provided to cardholders in the three-party schemes are financed (to the extent that there is reliance on “intrachange”) by way of premium merchant service charges. Insofar as the three-party schemes have to compete with the four-party schemes for merchants willing to accept their cards, their merchant service charges must retain a relation to the rough “benchmark” of comparative merchant service charges generally applicable within the far larger four-party schemes. A higher merchant service charge than the norm would thus generally have to be justified by a higher value of benefits to the merchant from accepting the three-party scheme card.

If the process, which we have outlined, of arriving at appropriate levels of interchange to be applied to the four-party card schemes is carried out effectively—if the imbalances in issuing and acquiring costs as well as the differing elasticities of demand on the issuing and acquiring sides of the market are reliably assessed—then the new comparative “benchmark” of merchant service charges resulting in the four-party schemes should be a rational one producing few if any anomalies.

In time, competition between the schemes should then cause the merchant service charges of the three-party schemes to be brought again into a relationship with the four-party
merchant service charges, so that any three-party premium again has to be justified by additional benefits to merchants. It would be different if appreciable market power could be exercised and sustained by three-party schemes over merchants – but at present it is most unlikely that it could.

Assuming that interchange levels were to come down in, say, the credit card payment stream as a result of the regulatory process, it is likely that there would be a period in which the three-party schemes could take advantage of merchant inertia, by continuing to levy their merchant service charges at or relatively nearer to the existing level. (That appears to have happened initially in Australia.) But if – in accordance with the recognised purpose in adjusting interchange – the merchant service charges in the four-party schemes were to come down significantly in consequence of lower interchange rates, then pressure on the three-party schemes to reduce their merchant service charges (or increase their benefits to merchants for the same charges) should follow.

In the interim, the “perverse” consequence entailed in the advantage that could be taken by the three-party schemes as interchange levels come down would be the result of a more fundamental perversity – namely, that the pre-existing rates of interchange had been collectively applied within the four-party schemes at a level above the necessary one, implying the extraction of supra-competitive profits within those schemes. Correcting the more fundamental perversity (assuming there is one which falls to be corrected by the lowering of interchange) should not be held back by fears of resulting temporary anomalies.

The suggestion that the three-party schemes should also be subjected to regulation in this area is not one that we can accept. They do not have interchange. Their “intrachange” is a matter of applying revenue to different costs within a single firm and of that firm’s own pricing to its cardholding and merchant customers respectively. To regulate “intrachange” in these firms at this stage would effectively require nothing less than the regulation of merchant service charges. That is not recommended. However, as the three-party schemes develop, the authorities (including the Competition Commission) should keep an eye on the situation. One may expect that their competitors will do the same. If their licensing arrangements were to evolve so that, whatever the form of things, there is in substance a transfer of revenue between different firms in order to use one firm’s revenue from the acquiring side to subsidise another firm’s issuing, then something akin to a four-party scheme will have been developed. In that event, the adaptation of the regulatory process to include them would have to be considered.

**The effect of regulation on innovation**

We have addressed this above, recommending that where innovations occur in the form of new methods of payment, including the introduction of new types of payment cards, interchange could (where interchange is necessary) be established for them initially by
private arrangements without immediately facing regulatory control.

The regulatory process would be invoked as and when the development of the new means of payment so takes hold that competition and/or consumer protection concerns arise in connection with the interchange arrangements. So far as existing means of payment are concerned, the flexibility of the interchange-setting methodology which we have proposed, the use of weighted-average costs as a criterion, and the possibility of invoking the process for reviewing interchange levels when new circumstances arise, should allow for and indeed encourage improvements.

The process provides a mechanism for the setting of interchange in all payment streams where interchange is deemed necessary, and provides a framework within which interchange for new payment mechanisms can be assessed and applied. It allows for the avoidance of a situation where innovators are disadvantaged by the pricing decisions of incumbents in a certain PCH and the setting of interchange below sustainable levels.  

