

## Chapter 2

### Market Power in the Provision of Personal Transaction Accounts

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## 2.1 Introduction and synopsis

### 2.1.1 Competitive banks... or banking cartel?

Banks maintain that they compete vigorously with each other.<sup>1</sup> Popular suspicion, on the other hand, is that banks are a cartel.<sup>2</sup> Where does the truth lie?

We have come to the conclusion generally that banks in South Africa operate not as a cartel but rather as oligopolists<sup>3</sup> that maximise their profits by avoiding outright price competition where they can<sup>4</sup> (although competing for customers in other ways), and by taking advantage of the degree to which customers, once recruited, become locked in to a particular bank. It is by differentiated product offerings and complicated pricing structures – rather than by combining to fix prices – that banks ensure the high profitability of their services. The cost and trouble involved in switching banks further weakens the competitive effect of price differences where those can be identified by customers, and allows supra-competitive pricing to be maintained.

At the same time, because banking is a closely-knit industry with relatively few players, and because so much of banking revolves round payment transactions, banks are constantly dealing with each other and must get together frequently at a high level to discuss and agree on issues concerning interoperability in the payment system. Banks know a great deal about each other, and are well-placed to shadow each other's business strategies as well as to set rules and conditions collectively favouring themselves. Consumers, as well as would-be competitors, are vulnerable to the effects of decisions made by the incumbent banks or their representatives behind closed doors.

We have tried during the Enquiry to gain a clear understanding of the payment system in order to identify any respects in which banks may be overstepping the bounds of legitimacy in their interbank arrangements, or in which actual or potential abuses may warrant intervention under the competition or consumer protection laws, or action by the banking and payment system regulators. While concluding generally that banks do not operate as a

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<sup>1</sup> Standard Bank, October 2006, First Submission, p 8. FRB's CEO, Mr Nxasana said, "...We believe that competition in the financial services industry is intense and banks and other players compete vigorously..." (Transcript 9 November 2006, p 5). Nedbank's Mr Shuter said, "...So what is our perspective on the level of competition? I can certainly say I having been involved in retail banking now for two years, that our experience is that the industry is very competitive." (Transcript 2 November 2006, p 25). Absa's Mr Booysen said, "The fact that banks have been willing to facilitate entry by non-banks is an indication of the competitiveness of the banking industry." Then the CEO states, "Competition between the various players in the market becomes quite noticeable when one considers the impact of competition on innovation, performance and access." (Transcript 30 November 2006, pp 5-6 & 10).

<sup>2</sup> Essentially, a cartel is a combination of producers that fixes prices, or otherwise deliberately restricts output and competition.

<sup>3</sup> As distinct from a monopoly with a single supplier (the monopolist), a market dominated by a few large suppliers is characterised as an "oligopoly" and those suppliers as oligopolists. The significance of this is discussed below.

<sup>4</sup> See Appendix on "Complex monopoly", "collective dominance" and "tacit collusion".

cartel, we have found a number of particular instances and aspects where, in our view, the conduct of banks and others in the payment system does require such action or intervention. These matters are addressed in detail in subsequent chapters of this report.

### 2.1.2 Personal transaction accounts (PTAs)

Our focus in the present chapter is on whether or not banks have significant market power in the provision of personal transaction accounts (PTAs) and related payment services – and, if so, what can be done to reduce it. Market power essentially means the ability of a firm to sustain its prices above the level that would prevail in a competitive market.<sup>5</sup> For reasons explained below, we have come to the conclusion that the major banks (at least) do indeed have significant market power in the provision of PTAs and related payment services.

By PTAs we mean the ordinary current accounts and transmission accounts (savings accounts with transactional facilities) that are used by individual consumers.<sup>6</sup> The terms of reference of the Enquiry are specifically concerned with the payment services aspect of retail banking and PTAs are central in this regard.

The traditional role of the bank, from a consumer's perspective, is to lend money and to invest savings. However, having a bank account also allows the consumer to plug into the national payment system and as such enables and facilitates economic activity in a number of areas. For example, consumers make use of payment services whenever they pay rates, taxes, purchase items with a credit or debit card, and otherwise receive or make payments other than in cash. For the unbanked there are considerable costs and risks associated with the handling of cash. By being able to rely on bank deposits, and draw on funds to receive cash or make payments as required, individuals can manage their money more safely and efficiently, and become financially empowered.

Without a bank account and access to payment services, it would be difficult if not impossible for an individual to participate effectively in any modern economy. Today, a bank account is usually required in the formal economy in order to receive wages and salaries, make a wide variety of routine payments, and access savings and credit facilities. There are currently no real alternatives for individuals and businesses that want to participate in the formal economy. Most employers insist on depositing salaries electronically into employees' bank accounts and many other payments are made via debit orders and other electronic payment systems. Credit facilities including home loans are generally only available to those able to service the debt via a transaction account.

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<sup>5</sup> The concept of "market power" is discussed below.

<sup>6</sup> The expression "transmission account" arose historically to describe an account on which the account-holder may carry out payment transactions without using a cheque. It thus refers essentially to savings accounts, as distinct from "current" (or cheque) accounts. Term deposit accounts, of course, are not transaction accounts at all.

Banking thus plays a central role in the economic life of society. A lack of effective competition in banking and payment services has far reaching consequences for consumers and the economy at large. It not only raises the cost to consumers of managing their money and making or receiving payments; it also drives a wedge into wider areas of economic activity by introducing inefficiencies and raising transaction costs for both individual consumers and businesses.

### 2.1.3 Structural concentration in the market for PTAs

The market for PTAs and related payment services is highly concentrated. The four largest banks – Absa, Standard Bank, FNB, and Nedbank (“the big four”) – together supply more than 90 per cent of this market. Barriers to entry by additional firms, and barriers to their competitive expansion, are high.

The market for PTAs in South Africa (as well as the market for most other retail banking services) can be characterised as an oligopoly, with a fringe of smaller players. Even important fringe players, such as Capitec, have not to date posed a serious competitive threat to the big four banks in their established market. Although there is potential for greater competition from innovative firms like Capitec, as well as other banks and non-bank players in the payment system, the extent to which they can impose an effective competitive constraint on the big four banks across the retail market will depend on whether existing restrictions on competition, both on the supply side and the demand side, can be effectively addressed.

The reality remains, however, that the cost structure of retail banking – high fixed and common costs – drives concentration in banking and places certain limits on the extent of competition. Economies of scale and scope are of vital importance. To an ever increasing extent, therefore, retail banking has become a volume business in which even medium-sized enterprises find it difficult to succeed. The concentration of banks produces an oligopoly structure which facilitates strategic interaction among the participants and obstructs competitive outcomes. The individual customer becomes – and feels like – a statistic.

With the ever-growing volume and sophistication of payments in the modern economy, banks have naturally extended their traditional deposit-taking and lending functions into the provision of payment services linked to bank accounts. Banks’ revenues and profits have increasingly come to reflect their activities and dominant role in the payment system. At the same time, technological innovations are creating new possibilities for smaller firms to operate successfully in providing various payment services, or components of payment services, that are not intrinsically dependent on deposit-taking. Faced with this challenge banks will naturally seek to leverage their strategic advantage as providers of PTAs which combine payment services with deposit and credit facilities. Elsewhere in this report we deal extensively with the need to open up access to the payment system, on a carefully regulated

basis, to qualified non-bank service providers.<sup>7</sup>

In competing with each other for PTA customers, banks recognise the underlying threat to their profits posed by the essential homogeneity of the services which they provide. The processes involved in the banks' operation of transaction accounts and payment services on a mass scale are increasingly standardised and automated, thanks to new technology. This relentless commoditisation of banking services brings with it a vulnerability of banks to intensified price competition and to the erosion of profit levels even in a highly concentrated market. To counteract this vulnerability, and to preserve market power, incumbent banks typically resort to measures which serve as buffers against price competition. By these measures, and by avoiding challenges to each other which could end up spoiling the game for all, the banking oligopolists are able to sustain supra-competitive pricing and profits, especially in segments of the consumer market judged able to bear the burden.

These measures, and the resulting dynamics, are explored in further detail in this chapter below. Here a brief outline must suffice.

#### 2.1.4 Product differentiation and price complexity

To keep essentially homogeneous products or services differentiated so that their prices are not readily compared by consumers is a considerable art. From a consumer welfare perspective, of course, there are advantages and disadvantages arising from product differentiation. On the one hand it allows suppliers to serve a variety of consumer needs through differentiated offerings. On the other hand, however, it complicates choices for the many consumers who are really looking for something quite simple and uniform.

Our argument is not against product differentiation *per se*, for that would risk inhibiting the development of innovations that would benefit consumers. However, we find that in current banking practice much of what passes for product differentiation arises from different combinations of product features and different pricing structures and not from intrinsic differences in the product features themselves. The incumbent full-service banks all offer the same set of account-holding and transaction facilities. It is the manner in which these facilities are bundled, packaged and priced which varies from bank to bank. We find that this unnecessarily complicates choices for consumers and thus weakens price competition. We believe that there is a need for simplified offerings that can be readily compared, in both price and content, across the banks and thus be subject to more direct price competition. The information contained in the chapter on Costing and Pricing substantiates this.

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<sup>7</sup> See the chapter on Access to the Payment System.

### 2.1.5 Information asymmetries

Information asymmetry describes the situation in which one party to a contract has the advantage of having more information than the other, so that the latter is effectively in the dark when weighing up the likely costs and benefits of the deal. There are considerable information asymmetries in the market for PTAs and related services which tend to benefit the banks but are detrimental to consumers. These asymmetries arise not only from the complexity already described, but also from inadequate transparency and disclosure in respect of the features and pricing of transactional banking products. Further, each bank uses its own terminology and nomenclature to describe its products and related product features and fees. This makes it very difficult for consumers to understand and assess the different offerings of the banks.

As a consequence, the great majority of consumers do not actively investigate what they are paying in bank fees, nor do they respond readily to changes in prices by seeking out an alternative provider. This is an important factor conferring on banks an appreciable degree of market power over their customers.

### 2.1.6 Switching and search costs

We have found that the cost to customers of switching banks (including the search costs in finding an alternative) are generally enough to create a significant degree of customer captivity and so confer on banks an appreciable degree of market power.

We were able to quantify the minimum objective costs likely to be incurred by customers when switching a typical transactional account from one bank to another. According to our calculations, total switching costs as a percentage of the net present value of average annual banking costs over three years are likely, on a conservative estimate, to be well in excess of 5 per cent.<sup>8</sup> We have concluded that, on the basis of these switching costs alone, the market power of each bank is appreciable, as each bank is in a position to impose a small but significant non-transitory increase in price without losing its customers. Customers would have to find an alternative bank which is substantially cheaper than their own and likely to remain so, in order to justify the expenditure of time and money in switching.

To switching costs must be added the search costs of finding a suitable substitute. In addition to problems of transparency and disclosure, the greatest obstacle faced by consumers in the search process lies in the difficulty of making meaningful comparisons across the product offerings of the banks. We found that there is no uniformity in the manner in which the packaged offerings are structured and priced. It is therefore impossible to make direct price comparisons between the offerings without having to input detailed information about the transactional behaviour of the prospective customer and then perform fairly

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<sup>8</sup> See discussion below on switching and switching costs.

lengthy calculations based on the different pricing formulas of the banks.

In their submissions the banks themselves have argued that price is not the most important factor influencing consumer choice and that consumers are driven by other considerations in selecting a bank and product offering. While the quality of service may well differ competitively as between banks, we do not consider such differences to be dramatic or fundamental. The evidence presented here suggests that the overriding reason consumers do not make choices primarily on the basis of price is that the cost and effort required to make such a determination with any accuracy is simply prohibitive for the great majority of consumers. This reinforces customer inertia when it comes to changing banks and accentuates the degree of market power that banks have. Inertia is not difficult to account for, even though expressions of discontent are widespread. Consumers – in particular those who depend on a range of banking and payment services provided by the full-service banks – have little reason to conclude that they would be substantially better off by switching. This is certainly not because prices are at a keenly competitive level.

### 2.1.7 Lack of effective price competition in an oligopolistic market

We find that appreciable customer inertia – having regard to all the underlying reasons for it – tends to facilitate price shadowing behaviour between the banks, while incentives for competitive price cutting tend to be mitigated further due to the interbank arrangements which underlie the various transaction services. Generally speaking, at least within established market segments, banks tend to set their fees within a close enough range of each other such that none would be likely to impinge greatly on the market share of the other. Their conduct is in that sense rational behaviour of oligopolists who stand to gain more in the medium and longer term if they refrain from competing prices down in the short term for the sake of temporary gains in market share.

In the rapidly expanding lower-income market for basic banking services, interbank competition is keener,<sup>9</sup> but the incumbents have been careful not to allow this to erode the surplus accruing to them in the more established parts of the retail market, the segmentation of which they are astute to maintain. In our view, that is the main reason for their resolute resistance to the idea of a basic banking product (or products) to be offered to the entire market, in order to facilitate comparison and intensify price competition across the board.

The analysis of banks' pricing and costing data in the next chapter of this report reveals the absence of any identifiable relationship between the prices of PTAs and related services and the costs to the banks of providing them. This is not what one would expect in a market characterised by effective price competition.

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<sup>9</sup> Given that banks seek to capture new customers through their entry level offerings.

Clear evidence that banks' prices in a major part of the market have continued rising, or have not been lowered significantly, while there has been a sustained rise in customer and transaction volumes accompanied by a sustained fall in average total costs (i.e. unit costs), satisfies us that the banks do not in fact subject each other to effective price competition. The fall in unit costs has simply provided the basis for increased profit, whereas in a competitive market prices would have come down markedly.

This combination of factors leads us to conclude that banks – the major or full-service banks specifically – have an appreciable degree of market power over their ordinary customers in the provision of PTAs and related services throughout the country, and that they do exercise that power in keeping prices above levels that effective competition would dictate.

### 2.1.8 Recommendations

To the extent that these problems are rooted in the conditions which produce banking concentration – a global as well as South African phenomenon – they are not susceptible to being resolved fundamentally by any recommendations that we can make here. However, there are a number of particular changes that can be made which would serve to improve competitive conditions. Many of them are presented and explained in the subsequent chapters of this report. In this chapter we concentrate on remedies that we believe would stimulate price competition between banks in the provision of PTAs and related services.

We recommend a combination of measures aimed at improving the ability of bank customers to compare product offerings and prices, and aimed at enhancing their ability to switch providers with a minimum of cost and difficulty. These involve codes of conduct and other measures:

- To ensure greater transparency and disclosure of product and price information by banks
- To reduce search costs and improve comparability of products and services
- To reduce switching costs and assist consumers in the process of switching.

We recommend that the role of the Ombudsman for Banking Services be expanded to include enforcement and monitoring of compliance with the proposed codes of conduct for information disclosure and switching.

## 2.2 The meaning of market power

In the technical sense, says the American antitrust scholar Herbert Hovenkamp, market power is:

a firm's ability to deviate from marginal cost pricing. Further, marginal cost, or competitive, pricing is an important goal of the antitrust laws. Marginal cost is therefore a useful base from which to measure market power: the greater the ratio of a firm's profit maximizing price to its

marginal cost, the more market power the firm has.<sup>10</sup>

This view, based on the Lerner Index, looks at performance of the firm, rather than industry concentration levels, to assess market power.<sup>11</sup> One must, however, take care in applying this concept. By “marginal cost, or competitive, pricing”, Prof Hovenkamp is referring to what usually takes place under perfect competition. Marginal cost is the additional cost incurred by a firm when increasing its output by one unit of the product concerned. Since a firm’s fixed costs remain unchanged at that *point*, marginal cost will consist entirely of the increment in variable costs. Under perfect competition, the market price is set by the intersection of the industry demand and supply curves. For the individual firm, this is typically where MR (marginal revenue<sup>12</sup>) = MC (marginal cost), and will be at the minimum of the average total cost curve in the long run. Being price takers, all such firms have no ability to exercise market power over the industry price.

When seeking to apply this concept of market power under conditions of imperfect competition, or monopolistic competition, or oligopolistic competition, one looks for indications of firms’ ability to price their goods and services above the level which, over the medium to longer term, would return a normal profit to an efficient producer. In short, one tries to determine whether or not competition is *effective* in the relevant market rather than whether it is “perfect” or not.

In the hypothetical perfectly competitive market characterised by marginal cost pricing, the firm faces a demand curve in the form of a horizontal line. Because of the horizontal demand curve, a firm cannot raise its price without losing *all* its customers to rivals. The demand for the firm’s product is thus completely elastic. The possibility of market power arises in a market in which a firm can raise the price above marginal cost without losing all its customers to competitors. In this case, the firm’s demand curve slopes downward.<sup>13</sup> The deviation between the price set by the firm and the marginal cost (which forms the basis of the Lerner index introduced above) can provide a measure of market power.<sup>14</sup> We shall be

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<sup>10</sup> *Federal Antitrust Policy: The Law of Competition and Its Practice*, 3<sup>rd</sup> edition, p 80. The simplest formulation of this in terms of the Lerner Index is  $\frac{P-MC}{P}$ , where P is the firm’s price at its profit-maximising level of output and MC is the firm’s marginal cost at that same output. If the firm’s price is equal to its marginal cost then the index reading for the firm’s market power would be zero. As price rises above marginal cost, or (conversely) as marginal cost falls below price, the index reading rises above zero. If price were to reach infinity, or marginal cost were to reach zero, then an index reading of 1 for market power would be obtained. However this index is of no practical use unless the firm’s marginal cost is known. As the chapter of this report on Costing and Pricing explains, it has not been possible to establish a relationship between costs and prices from the data submitted by the banks.

<sup>11</sup> Bilas, 1971 *Microeconomic theory*, p. 267.

<sup>12</sup> Marginal revenue is the firm’s additional revenue from selling the additional unit of output.

<sup>13</sup> Alfred Marshall, reputed to be the father of the elasticity concept, wrote: “The *elasticity (or responsiveness) of demand* in a market is great or small according as the amount demanded increases much or little for a given fall in price, and diminishes much or little for a given rise in price.” (*Principles of Economics*, 8<sup>th</sup> edition, p 102).

<sup>14</sup> Sullivan and Grimes, *The Law of Antitrust: An Integrated Handbook*, 2<sup>nd</sup> edition, p 27, provide a graphic illustration of market power. The firm whose demand curve is depicted is able to exercise significant market power over a certain range of prices – i.e., within that range its price changes will have little effect on quantity demanded (output), and so it is able to raise its price profitably above the price that would prevail if competition were really effective. At much higher or

returning to this index below.

American antitrust scholars Sullivan and Grimes deal with the implications of these realities for competition policy as follows:<sup>15</sup>

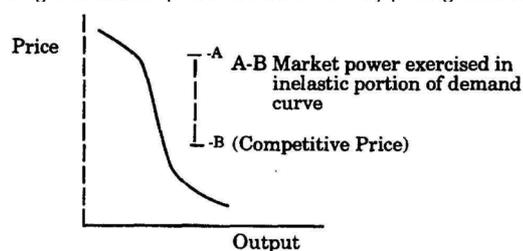
Some writers draw a distinction between the term "market power" as used in economic literature and the use of that term in antitrust. In economics, any downward sloping demand curve may describe a measure of market power. In antitrust, the focus is on substantial and nontransitory market power that suggests injury to competition. Inelasticity of demand that is transitory or, although nontransitory, is sustained over a very narrow range of prices, would not be considered the type of market power that warrants antitrust intervention. Each of these points may be illustrated. If a firm markets an improved product that performs better than competing offerings, it may increase its price, lowering its output below the level that perfect competition would produce. Or, if a retailer's newly adopted warehouse mode of operations allows it to sell more efficiently, it may sell at a price that passes only part of that gain on to consumers, preserving the remainder as a higher return. Each firm faces a downward sloping demand curve consistent with market power for each has the ability to raise or maintain price above the competitive level without losing substantial sales. In each of these cases, the higher profitability, although it may be substantial, may prove transitory. High profits will encourage rivals to emulate the improved product or innovative retailing method. The high profits serve as an incentive for rivals to mimic a new competitive initiative. ...

For antitrust purposes, then, market power must involve inelasticity of demand that is both nontransitory and covers more than a narrow range of prices. Such power might be exercised, for example, by a monopolist; by an oligopolist engaging in strategic behaviour; by a cartel; by a patent holder or branded product seller that has differentiated its product in a way other sellers cannot easily replicate; by a seller controlling its aftermarket; by a seller that exploits buyer information voids to extract a higher return; or by a seller or buyer in a vertical relationship with a smaller and dependent firm (as in franchising). These exercises of power are possible targets of antitrust, but are not uniformly vulnerable. Certain exercises of market power may be tolerated to obtain other social goals. A patent monopoly is tolerated (indeed fostered) to encourage innovation. Some manifestations of franchisor power over franchisees may be tolerated as enhancing the efficiencies of franchising. The monopolies thought to be efficient (such as utilities providing gas, electricity, or water) may be permitted subject to public regulation of rates.

Our Competition Act<sup>16</sup> links the concept of "market power" to that of dominance. It requires an especially high standard of behaviour from firms deemed to be dominant. They are not allowed to abuse their dominance, whether over customers or rivals, in various ways specified in the Act.<sup>17</sup> There may be a number of dominant firms in the same market. This is

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much lower prices, however, the effect of a further price change upon quantity demanded can become considerable, showing that market power would be lost by pricing outside the middle range.



<sup>15</sup> *Op cit*, pp 27-29.

<sup>16</sup> Act 89 of 1998, as amended.

<sup>17</sup> This applies only to firms whose annual turnover, or assets, exceed a threshold determined by the Minister of Trade and Industry and published in the *Government Gazette*. All the firms we are considering here exceed this threshold –

because section 7 of the Act (a) conclusively presumes a firm to be dominant if it has 45 per cent or more of the market in question; (b) raises a presumption of dominance if a firm has at least 35 per cent but less than 45 per cent of the market, unless it can show that it does not have “market power”; and (c) provides for any firm to be held to be dominant if *in fact* it has “market power”.

For reasons indicated below, we are unable to conclude that any bank in South Africa has crossed the threshold where its share of the market that we consider relevant for current purposes – that for PTAs and related payment services – would create a presumption of dominance.<sup>18</sup> Our focus is therefore on the question whether, as a matter of fact, banks should be found to have market power as contemplated by the Competition Act.<sup>19</sup>

Section 1(1) defines “market power” as meaning

the power of a firm to control prices, to exclude competition or to behave *to an appreciable extent* independently of its competitors, customers or suppliers.<sup>20</sup>

In other words, the mere existence of some slight degree of market power in the economic sense outlined above would not amount to “market power” under the Competition Act. The extent of the firm’s independence from, say, its customers would have to be more than merely capable of being perceived;<sup>21</sup> it would have to be considerable<sup>22</sup> – that is to say, notable and of consequence – in order to meet this test for dominance laid down by the Act.

A firm would be able to behave “independently” of its competitors and customers to an appreciable extent if, for instance, it could raise prices appreciably and sustain the increase for an appreciable period of time without thereby losing sales to the extent that the additional

currently R5 million – many times over, and so qualify to be subjected to the dominance test. See section 6 of the Competition Act.

<sup>18</sup> Statistical data showing that particular banks have a share of 35% or more of a particular transaction type, (e.g. credit cards — see data provided by Absa, October 2006, First Submission p 38) do not in themselves support a finding of market power inasmuch as the statistical categories concerned do not constitute distinct relevant markets for competition analysis.

<sup>19</sup> Where market shares must be established in order to reach a conclusion of dominance, accurate definition of the boundaries of the relevant market in product and geographical terms is obviously necessary. If market definition were lacking, then substitute products and/or suppliers could be wrongly excluded, or wrongly included, when it came to calculating a particular firm’s market share. However, where other factors including the behaviour of a firm itself provide the evidence that it possesses market power, then market definition loses its analytical importance. It is then enough to be able to describe the product and area in respect of which the power is held. As the Competition Tribunal expressed it in *Natal Wholesale Chemists (Pty) Ltd v Astra Pharmaceutical Distributors (Pty) Ltd* [2001-2002] CPLR 363 (CT) (Case No. 98/IR/Dec00), pp 376-377: “We concur with the complainant that the purpose of defining a relevant market is to identify the exercise of market power [as] defined in the Act ... and that market definition is only a tool for estimating market power, not a scientific test. ... If the exercise of market power, as defined, is identified — if, for example, the firm is able to raise appreciably the price of its product without occasioning a significant reduction in demand — then a market relevant for the purposes of the enquiry will have been identified.”

<sup>20</sup> Emphasis added. The Afrikaans text of the Act renders the expression “to an appreciable extent” as “*in ’n noemenswaardige mate*”.

<sup>21</sup> Cf *Black’s Law Dictionary*, 8<sup>th</sup> edition, sv ‘appreciable’.

<sup>22</sup> See *The Shorter Oxford English Dictionary*, 5<sup>th</sup> edition, sv ‘appreciable’.

profit derived from making the increase in the first place would be eliminated.<sup>23</sup> Likewise its independence would be appreciable if, over a sustained period when unit costs throughout the market were falling appreciably, it could maintain its prices at former levels without losing its customers to rivals, and so reap greater profits.

We proceed to examine and assess a number of indicators as to whether South African banks do indeed have appreciable market power.

### 2.3 Profits of SA banks, and the response of prices to falling unit costs

In a thorough initial submission in October 2006, Absa included (as Annex 4) a study of competition in the South African banking industry by the international economic consultancy CRA International,<sup>24</sup> which the bank had retained to assist it in the Enquiry.<sup>25</sup> In the course of this study,<sup>26</sup> CRA provided a critique of the profitability analysis that had been made in the *Task Group Report for the National Treasury and the South African Reserve Bank* (“Competition in South African Banking”, April 2004) – commonly known as “Falkena III”.<sup>27</sup> Also included (as Annex 6 to the submission) were Absa’s own comments on that report, repeating essentially the same points. Although misgivings were expressed in Falkena III regarding the use of profitability figures as a measure of competition, the report had nevertheless concluded that “the average return on equity of South African Banks was – with the exception of 2002 – consistently higher than the weighted average of the world’s leading banks over the study period”.<sup>28</sup>

In its critique, CRA acknowledged that high profits can be indicative of lack of competition and market power. “But high profits can also be the result of superior efficiency.”<sup>29</sup> That may be so, but if one is confronted by a pattern of high profits across an industry, based on the returns of all the major players, the superior efficiency of a particular firm or firms can scarcely provide the explanation. Nevertheless, as both Falkena III and CRA pointed out, international comparisons of profitability are severely limited in their usefulness.

<sup>23</sup> We assume here that the firm is operating on the inelastic portion of its demand curve – as (for example) depicted in Footnote 14.

<sup>24</sup> *Competition in the South African Banking Industry*, prepared by Robert Stillman, Kyla Malcolm, Rameet Sangha and Nicole Hildebrandt (Absa, First Submission, October 2006, Annex 4). References hereafter simply to the CRA study are references to this document.

<sup>25</sup> Absa, *id.*, Chapter 1 (Introduction), p 4.

<sup>26</sup> See p 25 ff.

<sup>27</sup> This was in response to our general invitation to participants in the Enquiry to comment on the *Task Group Report*. (Hans Falkena was chairman of the Task Group, and there had been two earlier reports with which his name is commonly associated.)

<sup>28</sup> P 25, read with graphs on p 26. Return on equity is the standard measure of profitability in analyses of bank profitability: see the CRA study (*supra*), p 27. “Return” here is pre-tax profit, and “equity” is average Tier One capital. (Transcript 17 July 2007, p 50.) Tier One capital is defined on p 76 of the CRA report as including common stock, non-cumulative preference stock, share premium reserve, disclosed reserves including retained earnings, minority interests, and fund for general banking risks (if stated as a separate item).

<sup>29</sup> P 25. Falkena III had also acknowledged this (p 19).

This subject was raised at the hearing on 17 July 2007, where the following question was posed to representatives of Absa:

ADV PETERSEN (of the Panel): Let me start by agreeing with the following, which is in your main October 2006 submission in Annex 6 (which is not confidential), page 24, paragraph 2.4.1:

“... [I]n a competitive market it is the marginal firm that makes the return equal to its cost of capital. Other, more efficient, competitors make higher profits. On average therefore, firms will make more profits than the costs of their capital. Given that firms would only choose to make investments if the expected returns are above the cost of capital, this should be of no surprise.”

I have no trouble with that, but my question following from that ... [is:] What are the indicators that we should be looking for in order to determine whether the profits of efficient firms are at a level suggesting the absence of effective competition?<sup>30</sup>

In response, Mr Stillman of CRA (appearing for Absa) said “the simple answer is that there is no real consensus and no clear bright lines that one can apply in this area” when using evidence of profitability to assess the intensity of competition and whether it is effective.<sup>31</sup> He went on to accept, however, that the level of profitability would be one of a number of factors that one would look at in making the assessment, and that it would also be of some relevance to compare banking profits locally with those in other parts of the world.<sup>32</sup> We recognise that the weight that can be given to such international comparisons is necessarily limited.

ADV PETERSEN: ... [L]et us take Annex 6, page 26, paragraph 2.4.4, where you point out the problems with international comparisons: (1) the markets are different; (2) the business cycles are or may be different; (3) inflation is different (although you go on to deal with that factor) and (4) the risks are different. It seems to me one could add – and this seems to me quite a fundamental point – that we do not know whether, and we do not know the degree to which, banking is truly competitive in any other country with which comparisons might be made.<sup>33</sup>

Mr Stillman agreed.<sup>34</sup>

CRA had been critical of the fact that the analysis in Falkena III did not adjust the various countries' profitability figures for inflation, and that it appeared that developing countries had not been included in the comparison study. CRA subsequently carried out its own study in which it adjusted for inflation and included certain developing countries.

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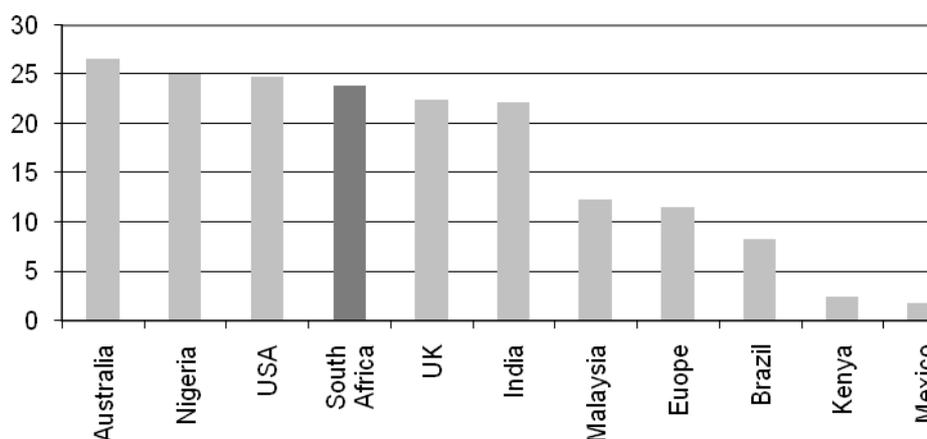
<sup>30</sup> Transcript 17 July 2007, p 44.

<sup>31</sup> *Id.*, p 45.

<sup>32</sup> *Id.*, p 46. See also p 64.

<sup>33</sup> *Id.*

<sup>34</sup> *Id.*, p 47.

**Figure 1 Profit on average capital 1996 – 2005 (inflation adjusted)**

Source: Absa, 2006, October, First Submission, Annex 4, p 30.

CRA concluded that “[t]he results of this analysis do not support the claim in the Falkena report that the profitability of South African banks has been consistently and significantly greater than the profitability of banks in other countries”.<sup>35</sup> The CRA analysis nevertheless shows that South African banks consistently rank among the most profitable in the world.

ADV PETERSEN: Now I want to ask you whether you would agree with the following, ... that over the whole period from 1996 to 2005, South African banks have had a substantially higher rate of profit on Tier One capital [return on equity] adjusted for inflation, than banks in Europe, Kenya, Brazil and Malaysia. ... That is not the whole picture, but I ask you whether you agree with that?

MR STILLMAN: That is what the data..., sure, I am referring to Figure 5.4 [in the CRA study].

MR VON ZEUNER: Correct...

ADV PETERSEN: I have understood that correctly. [And] that South Africa essentially matches the rate of return in Australia, Nigeria, India, the UK and the USA?

MR STILLMAN: Yes.

ADV PETERSEN: And then, let me put this to you, would you agree that no significant country has been identified in your very thorough study, that shows a substantially higher rate of profit in banking adjusted for inflation over that ten-year period than South Africa?

MR STILLMAN: Yes, and that is correct.<sup>36</sup>

No evidence or argument to the contrary was forthcoming during the Enquiry. Accordingly, we conclude that South African banks rank among the most profitable in the world. (See the Appendix on Updated statistics on the Task Group (Falkena III) report.) This would be consistent with the banks having market power. However, it is not conclusive.

A particular difficulty in evaluating the significance of the general level of profitability of banks is that, as CRA pointed out –

<sup>35</sup> CRA study, p 27.

<sup>36</sup> Transcript 17 July 2007, pp 51-52.

Banks are multi-product firms and the effectiveness of competition may vary across bank products. This means that if one were going to use profitability evidence to help assess the effectiveness of competition, one would want to examine the profitability and rates of return on the bank's activities in particular products.<sup>37</sup>

Mr Stillman confirmed the correctness of this at the hearing.<sup>38</sup> As it happens, Absa did provide information in its initial submission which, when carefully pieced together, allows a reliable evaluation to be made. We very much appreciate the contribution this has made to the Enquiry.

In assessing the profitability of banks in the provision of PTAs and related services we have reference to financial data provided by Absa for its Flexi Banking Services (FBS) and Retail Banking Services (RBS) segments.<sup>39</sup>

According to its submission, Absa's FBS segment provides transmission, savings and investment, and lending products to the mass market, which Absa defined as individuals earning [REDACTED]<sup>40</sup> PTAs include transmission accounts which, as noted by Absa, "are the primary formal banking products utilized by mass market customers in South Africa".<sup>41</sup> Of the total number of accounts provided by FBS in 2006 [REDACTED] [REDACTED] were PTAs.<sup>42</sup>

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Absa's RBS segment provides transmission, cheque, savings, investment, and lending products to the middle market, which Absa defined as individuals with a personal monthly income between [REDACTED]<sup>43</sup> PTA products (transmission and cheque accounts) also constitute a significant part of the RBS segment – [REDACTED] [REDACTED] We have no reason to believe that the lending and investment components (in both FBS and RBS) are subject to less competitive constraint than transaction account services.

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Absa provided data showing profit growth in the FBS segment at a compound [REDACTED]

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<sup>37</sup> CRA study, p 25.

<sup>38</sup> Transcript 17 July 2007, p 52. A corresponding passage from Annex 6 of Absa's First Submission, p 25 para 2.4.3.4, had been put to him.

<sup>39</sup> In the course of the submission, the FBS and RBS "segments" are also referred to as "units" and "divisions" of the bank. See *id.*, Chapter 4, p 40ff.

<sup>40</sup> *Id.*, p 40.

<sup>41</sup> *Id.*, p 41. The transmission accounts are personal transaction account products.

<sup>42</sup> The figure is calculated from the data provided in Table 5.1: Accounts and Absolute Balances for key FBS offerings, as at August 2006, *id.*, p 42.

<sup>43</sup> *Id.*, p 59.

<sup>44</sup> The figure is calculated from the data provided in Table 6.1: Accounts and Absolute Balances for key RBS offerings, as at August 2006, *id.*, p 60.

[REDACTED] This implies that the growth in the amount of profit in the FBS segment [REDACTED]<sup>45</sup>

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[REDACTED]  
 [REDACTED]  
 [REDACTED]  
 [REDACTED]<sup>46</sup> [REDACTED]  
 [REDACTED]  
 [REDACTED]  
 [REDACTED]  
 [REDACTED]<sup>47</sup> [REDACTED]  
 [REDACTED]  
 [REDACTED]

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[REDACTED]  
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 [REDACTED]  
 [REDACTED]<sup>48</sup> [REDACTED]  
 [REDACTED]<sup>49</sup> [REDACTED]  
 [REDACTED]

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We were not able to conduct the same specific analysis for the other banks, primarily because they did not provide data on operating expenses going back far enough in time to be useful for this purpose. However, there can be little doubt that in the prevailing conditions of market expansion, all the major banks benefited from economies of scale.<sup>50</sup> [REDACTED] there has been no real competitive pressure to reduce prices from other banks – indicating that they too have retained the greater portion of savings from unit cost reductions as profits rather than pass them on to consumers through lower prices. Indeed, effective competitive pressure on prices has generally been lacking from rivals in this market.