The possibility which would be open to the four-party schemes of introducing new types of cards – including premium cards – initially outside of the regulated interchange process, should also assist in ensuring a level playing field in this regard between them and the three-party schemes. It is important to ensure, however, that this latitude does not open the way for evasion of interchange regulation. The critical requirements here must be: (a) that the new card is not introduced and issued simply as a replacement, however modified, for an existing card currently subject to interchange regulation, but has to be separately applied for by cardholders; and (b) that the merchant has complete freedom whether or not to sign up for the acceptance of the new card on a separate and distinct basis.

If any aspect of the “honour all cards rule” were to be applied by a scheme or any of its participants so as to constrain the merchant who accepts a card that is subject to the regulation of interchange also to accept the new card, then the new card should be included automatically under the regulatory regime. Should the new card, independently, come to be issued and accepted en masse, it would soon enough become a candidate for inclusion in the regulatory process in its own right.

6.10 Other rules of the schemes

6.10.1 The “honour all cards” rule

The “honour all cards” rule is often abbreviated in the submissions as the “HAC rule” or the “HACR”.  

Concerns related to current pricing practices affecting innovation are further discussed in the Chapter on Access to the Payment System.
MasterCard Worldwide explains that

the HAC rule stated that if a merchant participates in the MasterCard system it must accept all MasterCard-branded cards. The rule ensured that consumers have the ability to choose their preferred method of payment at the point of sale. In fact, many networks that offer payment cards --- including MasterCard, Visa and American Express – have honour all cards rules.648

MasterCard International’s Merchant Rules Manual (Revised 7 April 2006), which was submitted to the Enquiry, provides excerpts from MasterCard bylaws and rules published in April 2005.649 These include that “each participating merchant must accept MasterCard cards universally”,650 and that the merchant “must honor all valid MasterCard cards without discrimination when properly presented for payment.”651 As to the comparable Maestro rules, see Maestro Global Rules (published July 2005).652 MasterCard has confirmed that these rules allow merchants to accept either all MasterCard cards or all Maestro cards, or both, as they wish.653 However, that would still oblige the merchant who accepts MasterCard credit cards also to accept all MasterCard-branded signature-based debit or “cheque” cards (hybrid cards).

Visa’s general rule in this regard is as follows:

If a Merchant decides to participate in the Visa International Network, the HACR obliges the merchant to accept all Visa Cards equally.654

Visa’s International Operating Regulations lay down that a merchant “must accept all Cards properly presented for payment, as specified in Table 4-1.”655 The effect of the table is to include (inter alia) all Visa and Visa Electron cards in the HACR.

These provisions – to the extent that they are not subject to exceptions applicable in various jurisdictions – combine into one rule what we would rather separate for purposes of analysis into two rules, namely an “honor all products” rule and an “honor all cards” rule in the narrower sense of all scheme cards of the same product type.

Taking the HAC rule in its narrower sense, we consider it to be legitimate. The positive network effects of payment card systems have been discussed above. The schemes exist precisely to maintain and develop such networks. The benefits to cardholders of being able to carry and rely on using a card instead of cash are obviously fundamental to the viability of

649 MasterCard, October 2006, First Submission, Annex O.
650 Id. Chapter 2, Rule 6.5.1.
651 Id. Chapter 2, Rule 9.11.1.
652 Id. Chapter 6, Rule 5.5.1 and Rule 7.1.6.
654 Visa, First Submission, October 2006, p 52.
655 Id., Annexure F (on CD-ROM), Vol 1, Chapter 5, Rule 5.1.B.1.a.
the schemes. If merchants displaying the scheme logo applicable to a certain card type were able to refuse to accept that card when it suited them – to differentiate between cardholding customers individually, for example by place of origin (local or foreign), or according to the identity of the issuing bank – then the schemes themselves would be radically undermined.

MasterCard notes that “The HAC rule also leads to the obligation of the acquirer to the merchant to guarantee payment irrespective of the identity of the issuer.”\(^{656}\) The obligation of the merchant to honour all cards of the same product type is a perfectly reasonable counterpart of the obligation of every issuing bank to pay the particular acquirer, and not choose whether or not to enter into and honour transactions depending on the identity of the merchant or the acquiring bank, etc.

6.10.2 The “honour all products” rule

The matter is different, however, with the “honour all products” rule.

This rule, in our opinion, facilitates the accumulation of market power by schemes and their participants over merchants. In principle, we consider that it constitutes anti-competitive product bundling or “tying” for which no necessity exists. It obliges the merchant who wishes to accept a card of one type (under the particular scheme) to accept cards of other types also notwithstanding that the latter may cost the merchant more on account of a higher merchant service charge per transaction resulting from a higher interchange rate.\(^{657}\)

In South Africa, interchange hitherto has varied only according to whether the card is a (PIN-based) debit card, a credit card or a hybrid card.\(^{658}\) In future, however, there could be different interchange rates for premium credit cards, for example. The introduction of the EMV card may also bring with it different interchange rates.\(^{659}\) In our view, where a different interchange rate is applicable to the type of card, the merchant should have a choice whether or not to sign up for the acceptance of that card (and so be obliged to honour all cards within the accepted card type).\(^{660}\)

The “honour all products” rule has been removed in several jurisdictions including Australia,

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656 MasterCard, October 2006, First Submission, p 63.
657 It should be noted, moreover, that the existence of the “honour all products” rule in South Africa, by compelling merchants who only wish to accept debit cards to accept credit cards also, will have had the effect inter alia of forcing them to bear the burden – under the existing interchange arrangements – of certain of the costs of credit extension engaged in by by issuing banks in which they (the merchants) may wish to have no part. MasterCard does not oblige merchants to accept both MasterCard branded cards and Maestro branded cards (see above). Visa does however require merchants to accept both debit and credit cards under their brands (see Visa, October 2006, First Submission, Annexure F (on CD-ROM), Vol 1, Chapter 5, Rule 5.1.B.1.a.).

658 See above.
659 See footnote 180.
660 If interchange rates were to vary by merchant category, the distinguishing criterion for our purposes would still be whether the merchant is affected within that category by different interchange rates applicable to the different card types.

Banking Enquiry Report to the Competition Commissioner  Contains confidential information
while leaving the "honor all cards" rule otherwise intact.\textsuperscript{661} There is no evident damage to the viability of the card schemes as a result.

In the United States, the "honor all products" rule has effectively been eliminated by way of a settlement arising out of litigation initiated by Wal-Mart and others. This has applied to both the Visa and MasterCard schemes. Visa says:\textsuperscript{662}

> In the United States, as part of the Wal-Mart settlement, Visa USA, Inc. and MasterCard agreed to bifurcate the "honor all products" dimension of the HACR (i.e. both payment card schemes no longer oblige merchants to accept debit cards and credit cards in the package of products covered under the acceptance contract).\textsuperscript{663} In Australia, Visa International and MasterCard were compelled by regulation to bifurcate the "honor all products" dimension of the HACR.

"Bifurcate" seems to be a euphemism for "abandon".

The following more detailed account of the settlement in the US is given by MasterCard, naturally promoting its point of view.\textsuperscript{664}

> In June 2003, MasterCard signed a settlement agreement on all claims in the class-action antitrust lawsuit brought against MasterCard and Visa in 1996 by merchants in the United States. … [U.S. District Court Judge John Gleeson approved the settlement on December 19, 2003.]

The suit, which was initiated by Wal-Mart and several other merchants, challenged each card association’s Honor All Cards rule. The merchants claimed that they did not want to accept consumers’ MasterCard- or Visa-branded off-line, or signature-based debit cards, and that the associations violated the antitrust laws by tying acceptance of debit to acceptance of credit. As a remedy, the merchants sought billions of dollars in damages as well as the right to elect not to accept MasterCard-branded debit cards while accepting MasterCard credit or charge cards.

The settlement agreed to by MasterCard and the merchants ensures that the payments system will continue to work for consumers, merchants and MasterCard member financial institutions. It preserves the important consumer benefits of MasterCard's Honor All Cards rule, while giving merchants flexibility to choose how broad a range of payment choices to offer their customers.