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If the market were characterised by effective competition, then surely competitive pressure, either from potential entrants or existing competitors, would have compelled Absa to reduce

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<sup>45</sup> *Id.*, Annex 4 (the CRA study), p 10. Mr von Zeuner added: “And reduction in impairments.” (Transcript 17 July 2007, p 66.)  
<sup>46</sup> *Id.*, Annex 4, pp 10-12.  
<sup>47</sup> *Id.*, p 12.  
<sup>48</sup> *Id.*, pp 14-15.  
<sup>49</sup> See also Transcript 17 July 2007, pp 66-67.  
<sup>50</sup> See e.g. FRB, March 2007, Second Submission Part A Data Request and FRB, October 2007, FRB Data and Info Request, p 4.

its prices in order to maintain its relative share of the market and grow its business in this segment. The fact that it did not do so suggests that banks are sheltered from effective competitive pressure when it comes to pricing of PTAs, particularly in the retail banking or middle-market segment.

This was put to Absa at the hearing on 17 July 2007.<sup>51</sup> After some initial wrestling which failed to get to grips with the essential point, the Absa team sought the opportunity to respond specifically in a further written submission.<sup>52</sup> That submission came in the form of a theoretical argument prepared by Mr Stillman.<sup>53</sup> He first set out the issue to be addressed:

[Redacted]

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1. [Redacted]

2. [Redacted]

3. [Redacted]

4. [Redacted]

5. [Redacted]

6. [Redacted]

<sup>51</sup> Transcript 17 July 2007, p 67, pp 75-76, pp 79-80, pp 84-86.

<sup>52</sup> *Id.*, p 86.

<sup>53</sup> CRA International, *Price changes and demand shifts*, Robert Stillman, 10 August 2007.

[Redacted]

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<sup>54</sup> [Footnote by Mr Stillman:] See, for example, slide 19 of Absa's Competition Commission Enquiry Presentation of 17 July 2007 which shows that fees on Absa's Silver Cheque (retail market) account increased by 5.6% per annum on average during the period 2001-07 while inflation (the CPIX) increased on average by 5.8% per annum over the same period.

[Redacted]

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[Redacted]

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[Redacted]

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This note explains why the final two points in the above line of reasoning are incorrect and why, more generally, the manner in which prices respond to a shift in demand does not provide any information about the degree of competition in a market.<sup>59</sup>

The CRA argument concluded that:

- First: it is marginal costs, not unit costs, which are relevant in determining how prices change. Accordingly, the Panel had been wrong in its intuition that, at least in competitive markets, reductions in unit costs (average total costs) should lead to reductions in prices.
- Second: the potential effects on price of a shift in demand are various, and nothing meaningful can be inferred about the competitiveness of a market from the manner in which price responds to shifts in demand.

On close examination we find that these assertions and their accompanying elaboration – while not lacking in ingenuity – do not address the case. In fact, indirectly, they reinforce the conclusion towards which the Panel had been feeling its way during the hearing.

Moreover, to a large extent, Mr Stillman's analysis ignores his point 3 above. This of course is key to the question posed by the Panel. Nonetheless, we continue to explore his argument.

Mr Stillman set out his argument in the following way: "It is a first principle of economics," he wrote, "that a firm maximizes profits by producing at the level at which marginal cost equals marginal revenue" (marginal revenue being the revenue earned from selling an additional unit of output).<sup>60</sup> At that quantity of output, the price which the firm can charge is determined by the demand curve which it faces, and this is true in competitive and uncompetitive markets alike. Changes in unit costs do not change either the demand curve or the point at which marginal revenue coincides with marginal cost. For a firm's price to change, there would have to be a change in marginal cost or a shift in the demand curve affecting the elasticity of demand. Marginal costs may be assumed to be constant in this analysis (the focus being on changes in fixed costs per unit of output); and there is no reason to assume a change in the elasticity of demand when the demand increases.

Whether a shift in demand will increase the elasticity of demand has to do with the factors leading to the increase in demand (e.g. whether demand is increasing primarily because existing consumers have become wealthier or primarily because new customers have been added who may be more price sensitive); it has nothing to do with the competitiveness of the market.<sup>61</sup>

Let us now turn to a diagrammatic view of the argument – provided by Mr Stillman himself. It

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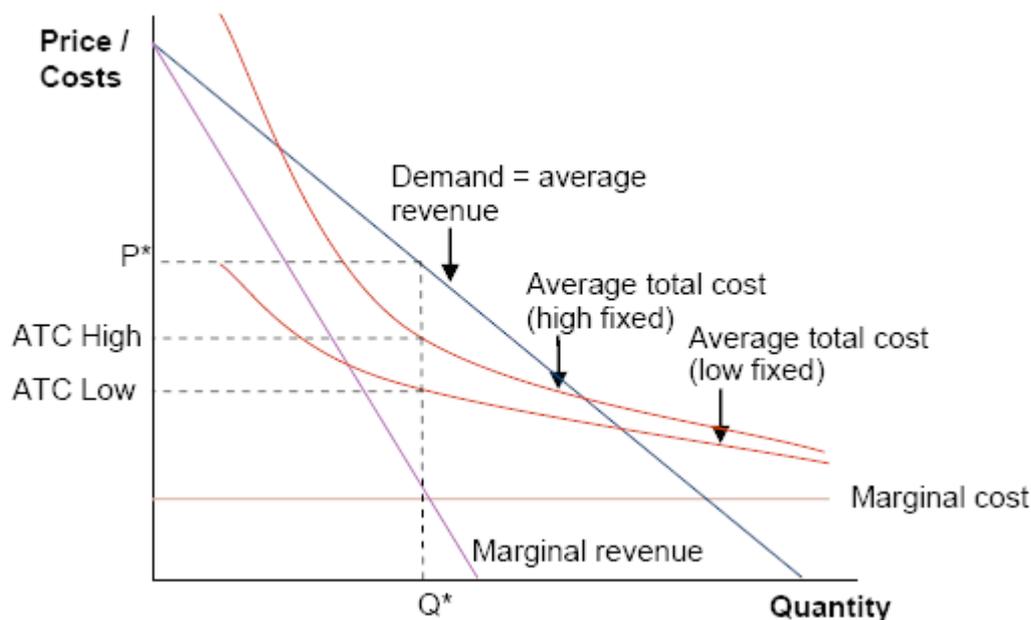
<sup>59</sup> *Id.*, p 1.

<sup>60</sup> *Id.*, p 2.

<sup>61</sup> *Id.*, p 5.

appears as Figure 2. In the figure, price exceeds average total cost and whether the average total cost curve is assumed to be high or low, the firm's profit-maximising price remains unchanged.

**Figure 2 Mr Stillman's diagram**



Source: CRA International, *Price changes and demand shifts*, Robert Stillman, 10 August 2007.

What is striking about this argument, and the diagram, is that we are not told if it represents the position of the firm before or after demand has increased. The firm faces a single downward-sloping demand curve.<sup>62</sup> The equilibrium is where marginal cost is equal to marginal revenue and is established at a level where price is comfortably in excess of average total cost (unit cost), whether the latter is assumed to be high or low. All Mr Stillman has demonstrated is that the equilibrium price will not be affected by whether average total costs are higher or lower *after* output has settled at its new equilibrium level. If the two average total cost curves are intended to present a before-and-after picture, then one would have expected before and after demand curves to have been drawn in as well.

To say that changes in the firm's level of unit costs will *then* only affect per-unit profit, and not directly affect the firm's per-unit price, does not address the question posed. The question concerned is the process by which a new equilibrium price would be established when the output of the firm (and that of its rivals) have increased, and when average total cost (unit cost) has fallen<sup>63</sup> – and how the outcome would differ over a period in which further

<sup>62</sup> A downward-sloping demand curve is itself indicative of the existence of market power, but is *per se* no proof that competition will be ineffective.

<sup>63</sup> The question related to changes in average costs with changes in output – i.e. a movement *along* some ATC curve and

adjustments may follow, depending on whether the market is competitive or not.

A firm's demand curve is affected by *the price at which its rivals offer substitute products*. Thus the supplier of butter, for example, will face two quite different demand curves (different in both position and slope), depending on whether the prevailing price of margarine is high or low,<sup>64</sup> and will be constrained accordingly in the price it can charge. The same must apply in any market where the substitution by the consumer of an existing product with a rival's product of the same kind would be relatively straightforward.

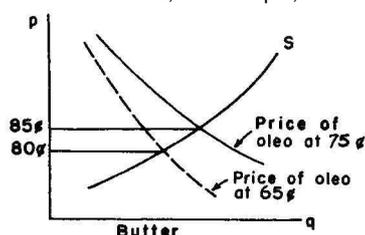
In his written submission, Mr Stillman does not use the term oligopoly. Prior to his written submission, he referred at the hearing on 17 July 2007 to "pricing in an *oligopoly* where you have multi-product firms and [a] lot of fixed costs"<sup>65</sup> and in the same sentence indicated that it would be useful to present "a short note on economics" that illustrated the concepts involved. We accordingly classify Mr Stillman's approach in his written submission (the "short note") as one that embraces oligopoly. Since he presents a picture in which excess profits are not eliminated by the entry of competitive firms, we can regard it as a closed model – in other words one in which entry is not allowed.<sup>66</sup> It should nevertheless be noted that the diagram is also compatible with monopoly and monopolistic competition (as long as there are barriers to entry). While Mr Stillman's employs the profit-maximising principle (marginal cost equals marginal revenue) to his model of oligopoly, it can also be applied to monopolistic competition and monopoly, and, for that matter, to perfect competition.

Let us investigate for a moment what Mr Stillman is showing in his diagram of a firm in conditions of oligopolistic competition. Such a firm has some degree of market power – and is neither a perfectly competitive firm nor an outright monopolist. Here (so Mr Stillman would have us assume), the firm is already producing at the profit maximizing level of output consistent with the marginal cost equals marginal revenue condition. This means the firm would make a loss on every additional unit of output produced, as its marginal cost would

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not an upwards or downwards shift of the ATC curve at a fixed level of output, as depicted in the diagram.

<sup>64</sup> That is illustrated, for example, in Milton Friedman, *Price Theory* (Transaction Publishers edition, 2007), p 24:



Samuelson and Nordhaus, *Economics*, 12<sup>th</sup> edition, p 503 state: "The perfectly competitive firm can sell all it wants to along its horizontal [demand] curve, never depressing market price. But the imperfect competitor will find that its demand curve slopes downward as its increased  $q$  forces down the  $P$  it can get. And **unless it is a sheltered monopolist**, a cut in its rivals'  $P$ s will appreciably shift its own [downward-sloping demand curve] leftward..." (Emphasis added. American economic writers often use the term "monopolist" to refer to firms having significant market power, and do not confine it, as we do, to a firm having the whole market to itself.)

<sup>65</sup> Transcript 17 July 2007, p 83, emphasis added.

<sup>66</sup> See Koutsoyiannis, A (1987). *Modern microeconomics*, Second edition, Macmillan, p 228.

then exceed its marginal revenue. All else remaining constant, it has nothing to gain from lowering price in order to increase the quantity demanded.

In Mr Stillman's analysis, the persistence of the price above the average total cost curve also implies that there is no whittling away of profits by competitors under-cutting the price, be they incumbents or new entrants. This is consistent with the existence of barriers to entry as well as existing rivals choosing to refrain from price competition. Either the latter all have nothing to gain, *even in the short term*, from presenting such competition – a colossal assumption to make – or else they prefer to live a quite life where pricing is concerned.<sup>67</sup>

Aspects of Mr Stillman's analysis can be challenged both on points of theory and with reference to market conditions experienced in the banking industry in recent years.

We begin with the theoretical challenges.

Mr. Stillman presents the assumption that all firms are in fact producing output at the point where  $MC = MR$  as if it were an inviolate principle – above reproach. A brief glance at the history of economic thought indicates otherwise.

The  $MC = MR$  argument employed by Mr Stillman came to the fore around 1880, during the so-called marginal revolution. The  $MC = MR$  principle was applied in the theory of perfect competition and in the theory of monopoly. It was also subsequently applied to models of oligopoly.

By the 1920s, economists were growing increasingly skeptical of the perfect competition model. In 1933, Joan Robinson<sup>68</sup> (in England) and Edward Chamberlin<sup>69</sup> (in the USA) independently put forward models of monopolistic competition, although Robinson preferred to use the term "imperfect competition". Here firms produce products that are close substitutes, even though each firm tries to promote a differentiated product. An individual firm faces a downward sloping demand curve for its product. In the theory of monopolistic competition the profit maximising condition ( $MC = MR$ ) is retained.

In the theory of monopolistic competition firms are generally assumed to have freedom of exit and entry. The existence of supra normal profits (sometimes referred to as "pure" profit<sup>70</sup>) lures firms into the arena and their entrance in turn puts excess profits under pressure. Firms are assumed to act independently of each other. Bilas points out that pure

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<sup>67</sup> As Bilas (1971) points out, the Lerner analysis shows what a firm is doing rather than what it is able to do, so a firm with market power may refrain from charging the highest possible price if that helps preserve its market power: "...the greatest of all monopoly power is the quiet life". *Op cit*, p 268.

<sup>68</sup> Robinson, J (1933). *The economics of imperfect competition*. Macmillan.

<sup>69</sup> Chamberlin, E H (1933). *The theory of monopolistic competition*. Harvard University Press.

<sup>70</sup> See Bilas, *op cit*, p 267.

profits can exist in monopoly and oligopoly but not in perfect competition and not in monopolistic competition.<sup>71</sup> This provides further evidence that Stillman's diagram depicts oligopolistic competition.

Although many oligopoly models saw the light of day from about 1940 onwards, writings on oligopoly can be traced back to 1848 when Augustin Cournot presented a duopoly model. So we can say that by the late 1930s at least four theories of the firm were in place: perfect competition, monopoly, monopolistic (imperfect) competition and oligopoly, although oligopoly had yet to come into its own. For present purposes the critical feature of all four approaches was that all four employed the assumption of profit maximisation with its associated  $MC = MR$  condition.

What we have shown is that Mr Stillman's diagrammatic approach is firmly entrenched in the marginalistic tradition that had pervaded conventional theories of the firm by the late 1930s. If there had been no further development in the theory of the firm since the 1930s, Mr Stillman's argument that "It is a first principle of economics that a firm maximises profits by producing at the level at which marginal cost equals marginal revenue" could perhaps be maintained. However, a lot has happened in economic theory since then.

Koutsoyiannis writes:

In 1939 Hall and Hitch published some results of research undertaken at Oxford... The most startling results of the studies of 'The Oxford Economists Research Group' reported by Hall and Hitch were that firms did not attempt to maximize their profits, that they did not use the marginalist rule  $MC = MR$ , and that oligopoly was the main market structure of the business world. Up to then the theory of monopolistic or imperfect competition of Chamberlin and Joan Robinson had been generally accepted as typical or relevant. The firms were assumed to be able to act atomistically, ignoring their rivals' reactions and pursuing their short-run (and long-run) profit maximization by equating marginal cost to marginal revenue in each time period.

...

Hall and Hitch found that firms do not attempt to maximize short-run profits by applying marginalistic rules ( $MC = MR$ ), but aim at long-run profit maximization. Firms set their price on the *average-cost principle*. That is, firms do not set their price and output at the levels determined by the intersection of the MC and MR curves, but they set a price to cover the average variable cost, the average fixed cost and a 'normal' profit margin ("usually 10%") ...<sup>72</sup>

Koutsoyiannis adds that the Hall & Hitch study points to a number of factors:

Firstly, short-run profit maximization was rarely stated by businessmen to be their goal. Most firms reported that they aimed at a 'fair' level of profit and that they had also other goals. ... Secondly, the demand curve and its price elasticity, on which marginalism so heavily relies, are unknown in practice, because neither consumers' preferences nor competitors' reactions are known with certainty. ... Thirdly, marginal costs are also unknown in multiproduct firms. ... Fourthly, even if MC and MR were known, and firms aimed at the maximization of their (short-run) profits, the adherence to this equality would require continuous changes in the price in view of the continuous changes in costs and demand. Such frequent changes in prices are

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<sup>71</sup> *Id.*

<sup>72</sup> *Op cit*, p 263.

not desirable, and prices have exhibited considerable stickiness despite changes in short-run costs and demand.<sup>73</sup>

A torrent of articles on the subject ensued, giving rise to the so-called marginalist controversy of the 1940s and 1950s. The details need not detain us here. Enough has been said to illustrate that it is misleading to present profit maximisation on the basis of  $MC = MR$  as an inviolate principle. Microeconomic texts display a staggering collection of different theories of the firm – to give a flavour of the argument we simply list three of them:

- Bain's limit-pricing theory (1949) – deals with the threat of potential entry.<sup>74</sup>
- The behavioural model of Cyert and March (1963) – indicates that firms have many goals, not just a single goal of profit maximisation.<sup>75</sup>
- Baumol's theory of sales revenue maximisation (1958) – suggests that firms attempt to maximise sales revenue rather than profits.<sup>76</sup>

How a firm will actually behave depends on its specific set of factual circumstances.

Mr Stillman argues that when fixed costs change, output is not affected. This follows from his  $MC = MR$  condition, with a change in fixed cost not affecting marginal cost. Because Baumol's theory makes use of the sales maximisation principle (rather than profit maximisation), Baumol can argue that firms will change output and price when overheads change.<sup>77</sup> Note that even in Mr Stillman's approach it is not generally true that a change in fixed cost will have no effect on output and price. If the change in fixed cost impinges upon the shut-down position, the equilibrium level of output will be affected.<sup>78</sup> Mr Stillman fails to address the reasons for the fall in average total costs, for example as might occur if demand shifts outwards and economies of scale are realised, and instead focuses all our attention on a change in fixed cost, which by his reasoning doesn't change price or output.

To forestall his  $MC = MR$  reasoning from degenerating into a tautology, Mr Stillman (here speaking for Absa) should have provided concrete evidence that the firms in question do, in fact, produce at a point where marginal cost is equal to marginal revenue. No evidence whatsoever was produced to show that Absa, or any of the other banks, is producing at such a point.

We now turn to the application of Mr Stillman's diagram in reality.

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<sup>73</sup> *Id.* p 265.

<sup>74</sup> Bain, J (1947) 'Oligopoly and entry-prevention', *American Economic Review*.

<sup>75</sup> Cyert, RM and March, JG (1963) *A behavioural theory of the firm*. Prentice-Hall.

<sup>76</sup> Baumol, WJ (1962) *Business behaviour, value and growth*. Harcourt & Brace.

<sup>77</sup> See also Koutsoyiannis, *op cit*, p 330.

<sup>78</sup> *Id.*, p 181.

The rapid expansion of account-holding and transaction volumes which the South African banking industry has experienced in recent years has nowhere been accompanied by indications that banks are reaching the limits of their profitable capacity to provide. Moreover, the advances in new technology suggest that not only average total (or unit) costs but also banks' marginal costs themselves are probably coming down. With the fall in unit costs which this implies, space would clearly have been created for prevailing prices to come down. Yet, at least in the important segment of the market for PTAs that we are analysing here, this has not occurred. The question remains: why not?

In terms of Mr Stillman's diagram, we are still in the world of excess (i.e. above normal) profits. Excess profits invite competitive challenges from rivals who could reduce their prices in order to gain market share. In an oligopolistic market, however, firms readily appreciate that by competing vigorously on price they may spoil the market and reduce their profit in the longer run.<sup>79</sup> In such a market, the lure of excess profits means that the possible entry of additional firms must be taken into consideration. If there is no entry of firms and excess profits persist, it is difficult to escape the conclusion that the incumbents individually have some market power and are refraining from competition that would spoil their ability to exercise it.

It does not require actual combinations or understandings among competitors to bring forth individual behaviour calculated to avoid longer-term competitive "spoiling". Sullivan and Grimes explain:

[T]he players in an oligopolistic market can actually increase the returns that all of them receive through disciplined pricing. To achieve this discipline, the oligopolists must recognize their interdependence and act accordingly. This is distinguished from the independent behavior assumed for the theoretical models of perfect competition or pure monopoly. *But in most real markets, each market participant recognizes that its output and pricing decisions will have an impact on and will draw a response from competitors. For such players, output and pricing decisions are taken with an eye to what the competitive response will be.*<sup>80</sup>

As Charles E. Mueller explains further when defining "OLIGOPOLY" in his "Glossary of Antitrust Terms":<sup>81</sup>

... Given a situation in which there are only a few sellers, a phenomenon called "oligopolistic interdependence" is expected. Whereas the individual firm in an atomistic industry [one characterised by many sellers] has such a small share of aggregate industry sales that nothing it can do will perceptibly influence the overall marketwide price (e.g., the withdrawal of its entire supply from the market would not affect that market price), the individual firm in an oligopolistic industry is, by definition, sufficiently large that any substantial change *in its* output volume will have a perceptible effect on the overall *market-wide* price – and hence on the volume of sales, and price received, by each of its rivals. The latter are thus expected to

<sup>79</sup> Marshall observed long ago that "the chief motive of all open combinations and of all informal silent and "customary" understandings whether among employers or employed is the need for preventing individuals from spoiling the common market by action that may bring them immediate gains, but at the cost of a greater aggregate loss to the trade." *Op cit*, p 498.

<sup>80</sup> *Op. cit.*, p 39 (emphasis added).

<sup>81</sup> *Antitrust Law & Economic Review*, Vol. 26, No. 4.

notice these changes, recognize their source, and take appropriate measures to protect their respective interests.

A price decrease, for example, will normally prove unprofitable for the price cutter. The others will promptly match his lower price, thus removing any incentive for buyers to switch suppliers. With his market share unchanged, but price now at a lower level, the price-cutter's profits are presumably lower than before. Similarly, a failure to go along with a price increase will generally prove unprofitable, since the others will quickly drop back to protect their market share if there's a holdout still selling at the lower price, the result being that the holdout gets no increase in his market share and foregoes a higher per-unit price that all could have had if he had gone along with the change. By a series of such adjustments, rational oligopolists are expected to eventually arrive at the price level that will maximize their joint profits, i.e., the *industry* profit-maximizing price level, the same price as that a single firm monopolist would charge.

The possibility of this result actually being reached is dependent on other factors, however, particularly on (1) whether the industry in question belongs to the Tight-Knit or Loose subcategory of oligopoly, that is, whether its concentration ratio is very high or only moderate, and on (2) whether its entry barriers are high enough to permit the exercise of that pricing power without inducing new entry. ...

TIGHT-KNIT OLIGOPOLY – A market structure so highly concentrated that prices are expected to be significantly above, and output significantly below, the competitive norm. In general, empirical studies suggest that this result is to be expected when the four largest sellers have 50% or more of sales in a market or when the eight largest have 70% or more.<sup>82</sup>

With the big four banks having more than 90 per cent of the market for PTAs in South Africa, it is not difficult to conclude that a tight-knit oligopoly exists. At the same time the barriers to new entry are substantial.

Mr Stillman observes that, in the case of constant marginal costs, “the impact of a shift in demand on price depends solely on how the shift *changes* the elasticity of demand.”<sup>83</sup>

Mr Stillman employs the Lerner Index to indicate that while an increase in demand can lead to an increase in price, nothing can be inferred about whether or not the process has rendered the market less competitive. Once again, his argument does not expand on the fact that in competitive markets, the presence of excess profits should lure other suppliers into the arena.<sup>84</sup>

Here we should bear in mind the rationale behind the Lerner Index (which first saw the light

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<sup>82</sup> These passages were quoted with approval and applied by the Competition Appeal Court in *Mondi Ltd and Kohler Cores and Tubes (a division of Kohler Packaging Ltd) v Competition Tribunal* [2003] 1 CPLR 25 (CAC) par [41].

<sup>83</sup> CRA International, *Price changes and demand shifts*, Robert Stillman, 10 August 2007, p 4. We have explained above why the assumption of constant marginal costs is unacceptable.

<sup>84</sup> In *Intermediate Microeconomics: A Modern Approach* 5<sup>th</sup> edition, pp 449-450 Hal R. Varian writes:

“As more and more firms enter the industry for a particular kind of product, how would we expect the demand curve of an incumbent firm to change? First, we would expect the demand curve to shift inward since we would expect that at each price, it would sell fewer units of output as more firms enter the industry. Second, we would expect that the demand curve facing a given firm would become more elastic as more firms produced more and more similar products. Thus entry into an industry by new firms with similar products will tend to shift the demand curve facing existing firms to the left and make them flatter.”

The same would apply if existing firms were able to mount a greater competitive challenge – if we assume it were in their interests to do so.

of day in 1934). The index suggests that the gap between market price and marginal cost provides an indication that market power might be present. If demand increases and the gap widens, that in itself does not indicate that monopoly power has increased. If there are no barriers to entry, the size of the gap will be affected by the behaviour of competitors. If there are barriers to entry, the persistence of the gap raises the possibility that market power is playing a role.

In spite of the increased volumes, unit cost savings and sustained profitability enjoyed by Absa, over an extended period, it has not lowered its retail banking prices substantially.<sup>85</sup> *The fact that it has not done so is because competitive pressures have not existed or been brought to bear, compelling it to do so.* This conclusion, although drawn from an analysis of Absa's data and submissions, does not point a finger at Absa in particular. What Absa's position reveals is *the unsatisfactory state of competition in the market as a whole.*

Standard Bank<sup>86</sup> and [REDACTED]

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[REDACTED] Although Nedbank has reduced its prices, we find that this has been from levels above a broad alignment with other major banks, which had caused it to lose a significant share of the market.<sup>88</sup> We have found no reason to conclude that Nedbank is now undercutting its rivals in the middle market to any significant extent.<sup>89</sup> Even in the lower-income market, Nedbank is still priced well above the lowest priced provider, Capitec. Although Capitec has managed to grow its low-income

<sup>85</sup> Volume growth has continued at a rapid rate. Absa's published financial results state that, in the year ended 31 December 2006, retail banking continued to show "strong growth" in transaction volumes "which emanated from the increased activities of existing and new customers", resulting in a non-interest income growth of 22%. In the year ended 31 December 2007, transaction volumes in retail banking "increased by 8.2% emanating from an increase in the customer base, improved product use and improved accessibility." Operating expenses in the segment increased by 13% while attributable earnings were up by 20%.

<sup>86</sup> Standard Bank's published results for the year ended 31 December 2006 state: "Average operating margin improved to 8,5% (2005: 7,0%). The Group continues to benefit from enhanced efficiencies throughout the supply chain, capacity utilisation as a result of improved economies of scale and the favourable terms of supply of finished products for resale." The Bank's results for the year ended 31 December 2007 state: "Net fee and commission revenue grew by 23%. The largest category, account transaction fees, grew 10% despite sub-inflation price increases in South Africa." Standard Bank audited results, 2007.

<sup>87</sup> See FRB, March 2007, Part A Data Request and FRB, October 2007, FRB Data and Info Request, p 4. In its interim results for the six months ended 31 December 2006, FRB stated that FNB's Consumer segment had performed well with profits before taxation increasing by 15 per cent. "This was achieved in an operating environment of rising interest rates, but continued good growth in both client and transaction volumes." FRB's Annual Report for the year ended 31 December 2007 states that the FNB mass (i.e. "Smart" account) segment which focuses on individuals earning less than R81,000 per annum "performed well during the year, with profits increasing significantly and customer numbers growing from 2.9 million to 3.3 million. The main driver of this performance was the strong growth in non interest income which increased 27%. This increase in turn, was driven by 22% growth in income generating transactions, including debit card transactions which grew 63%." Note: FNB is the commercial bank brand of FirstRand Bank. It is the latter which holds the bank licence.

<sup>88</sup> See Nedbank, May 2007, Second Submission, Data Request Part A, p 5. See also: Nedbank's preliminary financial results for 2006, published in February 2007 for the year ended 31 December 2006. They state that volume growth in Nedbank Corporate and Nedbank Retail had resulted in an increase of 13,3 per cent in commissions and fees despite the "more competitive pricing structure adopted in Nedbank Retail", where, in July 2006, transactional fees were reduced by an average of 13 per cent. Published preliminary results for the year ended 31 December 2007 (on the Nedbank website) show a further increase of 19 per cent in operating income in Nedbank Retail.

<sup>89</sup> See pricing brochures and Infochoice data.

customer base considerably by offering lower priced transaction accounts it has, as yet, not posed a significant competitive threat to the big four banks in their traditional areas of dominance.<sup>90</sup>

Our conclusion is that for Absa, and for the other major banks, the sustained fall in unit costs – with no real fall in unit price – indicates that competition has not been effective in constraining the banks from keeping prices above competitive levels over a significant period of time. We consider this to be strong evidence that there is appreciable market power on the part of these banks in the provision of PTAs and related services to the retail segment of the market.

In the subsequent sections in this chapter we examine the various structural and behavioural factors influencing the effectiveness of competition in constraining the ability of the banks to behave to an appreciable extent independently of their customers and competitors in the provision of PTAs and related services generally.

## 2.4 Market structure

The Task Group (Falkena III) report found that the concentration levels of the South African banking industry are high in terms of market share of assets, but not out of line with other emerging markets.<sup>91</sup> However, it is in the market segments rather than at firm level that concentration is even more marked. For example, while the big four banks accounted for 83 per cent of the total deposits of the public in June 2003, they accounted for 92 per cent of mortgage loans and 89 per cent of bank financed installment sales.<sup>92</sup>

Although there was some variation in the banks' estimates of their market shares, and in the manner of calculating market shares, an examination of the figures submitted to the Enquiry shows that the market for personal transaction services is highly concentrated, both at the broad level, and within the income segments.

Table 1 shows market shares in the provision of personal transaction services by monetary value of month end balances as of July 2006.<sup>93</sup>

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<sup>90</sup> We deal with this issue in greater detail in the discussion on barriers to entry and expansion.

<sup>91</sup> *Op cit.*, p 29.

<sup>92</sup> *Id.* p 34.

<sup>93</sup> Personal transaction services here include cheque and transmission accounts, demand deposits and short-term savings.

**Table 1 Market shares, personal transaction services: value of month-end balances**

	Standard Bank	Absa	FNB	Nedbank	Other
Value (R million)	36 485	36 300	29 632	36 962	6 552
Market Share <sup>94</sup>	25%	25%	20%	25%	4%

Source: Genesis report for Standard Bank, 08/11/2006, p18.

Therefore the top four banks collectively constitute roughly 95 per cent of the market for personal transaction services.

High levels of concentration appear to be characteristic of banking markets around the world.<sup>95</sup> This suggests that the cost structure of banking is such that there is a limit to the number of full-service banks that can be sustained over time in any particular market. In their submissions most of the banks have noted that approximately 80 per cent of their costs are fixed.<sup>96</sup>

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[REDACTED] A high fixed cost structure will limit the number of firms in a market because (if we assume all other factors remain constant) with each additional firm there will be a proportional increase in fixed costs that must be recovered from net revenues in the sector.<sup>98</sup>

Mr Stillman, speaking for Absa, noted:

It is clear that there are very large fixed costs in the banking industry. It is one of the themes that I think has been emphasised by all the banks in their presentations and I think rightly so. I think that in the order of 70%, 80% of the cost structure can be regarded as a fixed cost and that those costs in turn are common costs that are very difficult to allocate to particular products or even in some cases, business units. So as a consequence, what you necessarily are going to have in our world ... [are] very large economies of scale. ... So, in this kind of industry, you are going to have prices that are in excess of and indeed considerably in excess of the marginal cost of providing any particular service that is necessary to be able to cover all those fixed costs and provide a return to shareholders.<sup>99</sup>

<sup>94</sup> Totals do not add up to 100 per cent due to rounding.

<sup>95</sup> FNB presented information showing that there is no evident relationship between GDP and the structure of banking markets. Countries like Indonesia, Australia, Mexico, and the United Kingdom have larger economies than South Africa but are similarly concentrated – with each country (including South Africa) having only four banks holding more than 75 per cent of assets. Therefore, it does not necessarily follow that at greater levels of demand, banking markets will be less concentrated. (FNB, November 2006, Exhibit M, slide 9).

<sup>96</sup> See e.g. Transcript 9 November 2006, p 8 (FRB); Standard Bank, 11 April 2007. Exhibit GG, Appendix 3, slide 32.

<sup>97</sup> [REDACTED]

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<sup>98</sup> See Panzar, J.C. (1998), "Technological Determinants of Firm and Industry Structure", In: Schmalensee, R and Willig, R.D., *Handbook of Industrial Organisation*, Chapter 1, Volume 1, pp 3-59. Firms need to cover their variable costs in order to survive. Normal profits are an important component of fixed cost. Hence even when a firm is making normal profits (zero excess profits) it is still earning enough to want to stay in the industry.

<sup>99</sup> Transcript 17 July 2007, pp 37-38.

This particular cost structure (i.e. high fixed and common costs) drives concentration in banking and places certain limits on the extent of competition. The concentration of banks produces an oligopoly structure which facilitates strategic interaction among the participants and confers on each of the banks a degree of market power at least sufficient to cover fixed costs.

The potential for banks to exploit this market power to earn excessive returns will depend on the extent to which entry and expansion by new and existing firms effectively constrains the incumbent banks. In this regard we examine barriers to entry and expansion in retail banking in South Africa.

## 2.5 Barriers to entry and expansion

We find that barriers to entry and expansion are high in retail banking generally, including the provision of PTAs. The high proportion of fixed and common costs (including the cost of branch networks, other infrastructure and ensuring interoperability), and the consequent importance of economies of scale and scope, are themselves major barriers to the entry, survival and competitive expansion of new firms. The multi-product nature of retail banking also creates opportunities for cross-subsidisation by incumbents, which potentially increases the handicap facing new firms. Other barriers include the regulatory requirements for entry and participation in the banking industry, the costs faced by customers of incumbent banks in switching to new providers, and the effects of brand loyalty.

### 2.5.1 Regulatory requirements

We have seen a number of players in our industry who handed back their banking licences, because of the high cost of holding banking licences.

Mr Sizwe Nxasana, CEO of FirstRand Bank <sup>100</sup>

The Banks Act<sup>101</sup> requires a banking license and registration with the South African Reserve Bank (SARB) Office for Banks as a pre-requisite to operate as a bank. A banking license is required in order to offer deposit-taking services such as cheque and transmission accounts offering deposits, savings and payment facilities. The Banks Act, supplemented by regulations, sets out certain prudential requirements that must be met upon application for a banking license and prior to registration.

Prudential requirements are primarily concerned with the protection of depositors' funds and reducing the risk of bank crises. The primary prudential requirement is to maintain a

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<sup>100</sup> Transcript 9 November 2006, p 7.

<sup>101</sup> Act 94 of 1990 (as amended).

minimum level of capital and unimpaired reserves in the Republic to absorb potential losses in the event of risks materialising and to safeguard against the risk of insolvency. Currently, the general requirement is for banks to maintain a minimum capital and reserve balance of R250 million.

The regulatory and prudential requirements set out in the Banks Act are intended to protect the public. The fact that they are in place also provides regulators with a means of controlling financial conditions. They nevertheless pose a considerable barrier to entry by new firms and are an objective factor in any analysis of the degree of market power enjoyed by incumbents.

It is notable that since 2002, no new bank licenses have been granted, although there have been some purchases of existing bank licenses. The number of registered banks<sup>102</sup> has fallen from 41 in 2002 to 17 in 2006.

Our focus here is on conditions affecting competition in the market for the provision of PTAs and related services. As deposit-taking is involved, this is the preserve of banks. Issues of access to and participation in the payment system – historically but not necessarily in itself the preserve of banks – are dealt with comprehensively in the chapter of this report on Access to the Payment System. Nevertheless, insofar as the provision of PTAs necessarily involves banks in the payment system, the cost of that involvement must be taken into account when assessing barriers to entry for banks themselves.