MasterCard's key consumer protections prohibiting merchants from surcharging cardholders or discriminating against any MasterCard card or cardholder will be maintained for credit and charge cards and honored by merchants who continue to accept MasterCard debit cards. Merchants will have the right to choose not to accept U.S.-issued MasterCard debit cards, and under the terms of the agreement, MasterCard is free to establish an Honor All Cards rule for MasterCard debit cards. This will ensure that merchants who accept MasterCard debit will accept all MasterCard-branded debit cards.

MasterCard also agreed to establish a new interchange rate for debit at least one-third lower than the existing interchange rate, and at a level which should incent [sic] both issuance and acceptance of MasterCard debit cards. MasterCard will also develop rules requiring issuers to

\textsuperscript{661} Transcript 17 April 2007, p 27.
\textsuperscript{662} Visa, October 2006, First Submission, pp 57-58.
\textsuperscript{663} Visa added: “It should be noted that under the terms of the US Wal-Mart Settlement, bifurcation only applies to domestic cards issued in the US.”
\textsuperscript{664} http://www.mastercard.com/us/company/en/newsroom/merch_law.html
clearly and consistently identify MasterCard debit cards on their face and to make these debit cards identifiable through electronic terminals.

Also as part of the agreement, MasterCard agreed to pay into a settlement fund for eligible merchants $100 million a year for ten years, except for the first year when the payment will be $125 million.

One result of this lawsuit is that after January 1, 2004, the date by which merchants can choose to accept MasterCard-branded credit cards but not MasterCard-branded debit cards, some consumers may get to the front of the checkout line and find that the merchant rejects the payment option they have chosen. While this could impact a consumer’s ability to choose their preferred method of payment, MasterCard is confident that because of the strength of the MasterCard brand and the value proposition it brings to merchants and consumers, the vast majority of merchants will continue to choose to accept MasterCard-branded debit cards.

If a consumer finds that after January 2004, a merchant rejects his/her MasterCard-branded debit cards, the consumer has several options. First, the consumer can choose a store that welcomes the MasterCard debit card. Alternatively, the consumer can utilize a MasterCard credit card or other form of payment. Finally, the consumer can express his/her opinion that the merchant should offer their customers the broadest choice of payments by accepting MasterCard debit cards.

In South Africa, the elimination of the “honour all products” rule would seem most likely to facilitate the acceptance of debit cards, by completely freeing the acceptance of these cards from being tied to more expensive credit card acceptance by merchants.

If the complete withdrawal of the “honour all products” rule cannot be negotiated on a voluntary basis with the schemes concerned, then we would recommend a regulation or other appropriate statutory intervention to prohibit it. If this is not forthcoming within a reasonable time, we would recommend that the Commissioner give consideration to initiating and investigating a complaint or complaints of possible contraventions of the Competition Act through the application of the “honour all products” rule.

6.10.3 The rule against surcharging

MasterCard International’s Bylaws and Rules (published April 2005) provide that a merchant must neither directly nor indirectly require any MasterCard cardholder to pay a surcharge or any part of any merchant discount – i.e. the merchant service charge levied on the merchant by the acquirer – or any contemporaneous finance charge in connection with a MasterCard card transaction. However, a merchant may provide a discount to its customers for cash payments. A merchant is also permitted to charge commission, postage, an expedited service fee, etc., provided that the fee is charged on all like transactions regardless of the form of payment. “A surcharge is any fee charged in connection with any MasterCard transaction that is not charged if another payment method is used.”

Visa’s rules are similar in effect, save that the latitude allowed to merchants to provide

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discounts or other incentives extends beyond payments in cash to include rival networks’ payment cards.\textsuperscript{666}

It is argued that the rule against surcharging is necessary to sustain the “honour all cards” rule.\textsuperscript{667} There seems to be merit in this argument, at least so far as the legitimate ambit of the “honour all cards” rule (i.e. in its sense of cards of the same product type) is concerned.