In South Africa, registered banks may become clearing banks by obtaining a SAMOS settlement account with the SARB and membership of the Payment Association of South Africa (PASA) and the Banking Association.<sup>103</sup> There are membership and usage fees to be paid in this regard, and ultimately fees to Bankserv or any other operator or association (like MasterCard and Visa) in which the bank participates or whose services it uses. All of these are explicit costs that would mount up as a new entrant expands its participation in more payment streams<sup>104</sup>. Here too, the volume of business that a firm can expect in entering and remaining in the market must play a crucial part in any decision to do so.

## 2.5.2 Switching costs and customer inertia

Any new entrant faces the difficult challenge of having to attract new customers. In retail banking this is made particularly difficult by the inherent inertia of customers in this complex industry, and the established reputation of incumbents' brands. As will be demonstrated in

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<sup>102</sup> Apart from 15 local branches of foreign banks, which are not full service banks, and 2 mutual banks.

<sup>103</sup> It was indicated during the Enquiry that the last-mentioned requirement was in the process of being dropped.

<sup>104</sup> These matters are expanded in both the Chapters on the Payment Cards and Interchange and Access to the Payment System.

detail further in this chapter, switching costs are high and consumers are not very responsive to price. This means that any new entrant would face considerable difficulties attempting to attract customers on the basis of competitive pricing. It would have to be able to offer a significantly lower price and satisfy consumers that it would sustain that price difference, in order to attract customers from the incumbents. This factor adds considerably to barriers to entry, and so reinforces the incumbents' market power.

Every time a customer transfers funds from his or her account to somebody who banks at another bank, the bank from which funds are transferred will lose reserves. During the course of the trading day, there will, of course, be funds flowing in the opposite direction. With stable market shares, the banks have a good idea of how much to keep in the form of excess reserves (to alleviate risk). One of the problems facing a new bank is that until it has achieved a reasonable market share, it will have to keep enough excess reserves to deal with such a drain on its reserves.

### 2.5.3 Reputation and brand loyalty

Consumers tend to place a high premium on the reputation of incumbents' brands. This is particularly true in the case of banking where consumers perceive an established brand as being representative of the stability of the bank and thus the security of their deposits.

The consumer survey conducted for the Enquiry by KLA found that consumers perceived larger banks to be more secure and stable. It was noted that "advertising is more strongly associated with bigger banks which in turn emphasises their stronger sense of establishment."<sup>105</sup> Trust and security were among the themes typically invoked. Further, in differentiating between small banks and large banks, the majority of participants in the survey associated greater stability and financial security with "big banks" as opposed to "small banks".<sup>106</sup> Consumers appear to have bought into the notion of some banks being "too big to fail".

Already inert customers will not easily choose a new bank that does not have an established brand. It is thus not surprising that the banks spend substantial amounts of money on brand awareness and "top-of-mind" advertising.<sup>107</sup> FNB note that "building the brand" takes the form of advertising as well as sponsorships. "Brand building via advertising takes place

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<sup>105</sup> Kaufman, Levin, Associates "Qualitative research to understand what the main factors are that drive consumer choice when choosing a bank for the first time and when considering whether to switch to another bank", July 2007, Exhibit GGG, slide 13.

<sup>106</sup> *Id.*, slide 14.

<sup>107</sup> Hal R. Varian observes (*op cit*, p 453) that if firms can succeed in convincing the consumers that their product has no close substitutes, they will be able to charge a higher price for it than they would otherwise be able to do. "This leads each producer to invest heavily in creating a distinctive brand identity. Laundry soap, for example, is a pretty standardized commodity. Yet manufacturers invest huge amounts of money in advertisements that claim cleaner clothes, better smell, and a generally happier existence if you choose their brand rather than a competitor's. This 'product positioning' is much like the ice cream vendors locating far away from each other in order to avoid head-to-head competition."

across the market; however extra efforts are made in market segments where FNB is focused on improving market perception.”<sup>108</sup> FNB spent more than R15 million on sponsorships in 2006.<sup>109</sup> Brand-building is linked to product positioning and product differentiation (discussed further below). Our impression is that differential colour-branding and general image-building have tended to be emphasised in the major banks’ advertising rather than hard-edged messages advancing competitive prices. This poses a significant barrier for new entrants who must incur substantial sunk costs from spending on advertising and brand awareness.

#### 2.5.4 Extensive branch networks and infrastructure requirements

Although there are alternative distribution channels for the delivery of personal transaction services, physical branches have played, and are likely to continue to play, an important role in the channel strategy of retail banks. The costs of establishing and maintaining physical branch networks are substantial and pose a significant barrier for new entrants who do not have established branch infrastructure.

The importance of physical branches is evident in the banks’ response to the requirements of the Financial Sector Charter to provide banking to low-income individuals. Absa submitted to the Enquiry that it plans to increase its branch network over the coming years and noted that “network expansion will follow from the requirements of the Financial Sector Charter related to providing access to low-income individuals, and will also flow from Absa’s long-term growth across all customer segments”.<sup>110</sup>

#### 2.5.5 Limited expansion by firms in the competitive fringe

“Oligopoly”, write Lipsey, Courant and Ragan, “is consistent with a large number of small sellers, called a ‘competitive fringe’, as long as a ‘big few’ dominate the industry’s production.”<sup>111</sup> With appropriate caveats, the South African banking market for PTAs, while clearly an oligopoly, may be characterised as having a “competitive fringe”.<sup>112</sup>

In this regard it is important to assess whether competition from firms on the fringe effectively constrains the market power of the big banks. The combined share held by smaller banks in the market under consideration is very small, constituting altogether less

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<sup>108</sup> FRB, October 2006, First Submission, p A1.64.

<sup>109</sup> *Id.* Note that FNB is one of the brands of FirstRand Bank. See Transcript, 9 November 2006, p 5.

<sup>110</sup> Absa, First Submission, October 2006, p 7. Branch construction in order to meet FSC proposed densification objectives is estimated to be R27 million per year for each of the big four banks (*Id.*, p 20).

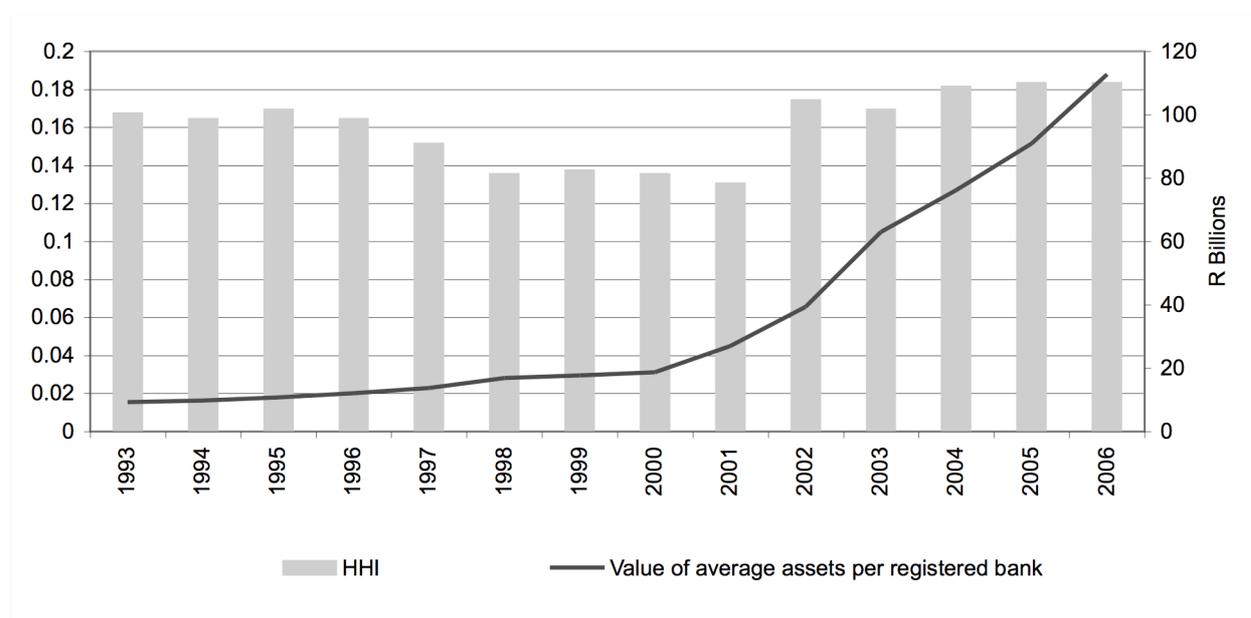
<sup>111</sup> *Economics*, 12<sup>th</sup> edition, p 260.

<sup>112</sup> When describing a fringe as “competitive”, it must be borne in mind that players on the fringe may in fact use the supra-competitive prices of the oligopolists as a benchmark when setting their own prices, thus diminishing effective competition with incumbent firms.

than 10 per cent. As noted above, the cost structure of banking drives concentration. The volumes needed to achieve the kind of scale economies enjoyed by the major banks are substantial and have, as yet, not even been approximated by other firms. Although there have been some success stories these have largely been in niche areas either at the high end or the low end of the market.<sup>113</sup> The dominance of the major full-service banks in the wider middle market has gone largely unchallenged.

In the past the scope for a smaller bank to develop into a serious contender has been stifled as a consequence of a fairly stagnant market. This situation has changed somewhat over the last few years, which has seen substantial growth in the market. Nevertheless, retail banking has become more rather than less concentrated since 2001. Figure 3 shows the HHI<sup>114</sup> (a measure of concentration), and the value of assets of registered banks (a proxy for market growth).<sup>115</sup>

**Figure 3 HHI and average value of assets per registered bank for South Africa**



Source: Bank Supervision Department, SARB.

A number of factors have contributed to increased levels of concentration since 2002. Prior to that, and after 1995, a number of new entrants reduced concentration in the industry, but the failure of Saambou and BOE (the seventh and sixth biggest banks, respectively, at the time) in 2001/2002 resulted in a number of smaller banks leaving the market. However, two

<sup>113</sup> In this regard we have reference to Investec – a bank providing PTAs and related services to high net worth individuals; and Capitec – a bank specializing in microfinance which has had success providing transaction accounts to low income consumers.

<sup>114</sup> HHI is the Herfindahl-Hirschman Index, a measure of concentration devised in the United States. It is calculated as the sum of the squares of the market shares of every firm in the relevant market. See Herbert Hovenkamp, *op cit*, p 518. We are not concerned here with the significance of particular HHI levels, the significance of which is debatable, but rather with the *trend* towards greater concentration which the index reveals.

<sup>115</sup> These and other data were originally part of the Falkena III report, and have been updated and presented in the Appendix at the end of this chapter.

features of the market have been consistent since 1993. The first is that the market has been dominated by the four largest banks. The second is that no new full-service bank has emerged to challenge the dominance of the big four.

There is currently no indication of a foreign bank intending to enter the market on a green fields basis. Even the recent entry into South Africa of Barclays Plc – one of the largest banks in the world – was by way of acquisition of control of Absa, one of the existing big four. Given the barriers to entry discussed above, as well as the particular challenges faced by smaller banks, there is little prospect for banks on the fringe to expand and pose a serious challenge to the dominant positions of the incumbent full-service banks.

The fringe consists of a number of smaller banks. These include Investec, Capitec, Postbank,<sup>116</sup> South African Bank of Athens/Wizzit, Mercantile Bank, Teba Bank, and Ithala.<sup>117</sup> In this section we discuss some of the key fringe competitors and evaluate the scope for their expansion and whether or not they are likely to pose a competitive constraint.

### **Investec**

Investec did not make a submission to the Enquiry. It is predominantly an investment bank focusing on “serving the needs of select market niches where the group can compete effectively”.<sup>118</sup> This approach also applies in the case of transactional banking where Investec targets high-net worth individuals only. It has shown no sign of deviating from this business model and thus cannot be considered as an existing or potential competitive constraint in the broader low and middle market for personal transaction accounts, although it does compete with the big four for high net worth individuals.

### **Capitec**

Of all the smaller banks, Capitec may have the greatest potential to introduce serious competition for the currently dominant banks. In its submission to the Enquiry in 2006, Capitec stated an ambitious “vision to be the dominant mass market bank”.<sup>119</sup> This goal could be achieved, it submitted, by offering affordable services to the low income market.

Capitec has had success in this regard. Fees for transaction services on its products are significantly lower than those of the other banks and it has increased the number of account holders from 399,000 in 2004 to 1,010,000 in 2007.<sup>120</sup>

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<sup>116</sup> The Postbank is excluded from the application of the Banks Act.

<sup>117</sup> Ithala Limited is not a registered bank. It has an exemption from the provisions of the Banks Act. (See further the chapter on Access to the Payment System.)

<sup>118</sup> <http://www.investec.com/GroupLinks/AboutInvestec/CoreActivities>.

<sup>119</sup> Capitec, First Submission, October 2006, p 18.

<sup>120</sup> Capitec, Annual Report, 2007, p 7.

Capitec's core business is in making loans to low-income consumers. Its transactional products are similarly targeted at low-income consumers. Capitec's offerings are thus limited to a particular segment of the market. Its business model is thus one of niche banking targeted at a specific segment. As noted in its submission, "small banks have the ability to compete with large banks, not directly with all the products, but they can specialise in a niche."<sup>121</sup> This suggests that Capitec do not see much scope for development into a full-service bank that would compete with the dominant banks in the broader middle market.<sup>122</sup>

In its submission, Capitec highlighted a number of factors that restrict small banks' ability to expand and compete head-on with the larger banks:

- The requirement to be interoperable with the incumbent banks limits the scope for smaller banks like Capitec to expand and innovate. Capitec noted in its submission that:

..due to the concentration of clients in the large banks it would be almost impossible to implement new innovative payment services unless all the large banks buy into the concept and see a business case. Smaller banks can implement payment instruments on their own but the success and volumes will only come when there is interoperability with the clients of the large banks. The market is therefore dependant on the ability of the large banks to move with new ideas.<sup>123</sup>

- Public perceptions that smaller banks are risky present a challenge to small banks attempting to attract depositors away from larger banks. As noted by Capitec:

Individuals therefore tend to place their deposits with large banks that are "too big to fail". This creates the challenge to small banks to attract depositors, normally paying higher interest rates as a risk premium, from large banks in order to grow their client base.<sup>124</sup>

### **South African Bank of Athens / WIZZIT**

The South African Bank of Athens focuses on lending to small and medium sized businesses generally owned by members of the Greek community.<sup>125</sup> Although it accepts deposits and offers transactional products, this is a limited part of its business and thus it cannot be considered a significant competitor in the market for personal transaction services.

However, the South African Bank of Athens recently (March 2005) launched a division called

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<sup>121</sup> Capitec, First Submission, October 2006, p 9

<sup>122</sup> As Mr Stassen, CEO of Capitec stated at the hearings, "We are a very focussed bank, we are not everything to everybody..." Transcript, 4 April 2007, p 121.

<sup>123</sup> Capitec, First Submission, October 2006, p 9

<sup>124</sup> *Id.*, p 5.

<sup>125</sup> <https://www.bankofathens.co.za/home>

WIZZIT, which provides transaction services on a low-cost basis to un-banked and under-banked consumers.<sup>126</sup> WIZZIT offers various transaction services through a combination of mobile phone technology, ATMs, and branches of Absa and the Post Office.<sup>127</sup>

The experience of WIZZIT shows the great potential that exists for technology to be used to overcome costs of establishing a branch infrastructure in order to provide low cost transactional services. However, WIZZIT's experience also illustrates the difficulties that non-bank innovators face in entering the market. It is noteworthy that WIZZIT originally arose as a business model developed by entrepreneurs who were not affiliated with registered banks. As a consequence of the bank-led model of regulation in South Africa, WIZZIT were compelled to partner with a licensed bank in order to be able to bring their product to market. As noted by CGAP,<sup>128</sup>

Technology firms and mobile operators that want to develop e-money based branchless banking have to partner with a licensed bank, thus increasing their costs and delaying time to market. The result is technically a bank-led model that is only marginally "branchless", in that the bank's infrastructure and personnel are used for all cash transactions except where services are rendered through post offices.<sup>129</sup>

The restrictive approach of South African authorities towards e-money, relative to international comparative standards, is discussed in the chapter on Access to the Payment System.

### **Mercantile Bank**

Mercantile Bank, is a subsidiary of Caixa Geral de Depósitos, a company registered in Portugal. While providing "a full range of domestic and international banking services", Mercantile operates in selected retail, commercial, corporate and alliance banking niches.<sup>130</sup> Apart from Portuguese customers, its focus is on small and mid-sized businesses.

Mercantile's relatively small scale and niche market focus does not pose a major challenge to the dominant position of the big four.

### **Postbank**

Postbank did not make a submission to, or engage with, the Enquiry in any way. As a result we have been unable to explore the important question of its potential for expansion as a

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<sup>126</sup> Wizzit, Submission, 2006, pp 4-5.

<sup>127</sup> Transcript, 9 November 2006, pp 140 and 150.

<sup>128</sup> A World Bank entity focussing on financial inclusion.

<sup>129</sup> CGAP Focus Note, No.38, October 2006, p 12, *Use of agents in branchless banking for the poor: rewards, risks, and regulations*.

<sup>130</sup> [http://www.mercantile.co.za/au/cp/cp\\_overview.asp](http://www.mercantile.co.za/au/cp/cp_overview.asp). Alliance banking refers here to cooperative arrangements with other entities which facilitates access to the payment system.

provider of deposit-taking and payment services in competition with the major banks, using for the purpose the extensive nationwide post office branch infrastructure.

In our view, concerted attention by the government to the role, regulation and development of Postbank is required. For purposes of the present chapter, we can only observe that we have no basis on which we could now conclude that Postbank will subject the major banks to any significant competitive pressure in the retail market segments of full-service banking where their market power is most pronounced.