At first sight this view may seem to lack foundation inasmuch as merchants who have signed up to accept scheme cards do not widely use surcharging where it is allowed.\textsuperscript{668} For example, there has been only a small incidence of surcharging by merchants in Australia.\textsuperscript{669} However, it stands to reason that consumers will tend to be deterred both from taking cards and from attempting to use them once issued, where surcharging is known to be a real possibility. As Visa puts it:\textsuperscript{670}

\begin{quote}
\ldots even though surcharging, where it is permitted, may affect only a minority of transactions, it can still have profound effects on the reputation and reliability of the payment card system which can consequently lead to a reduction in the number of cardholders and/or card usage, in particular, as cardholders will tend to “blame” the system and not the merchant if they are surcharged. \ldots
\end{quote}

One recent example of the impact of abolishing no surcharging rules is the experience in Denmark following changes to the Danish Payment Act, which permitted from 1 January 2005 charging only a capped MSC to merchants and to surcharge Dankort (the Danish national debit system) transactions. The total number of Dankort transactions fell from 42 million in January 2004 to 33 million transactions in January 2005 following the introduction of surcharging. Similarly, the average number of Dankort transactions per card fell from 175 in 2004 to 167 in 2005 due to customers’ fears of being surcharged. Due to opposition from cardholders, pre-election debate created political pressure to change the legislation again with the result that surcharging has not been allowed on Dankort transactions since March 2005 and on any Danish issued card since June 2005. \ldots

Although the Danish Competition Authority estimated that only approximately 19 per cent of (mainly the very large) merchants initially surcharged in Denmark, the effect on cardholders across the board was substantial as it resulted in the loss of certainty for cardholders that a payment card could be used anywhere which accepted that particular payment card, without penalty or unpleasant surprises and consequently without damage to the payment card’s reputation.

In Australia, however, where a far smaller percentage of merchants engaged in surcharging after the rule against surcharging was prohibited (see above), a negative effect on card issuing and usage has not so far been shown.

During our hearings, Absa indicated that it would not have a problem with abolition of no-
surcharging rules; in our view, it would not want merchants to be able to surcharge in excess of the merchant’s service charge when accepting payment by card. In our view, it would not be practicable to have to track and enforce such limits. The rules against surcharging should either stay or go. Generally, we do not consider that there is sufficient reason in the public interest to prohibit such rules.

Because of “price coherence” and the cost to merchants of price differentiation, the freedom to surcharge would not provide adequate protection for merchants (and end consumers) against the abuse of interchange setting by the schemes and their participating banks. Thus the abolition of the “no surcharge” rule, in and of itself, would be of little use as a remedy. If, on the other hand, the “honour all products” rule is eliminated, and if the setting of interchange is subjected to an independent, objective and transparent process under regulatory supervision as we recommend, then the continued existence of the “no surcharge” rule can do little if any harm, at least in domestic transactions.

Indeed there are positive reasons for maintaining the rule. Surcharging, where permitted, has mostly been utilised by large merchants rather than smaller ones, or by merchants having market power over customers as a device for extracting additional revenue. We find the following submission by Visa persuasive:

... [E]xperience has shown that customers are most likely to be surcharged where they are “captive” card-using customers. A captive card-using customer is one who, on a particular buying occasion, does not have ready access either to a non-surcharged means of payment, such as cash, or to a card-accepting merchant who is not levying a surcharge. The high cost to cardholders is particularly onerous where merchants, taking advantage of the fact that the customer may have no choice but to pay with a payment card, seek to make a profit from surcharging by imposing a surcharge with no reference to what it costs the merchant to accept the card. Foreign and out-of-town consumers are those likely to be most at risk.

With the increasing influx of tourists to South Africa, and as 2010 approaches, the argument for retaining the no-surcharging rule as a measure of consumer protection appears all the stronger. Although international interchange rates would not be subject to the regulated domestic process which we recommend, we would advise caution at this stage over any attempt to interfere with the schemes’ “no surcharge” rules even in respect of international transactions.

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671 Transcript 17 April 2007, p 98.
672 Id.