## Others

There are a number of other small banks and firms who offer transactional services in selected market segments. These include Ithala Limited, Teba Bank and MEEG Bank. However, they constitute a very small share of the total market and pose no significant competitive constraint to the major banks. Moreover, Absa has been in the process of acquiring MEEG, so that it may simply become another brand of Absa. The banking activity associated with retailers, which is frequently cited as evidence of banking competition, in reality, manifests joint ventures between retailers and major banks. These include Pick 'n Pay Go Banking (with Nedbank), Virgin credit card (with Absa), etc. These reflect brand proliferation rather than any fundamental change in the competitive landscape.

## 2.6 Product differentiation

Antitrust economists Viscusi, Harrington and Vernon write:

No discussion of oligopoly theory would be complete without mentioning product differentiation. One of the most significant ways in which firms compete is by trying to make their product unique relative to the other products in the market. The reason is that the more differentiated one's product is, the more one is able to act like a monopolist. That is, a firm can set a higher price without inducing large numbers of consumers to switch to buying competitors' products.<sup>131</sup>

In their submissions and presentations during the hearings the major banks stressed that they compete on the basis of a number of factors, of which price is not the most important.<sup>132</sup> Although product differentiation is limited in the low income segment – particularly in the case of Mzansi – in the middle and high income segments the product offerings of the banks (i.e. transmission and current accounts) are characterised by a high degree of differentiation.

Each bank has emphasised the importance of being able to differentiate its offerings in order to meet the increasing variety of consumer preferences. Transaction services are delivered through a number of different channels, and consumers differ with regard to their usage of and preference for these different channels. Banks develop different product packages

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<sup>131</sup> *Economics of Regulation and Antitrust*, 4<sup>th</sup> edition, pp 113-114. See also Transcript 17 July 2007, pp 92-98.

<sup>132</sup> See further the chapter on Costing and Pricing.

based on unique channel combinations and pricing structures to be able to service as wide a variety of customer preferences as possible. Further, based on their strengths in particular channels and other strategic considerations, banks will differentiate their offerings to target different customer segments. In a report prepared for Standard Bank, Genesis Analytics (Pty) Ltd (Genesis) noted that comparisons between banks on the basis of a common profile of customer behaviour is rendered meaningless by the fact that banks differentiate their offerings to target different customer segments.

Standard Bank submitted that:

Banks have, over time, evolved their products and service offering in line with increased understanding of their customers and their behaviours. As the ability to manage data and evaluate customers' preferences on channels has improved, customers have in turn displayed their preferences in unique combinations which allow them to optimise their lifestyle choices with increased diversity of channel access.<sup>133</sup>

Evidence of this can be found in the fact that while certain customers prefer to do their banking through electronic means such as the Internet and payment cards, other customers (who perhaps do not have access to the Internet) make greater use of branches and ATMs. Customer usage of different channels is also influenced by differences in income. For example, access to and frequency of use of payment cards will vary depending on the level of income of the customer.<sup>134</sup>

Banks therefore compete to develop products which best match the behavioural characteristics of customers. The closer the fit between the features of the product and the behaviour and preferences of the customer, the more willing the customer will be to pay a higher price. Of course, consumers' willingness to pay is greatly influenced by income levels – with higher levels of income being associated with a greater willingness to pay. This explains why there is greater product differentiation and product variety in the middle and higher income segments than there is in the low income segments.

The consequence of this form of product differentiation is greater product variety and, given the presence of alternative channels of distribution, greater product complexity. It is important to note, however, that differentiation arises from different *combinations* of product features and different pricing structures and not from intrinsic differences in the product features themselves. The full-service banks all offer the same set of transaction facilities. It is the manner in which these facilities are packaged and priced which varies from bank to bank.

The consequence of the prevailing practice of product differentiation by the banks in South Africa is that it is a *fait accompli* that each of the major banks will have a degree of market

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<sup>133</sup> SBSA, July 2007, Comparison Shopping for Banking Services, p 4.

<sup>134</sup> *Id.*

power over its customers. What is disputed, however, is whether this market power is *appreciable*. In the following section we explore the extent to which the market power of each of the banks (which is inherent in a model of product differentiation) is enhanced as a result of the information asymmetries and costs of searching and switching which are prevalent in the market for personal transaction accounts.

## 2.7 Information asymmetries

When customers have sufficient information they are able to use this information to make efficient and rational choices. Firms thus have an incentive to provide products that best meet the needs of customers and are forced to compete with one another as consumers are sufficiently informed to be able to differentiate between the offerings of the different firms. Competition tends to result in prices that reflect the value to the consumer of the particular product or service, rather than the ability of the firm to exercise market power.

However, when firms have more information than their customers about the attributes of their products, this information asymmetry confers on these suppliers a degree of market power over their customers. In such circumstances it may be difficult for consumers to assess the attributes of the products or to differentiate between the different offerings of the firms. This may be because of the complexity of these products or because they are purchased infrequently. Where customers are not adequately informed, and suppliers do not adequately disclose relevant information, competition on price, quality, and other factors is likely to be diminished.

There are a number of factors which contribute to and exacerbate information asymmetries in the market for personal transaction services. These are discussed below.

### 2.7.1 Limited knowledge and understanding of fees paid by consumers

There are several products in the market for PTAs and related services where pricing is not transparent. These include the pay-as-you transact and packaged cheque and current account services of the banks. The actual cost to consumers of purchasing these products depends on the interest rates and fees applied to the accounts, as well as the various fees for payment services. The combination of these elements makes it very difficult for consumers to determine exactly what they will pay for particular products, and thus also makes it difficult to compare products.

The KLA study for the Enquiry showed that most of the focus group participants had limited knowledge about what they were being charged for transaction account services. In particular, the study reported that “the sheer variation with respect to fees (different for

different banks and different applications) is experienced as very confusing<sup>135</sup> and difficult to calculate.<sup>136</sup> As a result, participants felt disempowered and were forced to rely on and trust the experts, namely the banks. It was reported that there was an element of blind faith among consumers entering into relationships with the banks, and that consumers are not able to “interrogate, confront, and challenge these experts due to a lack of knowledge, experience and confidence”.<sup>137</sup> These problems are exacerbated where many consumers suffer the additional disadvantage of low levels of formal education.

A focus group study done by the Monitor Group for the Banking Association produced similar results.<sup>138</sup> In particular Monitor found that:

- Customer awareness of fees and fee levels is limited
- Many customers do not use the cheapest channels, although price is a driver of behaviour
- Customers find it difficult to understand fee information and tables in bank statements and other bank documents.

At the hearing on 9 July 2007, Mr Shuter of Nedbank discussed some of the findings of Nedbank’s own research indicating that consumers have little knowledge of and do not really interrogate what they pay in bank fees:

One of the challenges with bank fees is, we still do not see a huge trend of clients actively inquiring on what their fees are inasmuch as all of the information is available in the branch space and the things are printed out and all of that. The research we have done on people opening current accounts in our branch system is that they are not actively inquiring on fees as to one of the challenges we have had because we have to..., must explain to our stakeholders [shareholders] why it is important that we are competing so strongly on the price element when some of our own internal research says that much as there is a sort of general view that banking is expensive and people are being charged too much, there is not a great deal of inquiring at an individual level on the cost of banking and you only have got to do, you know pop surveys just amongst just our own peers, very few people had actually interrogated what they are paying. So I would not accept the argument that clients are trying very hard to compare but it is so difficult that they are actually now focusing on service and product.<sup>139</sup>

Mr Shuter appeared to conclude that perceptions of a lack of transparency are unfounded, and that consumers’ ignorance arises from apathy and consequent failure to question what they pay for bank fees rather than inadequate disclosure of information on the part of the banks.<sup>140</sup> In this regard he referred to anecdotal evidence as well as research conducted by

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<sup>135</sup> Exhibit GGG, slide 38. See also slide 35.

<sup>136</sup> Transcript 17 July 2007, pp 175-177 (Ms Matterson).

<sup>137</sup> Exhibit GGG, Slide 38.

<sup>138</sup> Monitor Group, Competitiveness Report, 20 October 2006.

<sup>139</sup> Transcript 9 July 2007, p 74.

<sup>140</sup> Consumers would challenge this however. Mr. N Kholisile of the FSCC noted how fees are charged without adequate explanation: “ I ...did some of the research and...even went to my own bank statements and got reminded of some of the ...charges that appeared there...You will get a R10 ...”fee”, a R4.90 ...”fee” and a R2.00...”fee”...” Transcript, 3

Nedbank (not supplied). The KLA and Monitor studies also support the finding that consumers generally do not actively question what they pay in bank fees. However, this is not because the level of fees is unimportant to them. Lower bank fees would be a key factor when choosing a bank.<sup>141</sup>

We find that consumers' failure to question fees is symptomatic of a number of factors. Consumer apathy certainly plays a role, but it is not surprising that consumers are apathetic given the difficulties they face when trying to decode complex product features and pricing structures (see further below). Pro-active measures need to be taken to improve transparency and disclosure so that consumers are able to actively interrogate their bank fees.<sup>142</sup> This will stimulate competition. As the situation currently stands, consumers' failure to question fees means that, in general, consumers are not responsive to changes in price. This is a constraint on effective competition as it makes demand more inelastic and is thus a source of market power for the banks.

### 2.7.2 Price and product complexity

As noted in the discussion of product differentiation above, there are a number of alternative channels available for the distribution and delivery of various transaction services. Transactional products are complicated because they consist of combinations of channels with differing pricing structures for each. While it is possible to simplify pricing structures, transactional products are likely to remain inherently complex.

In addition to problems of transparency and disclosure, the greatest difficulty faced by consumers in the searching process lies in the ability to make meaningful comparisons across the product offerings of the banks.

At the request of the Panel, the Enquiry's Technical Team compiled a table containing the product features and pricing of the basic packaged offerings of Absa, Standard Bank, FNB and Nedbank.

It is evident from the comparison table that there is no uniformity in the manner in which the packaged offerings are structured and priced. It is therefore impossible to make direct price comparisons between the offerings without having to input detailed information about the transactional behaviour of the prospective customer and then perform fairly lengthy calculations based on the different pricing formulas of the banks.<sup>143</sup>

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November 2006, p 85.

<sup>141</sup> Transcript 17 July 2007, p 165.

<sup>142</sup> Note that consumer groups called for improved (and even mandatory) education of consumers. Transcript, 2 November 2006, p 10.

<sup>143</sup> An added difficulty for the customer would be to factor in different interest rates, if any, on credit balances and their ultimate net effect on the likely real fee. We have not found it feasible to perform such an exercise.

**Table 2 Comparison of bundled current account options (2007)**<sup>144</sup>

	<b>Absa</b>	<b>Standard Bank</b>	<b>FNB</b>	<b>Nedbank</b>
<b>Name of bundle</b>	Absa Silver Package	Classic Current account pricing option	Personal Cheque Account - Fee Manager	Every-day current Account
<b>Pricing</b>	R99.00	R76.00	Option 1: R45 Option 2: R85 Option 3: R135 Plus Option: <sup>145</sup> R140	R85.00 This fee can be rebated to R55 per month if the client holds a Nedbank homeloan and credit card.
<b>Number of transactions</b>	25 of the features discussed below	Bundle of specified transactions (53 transactions)	Option 1: 6 Option 2: 12 Option 3: 20 Plus Option: 12	Bundle of specified transactions (some unlimited and number of some specified)
<b>Per item thereafter</b>	R10 for transactions in the bundle, and all other transactions not included in the bundle are charged at the Silver current account standard fee rates.	Pay as you transact will apply	Option 1: R9.00 Option 2: R8.00 Option 3: R7.00	Special current account rates apply
<b>Eligibility</b>	Income between R5,000 and R9,999	Earn at least R3000	Earn at least R24,000 a year and are over 21 years of age	Over 21 years of age Have a credit history Earn > R3,000 per month
<b>Features in all</b>	Cash withdrawals (Absa ATM) Electronic fund transfers Account Payments Prepaid top-ups Cheque or debit card purchases Debit orders and Stop orders Internet, Cellphone and Telephone banking	8 Cash withdrawals (Auto bank) (The Standard Bank portion of other bank ATM withdrawals is also included in the 8 cash withdrawals) 15 Electronic fund transfers and Account Payments and Debit orders and Stop orders Unlimited Prepaid purchases 15 Cheque Debit card Purchases Internet, Cellphone and Telephone banking	Cash withdrawals (FNB ATM) Linked Account Transfers Account Payments Prepaid purchases Cheque Debit card Purchases Debit orders and Stop orders Internet, Cellphone and Telephone banking	4 Cash withdrawals (NEDBANK ATM) Unlimited Electronic fund transfers Account Payments Prepaid purchases Unlimited Cheque Debit card Purchases Unlimited Debit orders and Stop orders. Internet, Cellphone and Telephone banking

<sup>144</sup> The information contained in this table has been verified and confirmed by each of the relevant banks.

<sup>145</sup> According to the FNB pricing Brochure 1 June 2007 – 30 June 2008, p 12, "this option is available to Smart Cheque Account customers only. If you earn R2000 or more per month you may qualify for the Smart Cheque Account Plus Option. For only a monthly fee of R140 you will receive a) 12 included transactions (as per the included fee manager transactions...) and b) A funeral policy of R10,000 for you, your spouse and up to five children."

	<b>Absa</b>	<b>Standard Bank</b>	<b>FNB</b>	<b>Nedbank</b>
<b>Special features</b>	No monthly fees for NotifyMe, An interest free overdraft up to R500 Free life cover to the value of R10,000 Silver credit card with no annual fees Access to a Budget tool for financial planning Access to savings and investment options Overdraft ledger fee Electronic Balance enquiries and mini statements Absa ATM cash deposit (max 2 per month) Cash back on Vehicle finance and Home Loan deals	10 Cheques 2 Auto bank cash deposits Unlimited Electronic balance enquiries, mini-statements Annual cheque card fees (includes secondary card and lost card protection) 3 Branch cash withdrawals (includes withdrawal fee portion of cheque encashment)	Scheduled Payments and transfers Mini-ATM cash withdrawals Branch cash withdrawals Cheques Cashback at Point of Sale Petrol Card Purchases Free ATM, Internet, IVR Telephone, Cellphone Balance Enquiries Free ATM Cash Deposits Free Internet Statements 1 Free Printed & Posted Statement Per Month Free Cheque Books Free Internet Free InContact Statements The Plus Options is available	Garage debit card fuel transactions Annual cheque card and garage debit card fees Chequebooks Unlimited Balance enquiries at Nedbank and Nedbank Group ATMs and self-service terminals (SSTs) Unlimited Statement requests All statements 1 Cash deposit in branch or ATM 1 over the counter branch withdrawal The overdraft facility has been included since 1 June 2007.
<b>Features charged for separately in all (outside the bundle)</b>	Saswitch transactions	Saswitch fee component (R6.70) of agent bank cash withdrawals	Saswitch transactions	Saswitch ATM transactions
<b>Other features charged for separately (outside bundle)</b>	Branch transactions Any other transactions	All other transactions get paid for	Branch Cash Deposits Balance enquiries at branch Cash handling fees on branch cash withdrawals Special instructions Penalty fees Cash deposits at branch ATM mini-statements Any other	International ATM withdrawals Cheque payments Unpaid items Stop-payment instructions Any other

Source: 2007 Pricing Brochures.<sup>146</sup>

In our assessment, the difficulties involved in making direct price comparisons are prohibitive for most consumers. The reality is that most consumers do not make product choices on the basis of price because they cannot do so readily and effectively.

<sup>146</sup> Verified by the appropriate banks in July 2007.

In their submission FNB note that:

banking services are inherently complex products, and the structure of pricing must reflect that. ... In particular, most banking products are compound goods, combining a number of elements and services.<sup>147</sup>

During the hearings Mr Shuter of Nedbank said:

We have got a complex geography, complex array of clients. *We segment the market and we try very hard to differentiate and a lot of the complexity comes from that.* Now there is one school of thought that says that is a bad thing, no one can compare. There is another school of thought that says the complexities arise from the fact that there is a competitive environment where people interpret clients' needs differently, and one bank adds in this [while] another takes it out.<sup>148</sup>

It is clear that product complexity is an inherent property of product differentiation across multiple channels. What has not been demonstrated is that such differentiation has been successful in maximising consumer welfare by delivering affordable banking that meets the needs of consumers. As has been discussed above and is pursued subsequently in this chapter, there is inadequate transparency and disclosure in respect of the features and pricing of transactional banking products. The inherently complex nature of composite transactional banking products serves to aggravate this problem and further highlights the need to introduce proactive measures to improve transparency and disclosure.

### 2.7.3 Confusing terminology

In differentiating their product offerings, each bank uses its own terminology to describe its products and related product features. This makes it all the more difficult for consumers to understand and assess the different offerings of the banks.

Nedbank, for example – while arguing that product differentiation is part of healthy competition – agreed that “where you have exactly the same fee but it is called a different name, we do not think that is particularly helpful. We ... think some standardisation on the vocabulary would be helpful.”<sup>149</sup>

Currently, there are no codes providing for a standardisation of terminology in respect of personal transaction services. This hinders comparability and is thus likely to soften considerably the degree of effective price competition. The need to standardise terminology runs together with the need for industry standards generally to facilitate price comparisons.

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<sup>147</sup> FRB, October 2006, First Submission, p 23.

<sup>148</sup> Transcript 9 July 2007, pp 71-72. (Emphasis added.)

<sup>149</sup> See *id.*, pp 45-46.

## 2.8 Switching and search costs

Competition tends to be more robust when consumers are able to easily switch from one supplier to another in response to a competitive price or some other factor that offers the customer better value for money.

However, when consumers are restricted from switching – whether deliberately (by the banks) or otherwise<sup>150</sup> – competition is inhibited. In particular, when consumers face switching costs they become captives of their suppliers, thus conferring on the latter a degree of market power. In particular, higher switching costs mean that consumers will be less responsive to changes in price and thus the demand for firms' products will be relatively price inelastic.

Banks assured the Enquiry of their willingness to assist customers in switching. As Mr Jordaan of FNB puts it, "What we try and do is from our side, make it as easy as possible for customers to switch to us."<sup>151</sup> We believe that all banks do assist customers in switching their accounts *to them*. Assisting customers who want to switch their accounts to another bank is not something that can appeal to an incumbent. As FNB frankly acknowledged, it is imperative for the bank that each account opened remain active for as long as possible.<sup>152</sup>

A useful way to determine whether the banks have an appreciable degree of market power is to test whether each bank would be able to implement a "SSNIP" – a small but significant non-transitory increase in price – without losing so much business to rival suppliers that the increase would not be worthwhile.<sup>153</sup> Ordinarily, a sustained price increase of 5 per cent or more would be sufficient in this regard to enable a significant degree of market power to be identified.<sup>154</sup>

The European Commission guidelines on market analysis and the assessment of significant

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<sup>150</sup> The difficulty for customers in switching banks derives to a large extent from the complexity and combination of services they receive from full service banks, which tend to discourage them from switching banks unless they are intensely driven to do so. For most bank customers, switching banks will also entail re-arrangements with service providers, employers, etc all of which will add to the hassle factor of switching.

<sup>151</sup> Transcript 9 July 2007, p 196.

<sup>152</sup> FRB, Response to the Request for Information from the Competition Commission Banking Enquiry: Switching Costs, August 2007, p 2. See also Transcript 9 July, 2007, p 143 and p 151.

<sup>153</sup> The "SSNIP" test, first devised in the United States as a tool for defining relevant markets in merger evaluations, has been applied more generally where the existence of market power needs to be determined and has gained general acceptance internationally. Here it has been specifically approved by the Competition Appeal Court in *Patensie Sitrus Beherend Bpk v Competition Commission* [2003] 2 CPLR 247 (CAC) at 257*h-i*. See also *Medicross Healthcare and another v Competition Commission* [2006] 1 CPLR 1 (CAC) at 9*d-10c*.

<sup>154</sup> In the usual application of the "SSNIP" test, the assumption would be that the existing price charged is at no more than an effectively competitive level. However, the existing price may in fact be higher. The real test is therefore whether a price 5 per cent or more *above the competitive level* could be charged without losing the customers. The "SSNIP" test provides a possible means of establishing that. Where, say, a monopolist is already charging customers a supra-competitive price at the limit they can bear, even the smallest further increase could cause the loss of customers, who simply fall out of the market. Where, however, a sustained increase of 5 per cent or more could be imposed without the loss of customers, one can (without having to pin down the notional competitive price) safely conclude that significant market power prevails.

market power under the Community regulatory framework for electronic communications networks and services state:

The possibility for consumers to substitute a product or a service for another because of a small, but significant lasting price increase may ... be hindered by considerable switching costs. ... Accordingly, in a situation where end users face significant switching costs in order to substitute product A for product B, these two products should not be included in the same relevant market.<sup>155</sup>

By parity of reasoning, if customers would be deterred from switching banks by the cost of doing so even if the price charged by their existing supplier were to rise by 5 per cent or more above that charged by its rivals (and kept there), it must follow that that supplier enjoys appreciable market power. Likewise, such a conclusion would follow if a rival would have to offer a price that is lower by more than 5 per cent over a significant period (all else being equal) in order to induce the other's customers to switch. For this reason a calculation of the switching costs faced by bank customers provides the basis for applying a variant of the "SSNIP" test in order to assess the degree of customer *captivity*, and thus of banks' market power.<sup>156</sup> Before proceeding to that calculation,<sup>157</sup> we must deal with a preliminary issue.

In their submissions the banks have argued that switching costs faced by their customers are not significant. In this regard they refer to "churn" figures which they say indicate substantial customer mobility and thus relative ease of switching.

The following table, presented by Standard Bank at the hearing on 13 November 2006,<sup>157</sup> shows annual churn figures for Standard Bank for a number of different market segments in personal banking:<sup>158</sup>

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<sup>155</sup> (2002/C 165/03), 11.7.2002, para 50.

<sup>156</sup> Of course, a sure way for customers to escape captivity in the hands of their suppliers is to drop out of the market altogether and simply go without. In the case of retail banking services, such a course would imply such adverse consequences for the great majority of customers that we can safely assume that a small but significant non-transitory increase in price from current levels would not generally induce so drastic a step. Customer would generally remain available for exploitation by their "captors".

<sup>157</sup> Exhibit V, slide 9.

<sup>158</sup> These "churn" figures are more or less consistent with the Enquiry Technical Team's calculations based on confidential data submitted by all the major banks.

**Table 3 Churn figures calculated by Standard Bank for market segments**

Market	Churn
Cash management / transactions	20%
Low income ("Convenience")	21%
Middle income	11%
Term/notice deposits	46%
Home loans	18 - 31%
Overdrafts	11%
Credit card	38%
Personal loans	24%

Source: Standard Bank Presentation, Exhibit V, slide 9.

We do not accept that these churn figures reflect *switching*. Churn has been calculated as:

$$\frac{(\text{No. of accounts opened} + \text{No. of accounts closed})}{2 \times \text{Total No. of accounts at the beginning of the year}}$$

The figures thus include all forms of account closure and opening and do not isolate those instances where individuals close their account at one bank and open an account at another bank. First, churn figures based on the above formula will reflect the large increase in the number of accounts opened by people who have not previously been banked. Second, churn figures will include accounts opened in error and subsequently closed; accounts closed as a result of death; facilities being repaid (i.e. home loans and personal loans where relevant); and accounts closed as a result of abandonment as customers exit the banking system or leave the country. Third, included in churn would be those accounts opened and closed by customers who change products but stay with the same bank. The following exchange took place during the hearings (Mr Pintusewitz for FNB):

MRS NYASULU (of the Panel): ... I am trying to understand, on the issue of the switching to a rival bank, whether you are able to isolate specifically those figures, as opposed to someone just saying "I do not like this product because you are overcharging me on it, I am still your customer but I do not want your cheque account anymore." Are you able to isolate the specific number of people who just pack up in toto and move to another bank?

MR PINTUSEWITZ: The numbers we have got include both, so we cannot show you the one piece and the other.

MRS NYASULU: You cannot isolate?

MR PINTUSEWITZ: So we cannot isolate it at this time and, as I say, we do those customer surveys to try and understand that as well as possible.<sup>159</sup>

Therefore churn cannot be said to quantify switching in any sense of the word.

<sup>159</sup> Transcript 9 November 2006, pp 37-38..See also *id.*, pp 46-48. No bank was able to supply the Enquiry with figures for actual switching.

However, even accepting that there must be some level of actual switching, this says nothing about the level of switching costs or whether or not firms have market power. In a very competitive market, with zero switching costs, switching rates may in fact be very low – because the satisfied customers of competitive firms would have little incentive to switch to equally competitive rivals.<sup>160</sup> However, a firm with significant market power may raise price to a level where other (perhaps less optimal) substitutes become viable for the customer.<sup>161</sup>

In the market for personal transaction services, prevailing prices would already reflect the market power conferred on the banks as a result of search and switching costs. Even if churn reflected switching, the fact that we observe churn at prevailing prices says nothing about the degree of pricing power conferred on the banks due to search and switching costs. Nor does it say anything about whether this market power is appreciable or not. The degree of pricing power conferred on the banks as a result of search or switching costs can only be determined by calculating directly the actual costs of searching and switching as a percentage of the competitive price.

In its report referred to above, Genesis, economic consultants assisting Standard Bank, estimated actual switching costs for personal transaction accounts by costing the steps required to switch from one provider to another.<sup>162</sup> Genesis assumed that consumers would typically be likely to keep the same banking account for a period of three years and calculated the base price as the net present value of three years of bank fees. For products in the middle income segment, switching costs (calculated as a percentage of this base price), were estimated to be less than 3 per cent.<sup>163</sup>

Genesis argued that, at this level, switching costs are sufficiently low that any transaction account holder who wishes to switch to a bank offering 3 per cent lower fees would be able to do so and recover their costs within three years. Although not explicitly stated it appears that because that percentage falls below the 5 per cent threshold required for a SSNIP, Genesis concluded that switching costs do not confer meaningful market power on Standard Bank.

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<sup>160</sup> Cf FRB, August 2007. FRB view on the costs of switching bank accounts, p 2.

<sup>161</sup> Church and Ware, 2000, *Industrial Organisation – a Strategic Approach*, p 617: “A monopolist will always raise price until demand is elastic, thereby making it more likely that there are, as the Supreme Court found in *Cellophane*, products “that have reasonable interchangeability for the purposes for which they are produced – price, use and qualities considered”. “*Cellophane*” refers to the now-notorious “cellophane fallacy” introduced in *U.S. v E.I. du Pont de Nemours & Co.* 351 U.S. 377, 76 S.Ct. 994 (1956), where the court found that there was no distinct market for cellophane because other flexible packaging materials would be substituted by consumers if cellophane prices were to rise. As Prof Hovenkamp explains the fallacy (*Antitrust*, 4<sup>th</sup> edition, p 133): “When the monopolist charges its profit-maximizing price, it is trying to charge as high a price as it can without losing a substantial number of customers. In that case the cross elasticity of demand will appear high, not because the monopolist has no monopoly power, but because it is *already* charging a monopoly price.” See also *York Timbers Ltd v SA Forestry Company Ltd (1)* [2001-2002] CPLR 408 (CT) at 424, par 79.

<sup>162</sup> Genesis Report to Standard Bank, 08/11/2006, pp 6-8, pp 20-24.

<sup>163</sup> See also Transcript 18 June 2007, pp 192-195.





accept that the value of customers' time can be disregarded.<sup>167</sup>

According to these calculations total switching costs as a percentage of the net present value of average annual banking costs over three years is likely, on a conservative estimate, to be well in excess of 5 per cent. This means that, on the basis of switching costs alone, the market power of each bank is appreciable as each bank is in a position to impose a small but significant non-transitory increase in price, even from current price levels which are in all probability already supra-competitive.

We do not accept the argument that existing customers are protected from the exercise of such pricing power by the existence of vigorous price competition between the banks for new customers. All the indications are, as this chapter has explained, that the banks' competition for new customers is not based fundamentally on price competition. Thus, the real dynamic is that the market power of banks over existing customers is extended into the market for new customers.

The above calculations make no allowance for one of the most formidable barriers to switching, namely, the procedures requirements under the Financial Intelligence Centre Act (FICA) for verifying the identity of bank customers. Necessary though these procedures may be for combating financial and other serious crime, they constitute an additional deterrent that impedes customers from readily switching banks.

Furthermore, the above calculations include only those switching costs readily capable of being quantified, and thus represent the minimum level of switching costs. They are likely to under-represent the full extent of switching costs faced by consumers. In this regard we note that there are also other switching costs that cannot easily be measured.<sup>168</sup> For example, perceptions play an important role in influencing customer behaviour. If some costs are perceived rather than real they will nevertheless factor into the customer's calculation of what it costs to switch. If these perceptions are shared by a significant number of customers then they must be factored into the calculation of the actual switching cost. The results of the KLA survey<sup>169</sup> and the Monitor Report discussed above show that there is a strong perception among consumers that switching is costly. In the Monitor report it is suggested that the perceived cost of switching is greater than the actual cost of switching.<sup>170</sup>

The analysis of switching costs by Genesis assumed that the customer in question has

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<sup>167</sup> Cf Transcript 9 July 2007, p 196 (FNB).

<sup>168</sup> Cf Shy, "A quick and easy method for estimating switching costs", *International Journal of Industrial Organisation*, Vol 20, pp 71-87. The reality is that it would be very difficult, if not impossible, to directly observe actual switching costs. As noted by Shy: "The reason why switching costs are not observed is that they are partly consumer-specific, reflecting the individual's human capital needed for switching among systems, and are therefore treated as a utility loss which cannot be directly calculated from any data."

<sup>169</sup> Exhibit GGG, slides 41-42.

<sup>170</sup> Monitor Group, Competitiveness Report, 20 October 2006, p 158.

already made her/his choice and identified her/his preferred provider. Genesis thus completely ignores the costs involved in shopping around, searching for, and identifying the most competitive alternative. While switching costs may be distinct from search costs, search costs cannot be ignored when assessing the market power of firms.<sup>171</sup>

Assuming access to the Internet, we estimated that a relatively well informed middle income individual would take at least one hour to search for a suitable alternative and calculate which alternative is most affordable. A monetary estimate of the value of this time to the consumer is contained in Table 5. We note again that this is a conservative estimate and is meant to reflect the minimum time and minimum cost associated with searching.

Although some search costs are unavoidable the Enquiry found that search costs in the market for personal transaction services in South Africa are inordinately high. These inordinate search costs are the result of a lack of transparency and inadequate disclosure of product and price information. These factors increase considerably the amount of time that consumers must spend searching in order to determine which product is most competitive. Actual search costs in the market for personal transaction services in South Africa are thus likely to be much greater than indicated in Table 5.

## 2.9 Nature of strategic interaction among firms

We have seen that retail banking in South Africa, and the market for personal transaction services in particular, is an oligopoly consisting of four banks (that collectively hold in excess of 90 per cent of the market) and a competitive fringe. The defining characteristic of an oligopoly is that each firm makes strategic decisions based on the expected reactions of its rivals.<sup>172</sup> Whether or not firms' strategic decision-making will result in effective competition depends on the structural and behavioural features of the relevant market.<sup>173</sup>

Strategic interaction between oligopolists is distinct from outright collusion.<sup>174</sup> It refers rather to the situation where firms are able to anticipate and rely on each other's behaviour without either expressly or tacitly entering into an agreement or understanding to co-ordinate. We find that in the market for PTAs and related services the nature of strategic interaction

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<sup>171</sup> Cf Wilson, "Markets with Search and Switching Costs," MPRA Paper No. 131. <http://mpra.ub.uni-muenchen.de/131/>. Wilson notes: "Due to the assumption that search costs, unlike switching costs, are incurred unconditionally on the decision to switch suppliers it is shown that the anticompetitive effects of search costs are consistently larger than those from an equivalent level of switching costs. The finding suggests that obfuscation practices that aim to deter consumers from searching, such as competing on deliberately complex tariffs, may be particularly powerful relative to practices that increase the costs of substitution between firms, such as loyalty programs or termination fees."

<sup>172</sup> "Oligopoly behavior is necessarily strategic behavior. Oligopolists must take into account how their rivals will react to their actions. In deciding on strategies, oligopolists face a basic dilemma between *competing* and *cooperating*. The firms in an oligopolistic industry will make more profits as a group if they cooperate; any one firm, however, may make more profits for itself if it defects while the others cooperate." Lipsey, Courant and Regan, *op cit*, p 261.

<sup>173</sup> The outcome cannot be determined *a priori*: See Mark Blaug, *Economic Theory in Retrospect*, 5<sup>th</sup> edition (Cambridge University Press, 1997) pp 302-303.

<sup>174</sup> See Appendix on "Complex monopoly", "collective dominance" and "tacit collusion".

among the four major banks is such that effective competition tends to be restricted rather than enhanced. There are two main factors present in this market which facilitate competition-restricting strategic interaction among participants.

The first factor arises from customer inertia or “captivity”. The expected reaction of rivals to price changes is affected by the responsiveness of consumers to price changes. In the course of this chapter we have examined a range of indications pointing to market power of banks in providing PTAs and related services. This power rests on a combination of objective and subjective factors. We found that the nature of product differentiation, the extent of information asymmetries, and the considerable costs of searching and switching all provide strong evidence of a high degree of inertia on the part of the majority of consumers of personal transaction services in South Africa. Hence these consumers are not very responsive to price changes in the short to medium-term. Their demand is thus *inelastic*. An important consequence is that a small but significant reduction in price by one firm will result in an immediate reduction in its revenue without an increase in its volumes to make up for that. Under these conditions, it makes more sense for the rational oligopolist to raise prices cautiously or at least leave them unchanged. For example, because of the degree of customer inertia or “captivity”, a small increase in the firm’s price would result in an immediate increase in its revenue. Strategically, the best response of its rivals would be to leave their prices unchanged or to raise prices in line with the leader.

The second factor arises from the fact that interbank arrangements are required in order for the payment system to work effectively. Interoperability obviously has positive benefits but it also has the potential to restrict competition because it brings competitors together on a common platform. We have found arrangements in certain payment streams that facilitate non-competitive outcomes. The chapters of this report dealing with ATM transactions and interchange arrangements between the banks provide illustrations of this. The nature of interbank arrangements that underlie many personal transaction services are such that unilateral moves to reduce transaction fees would tend to disadvantage the fee cutter relative to the rivals who do not change their fees.

The disadvantage for a bank in moving alone to reduce its charge to customers when its fee arrangements with other banks are unchanged was graphically illustrated during the hearing on 3 April 2007. In 2006, FNB had recommended that the so-called “Saswitch premium” (i.e., the disincentive fee that a bank charges its customer for using another bank’s ATM) should be eliminated. However, FNB had argued that it would not be commercially viable for one bank to unilaterally eliminate its disincentive fee for off-us ATM transactions. It recommended that such a move would have to be done at an industry level, i.e. all the banks would either have to agree or be compelled to eliminate their disincentive fee for off-us ATM transactions.

At the hearing the Panel asked FNB to explain why it would not be possible for FNB to

unilaterally eliminate its disincentive or “Saswitch premium”.<sup>175</sup> Mr Jordaan replied that FNB would then lose a lot of volume from its own ATMs, which would go to competing ATMs. “[I]t would be extremely naïve from a commercial perspective if we were to do something like that. This would really have to be an industry solution that would involve all the banks.”<sup>176</sup>

Crucial in this reasoning was that FNB believed that if it acted alone it would probably not be able to attract enough customers from the other banks to make up for the loss in revenue that would follow as a result of the reduction to zero of its own disincentive or “Saswitch” fee. This is summed up in the following comments by Ms Durbach and Mr Jordaan of FNB:

MS DURBACH: And if I can also just address the possibility of us attracting enough customers by dropping that fee to cover the very significant loss that we would take: in our assessment it's probably unlikely. I know in our previous submission we also addressed, [and] I think to some extent in this one, what actually attracts customers to banks. I know it's not a topic of this hearing but with reference to your question about “Would more customers come to FNB?”, there are a wide range of factors that drive the choice of banking and it is very uncertain whether the drop in this fee would attract sufficient to justify it.

MR JORDAAN: We [would be] uncomfortable discussing the exact number. But I mean just to illustrate the point, not a theoretical point. It is on the bottom of page 7 of our submission. We have modelled what that then will do to FNB, and I think if you look at that figure in the second column at the bottom it has got a minus next to it.<sup>177</sup>

The fact that FNB would not be able to attract enough customers from other banks to cover their direct revenue losses indicates that the customers of those other banks are effectively captured when it comes to their ability to exercise choice in respect of what they pay for off-us ATM cash withdrawals.<sup>178</sup>

In addition to the immediate loss of disincentive or “Saswitch” fee revenue the expected revenue loss would also be a consequence of the fact that many of FNB's own account holders would have no reason to avoid using other banks' ATM infrastructure whenever convenient, thus increasing the amount of interbank carriage fees that FNB would have to pay out to other banks.<sup>179</sup>

Therefore the nature of the interbank arrangement in respect of ATM transactions is such that any unilateral reduction of the disincentive fee for off-us ATM withdrawals would result in significant losses for the bank reducing the fee.<sup>180</sup> Consequently, individual banks gain much more from shadowing each other in respect of upward movements in price as they face

<sup>175</sup> Transcript 3 April 2007, pp 106-107.

<sup>176</sup> *Id.*, p 108.

<sup>177</sup> *Id.*, pp 109-110. The reference is to FRB, March 2007, Second Submission, ATM transactions (Initial questions), p 7. The anticipated net position, given confidentially, [REDACTED].

Confidential:  
FRB

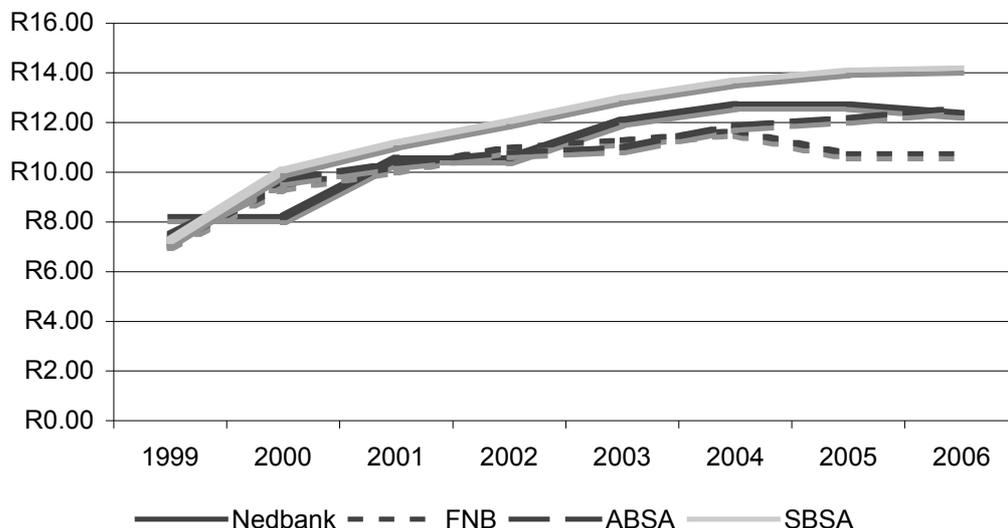
<sup>178</sup> Conversely, the customers of FNB would be similarly captured if another bank were to act unilaterally in dropping its ATM “off-us” disincentive fee.

<sup>179</sup> FRB, March 2007, February, Second Submission, ATM transactions (Initial questions), p 8.

<sup>180</sup> To eliminate this problem *inter alia*, we propose that South Africa move to a model of direct charging for ATM transactions. This is explained and discussed fully in the chapter on ATMs and Direct Charging.

considerable costs if they attempt to compete through unilateral price reductions. As can be seen from the graph below, the fees the banks charge for off-us ATM transactions have followed each other quite closely since 1999.

**Figure 4 Fees for “off-us” ATM withdrawals (R500), current accounts 1999 - 2006**



Source: Infochoice.

As outlined above and analysed further in the chapter on Costing and Pricing, the banks engage generally in a strategy of differentiated pricing aimed at segmenting the market so as to maximise revenues generated from different customer groupings. The bank may charge a lower fee (or no fee) for a particular transaction service in order to differentiate its product. However, for the same product, it will be prepared to charge a higher fee than its competitors for another transaction service. This suggests that the banks will exploit inelasticities in respect of individual transaction services in order to maximise revenue at the product level.

In this regard the banks are cautious that their fees are not set so out of line with those of the competition that it would weaken the hold of the differentiated offering. Evidence regarding the setting of off-us ATM fees, where price comparison is relatively simple, suggests a tendency on the part of the banks to set their fees within a sufficiently close range of their rivals' such that no rival would be likely to impinge on the market share of the other. Given a high degree of customer inertia and substantial switching costs, we consider that this behaviour tends to result in price rigidities with prices moving gradually upwards over time.<sup>181</sup>

As is demonstrated in the Costing and Pricing chapter of this report, the lack of any identifiable relationship between the cost of providing PTAs and related services and the

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See Shy, *The Economics of Network Industries*, p 309. This kind of behaviour is formalised in Shy in terms of the Undercut-Proof Equilibrium UPE. UPE states that firm A will charge the highest price it can while preventing its rival from undercutting and grabbing firm A's customers. In terms of UPE prices tend to rise with "distaste costs". Distaste costs include transport costs and switching costs.

price charged for them, points strongly to the exercise of market power by the major banks whose figures are presented and analysed. In the case of penalty fees on debit order transactions, its abuse is absolutely manifest.

## 2.10 Conclusions on market power

Although there is considerable scope to improve the competitive conditions of entry and participation, particularly in the case of payment services, the persistence of high fixed costs and scale economies is such that competitive conditions on the supply side in full-service banking are likely to continue to be restrictive.

Competition problems on the supply side in the payment system are dealt with in detail in the chapter on Access to the Payment System, as well as in the chapter on ATMs and Direct Charging. Proposed remedies to address these problems are put forward in those chapters. It is particularly important that the supply of payment services (and components of payment services) independently of deposit taking should be encouraged, and thus cease to be the preserve of the banks. The growing potential for this should be assisted through the removal of unnecessary barriers and through proactive and effective regulation which aims to facilitate rather than deter such a development. In our view, a change of mind-set on the part of the regulatory authorities is called for in this regard.

We find that there are five main features of the market for PTAs and related services which, either singly or jointly, confer on (at least) the major banks an appreciable degree of market power and which tend to prevent, restrict or distort competition in respect of the provision of PTAs and related services throughout South Africa:

- Complexity – both inherent and undue – in the provision of products and the structure of charges and fees.
- Inadequate disclosure and inadequate transparency of information in respect of product features and charging structures.
- Failure of consumers to actively question fees and charges associated with personal transaction accounts, both for objective and subjective reasons.
- Considerable costs of searching and switching and resulting failure of consumers to actively search for competitive alternatives and switch to them.
- Oligopolistic conditions which reduce any incentive to lower prices, reinforce the confidence of each bank in the expected reactions of its rivals, engender price rigidities, and produce a tendency towards upward price-following behaviour.

To the extent that these problems are rooted in the conditions which produce banking concentration – a global as well as South African phenomenon – they are not susceptible to being resolved by any recommendations that we can make here. However, there are a

number of particular changes that can be made which would serve to improve competitive conditions. Many of them are more appropriately presented and explained in the subsequent chapters of this report. In this chapter we concentrate on remedies that we believe would stimulate price competition between banks in the provision of PTAs and related services.

## 2.11 Recommendations

There is a clear need for measures aimed at improving the ability of bank customers to:

- Compare product offerings and prices
- Switch providers with a minimum of cost and difficulty.

In order to achieve these objectives we recommend the following:<sup>182</sup>

### 2.11.1 Standards and criteria for transparency and disclosure

The Banking Association – after consultation with the Ombudsman for Banking Services,<sup>183</sup> consumer protection agencies and organisations, the regulatory authorities, the Competition Commission and other relevant bodies – should develop a set of minimum standards for the disclosure of product and price information to be included in the Banking Association Code of Banking Practice. This code should at least include criteria regarding:

- Standardisation of terminology and a plain language requirement
- Communication and provision of information to clients
- A requirement for at least certain minimum information to be included in bank statements
- A summary and breakdown of charges and interest (both debit and credit) on every account

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<sup>182</sup> We have been greatly assisted in deciding on these recommendations by the off-the-record and non-binding exploratory process which was undertaken by the Enquiry's Technical Team with the participation of all the major banks and several others, after the formal hearings had been concluded. The exploratory process took place as part of our engagement with the banks and others envisaged by paragraph 6(c) of the Enquiry Terms of Reference. On this basis, meetings to consider the practicality of various measures to improve comparability of bank products and prices, and to improve the ability of customers to switch banks, were held on 15 August and 4 September 2007. While we have drawn on ideas raised and points debated during those consultations, the views formulated here are our own and are not attributed to any participant. The particular remedies that were formally proposed by different banks in their extensive written submissions and at the public hearings became subsumed into broader discussions during the exploratory process. Accordingly, we do not deal with them separately here in the form in which they were originally advanced, nor do we identify them as having emanated from particular banks. Those original proposals remain, of course, on the record of the Enquiry should it be necessary to refer to them specifically.

<sup>183</sup> See <http://www.obssa.co.za/>. The Ombudsman for Banking Services is an incorporated association not for gain registered under section 21 of the Companies Act 61 of 1973 (as amended). It was established by the banking industry to provide an independent, impartial dispute resolving service for bank customers and their banks. The service is provided free to bank customers who have failed to resolve their dispute with their bank through its own internal procedures. Its jurisdiction is limited to banks that are members of the Banking Association, and it may not assist in disputes involving a bank's commercial decision about lending or credit, interest rates or bank charges, unless there has been "maladministration" or a fee or charge has been incorrectly applied. The Ombudsman for Banking Services is recognised in terms of the Financial Services Ombud Schemes Act 37 of 2004, which commenced on 1 April 2005. (See OBS Annual Report 2006, p 2.) The Act serves *inter alia* to ensure the independence of ombuds, both in the manner of their appointment and in the procedures for resolving a complaint or making a determination (see section 10).

- Advance notice of new charges and altered charges
- A regular rights reminder to customers.

The code on transparency and disclosure should be subject to a process of periodic review, involving similar consultation.

The provisions of the code should be incorporated by reference into banks' standard customer contracts, so that the protection which they afford to customers become part of the customer's contractual rights capable of being enforced with the assistance of the Ombudsman for Banking Services. Although membership of the Banking Association is not compulsory for banks, and its code is therefore not binding on every bank, all the major banks are members and would be bound by changes to its code. Should this position change, or should the provisions of the voluntary code prove inadequate for the purpose described, a legislative or regulatory intervention would be warranted to impose appropriate standards on all banks.

### 2.11.2 Measures to reduce search costs and to facilitate comparisons

While improvements in transparency and disclosure of product and price information should help reduce the costs of searching, more direct and proactive measures are needed to simplify comparisons between the prices and product offerings of different banks.

#### **Generic customer profiles**

We recommend that generic customer profiles be drawn up and publicised to facilitate comparison shopping. In this regard, a generic profile is essentially a typical combination of customer needs.

For this purpose, the Banking Association should initiate and support an independent process – carried out by persons of standing and experience or expertise, who cannot be considered to be beholden to or interested in supporting the preferences of any particular bank – to establish a limited number of generic profiles that would apply to various typical customers of all banks in the middle market segments.

This will not be a simple task, as banks themselves apply somewhat different criteria when deciding on the segmentation of their product market. Thus the profiles must be constructed from the point of view of various *typical customers*, and *not* from the point of view of particular banks. To the extent, say, that some customers may typically prefer a product bundle emphasising electronic payment channels, and others the facility of branch and paper-based transactions, that would have to be taken into account in deciding on the range of appropriate profiles.

Too many profiles would defeat the remedy whilst too few profiles would tend to distort investment decisions and stifle needed variety in banks' offerings and the range of consumer choices.

Once the profiles are established, and publicised by the Banking Association, the different banks can reveal in their own advertising and other information whether, how and to what extent they accommodate them, and their respective prices in that regard. Misleading advertising could then be combated via the Advertising Standards Authority,<sup>184</sup> or with the assistance of the Ombudsman for Banking Services.

A regular review would be needed:

- To account for changes in technology and consumer behaviour
- To monitor the effectiveness of the process in facilitating comparability and stimulating price competition
- To determine whether or not any changes to profiles and/or the process is necessary in order to achieve the stated objectives.

### **Banking fee calculator**

In addition to the process around generic customer profiles, we are also in favour of other measures to facilitate comparative shopping. One that has been suggested is a centralised banking fee calculator service. Established by the Banking Association on a similarly independent basis, this should provide an accessible facility for consumers to input their own product requirements – with assistance if necessary – and obtain (without cost) an automatic, objective indication of where they could obtain exactly those services and for what prices.

It would be up to the banks to make available reliable product and pricing data (open to public inspection and to audit and correction by the Banking Association in the event of dispute), if they wish their services to be included in the answers supplied by the calculator service.

### **Comparative advertising**

It was suggested by one of the major banks that laws and codes currently prohibiting or restricting comparative advertising by firms should be changed to allow banks to compare their own prices and product offerings directly and explicitly with those of their rivals. There is much to be said for this proposal. However, because it might require changes to trade mark and other complex legislation, which might have various consequences in other industries that we are not in a position to assess, we refrain from making a definite recommendation to

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<sup>184</sup> <http://www.asasa.org.za/>

that effect.

We recommend that the Competition Commission propose to the Minister of Trade and Industry that serious consideration be given to such a step.

### **Basic banking product or products**

During the hearings on 18 June and 9 July 2007, the Enquiry's Technical Team mooted the idea that competition between banks would be enhanced if banks operating in the retail market were obliged to provide one or more basic banking products with similar content, capable of being simply and directly compared.<sup>185</sup> This would enable customers, whose needs would be satisfied by such a particular product, to compare prices and choose their bank accordingly. That in turn would intensify price competition, and cut across the existing segmentation of the market at least to the extent that segmentation has been contrived by banks in order to maintain market power.

This gave rise to protests from banks, with strong echoes in the financial press. In our view, this resistance – to the extent that it is not based on misunderstanding – is mainly because banks' supra-competitive pricing in the retail market is heavily dependent on unnecessarily complex product bundling and segmentation of the market.

Much of the argument raised against the basic banking product idea seems specious. Although initially conceived as a single package, it was not maintained that one size should fit all. There is no reason why there could not be several different basic product bundles offered, just as there could be several generic profiles (see above). Moreover, there would be nothing to prevent banks offering add-on features (separately priced) or bundling complete parallel offerings as they do at present, provided the basic product or products were also offered alongside.<sup>186</sup>

Nevertheless, to compel the adoption of such a measure would involve considerable difficulties in practice and might serve to hamper product innovation. Thus benefits through intensified price competition might be offset by disadvantages to consumers which are difficult to assess in the abstract.

Our recommendation is therefore that the "basic banking product or products" idea should be put on hold. If, after two or three years, the other recommendations put forward in this chapter have not been implemented or (once implemented) have not had the desired effect of increasing price competition and bringing prices for PTAs and related services down significantly, then the Competition Commissioner should revisit the idea with a view to

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<sup>185</sup> Exhibit YY, slides 33-35; Transcript 18 June 2007, pp 33-35; Transcript 9 July 2007, pp 12-13.

<sup>186</sup> This was made clear from the outset: *id.*, slide 35.

evaluating it further and securing its implementation if so advised, if necessary by legislation.

### 2.11.3 Measures to reduce switching costs and to assist consumers in switching

Easier product and price comparison will not help consumers much if it remains too expensive or troublesome to switch banks. Measures to reduce switching costs and assist bank customers in switching are therefore of crucial importance.

#### **Code of switching practice**

We recommend that the Banking Association, after consultation with bodies referred to in paragraph 2.11.1 above, develop a set of criteria for a switching code to be included in the Banking Association Code of Banking Practice. This code should include criteria regarding:

- The provision of sufficient information and documentation by banks to new and existing customers explaining the process of switching in their branches.
- A schedule in terms of which the old bank is to provide the new bank with information on standing orders and direct debits within a specified period of time of receiving the request to do so.
- A schedule in terms of which the balance on the account, standing orders and direct debits, net of any charges and interest but including any interest due, will be transferred from the old bank directly to the new bank, and the account with the old bank closed, within a specified period of time.
- Provision to be made for customers to be exempt from paying, or be refunded, any fees and/or interest charges which are incurred within a specified period after the new account is opened as a result of a failure in the switching process.

The code on switching should also be subject to an independent process of periodic review, following similar consultation.

#### **Central FICA information “hub”**

Several banks raised during the Enquiry the advantages that would flow from having a central repository of customer information which could be used to facilitate compliance with FICA, and so make switching easier for bank customers. It is clear that a considerable amount of work has already been done in the banking industry to explore the feasibility of establishing and operating such a hub.

This has a number of complex implications which we have not been in a position to explore. Nevertheless, the potential benefits in facilitating switching are such that we would recommend that the National Treasury encourage and pursue this investigation in consultation with the banking industry, to see whether such a central hub could be

established and operated in a manner that is consistent with the anti-money laundering objectives of FICA.

### **Bank account number portability**

In a number of other jurisdictions, bank account number portability (i.e. the customer retaining the same account number, irrespective of bank) has been explored with a view to facilitating switching. All the major banks, at our request, made detailed submissions on the implications of introducing such a measure here.<sup>187</sup> It seems clear that, while bank number portability would facilitate debit order switching to some extent, the costs that would be entailed in introducing such a change throughout the banking industry would far outweigh the potential advantages. Accordingly, we do not recommend the introduction of such a measure. We note that this was also the conclusion reached by the Competition Commission in the UK.

However – particularly because a great deal of comparative research material on the matter has already been gathered by the banks – bank account number portability should be kept under consideration by the Banking Association, as new technology develops.

#### **2.11.4 Expand the mandate of the Ombudsman for Banking Services**

We recommend that the role of the Ombudsman for Banking Services be expanded to include enforcement and monitoring of compliance with the proposed codes of conduct for information disclosure and switching.

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<sup>187</sup> Absa, March 2007, Access and interoperability, p 9; FRB, March 2007, Bank Account Number portability Position paper 2. Nedbank, March 2007. Access and interoperability, pp 36-38. Standard bank, April 2007. Access and Interoperability, pp 52-53.