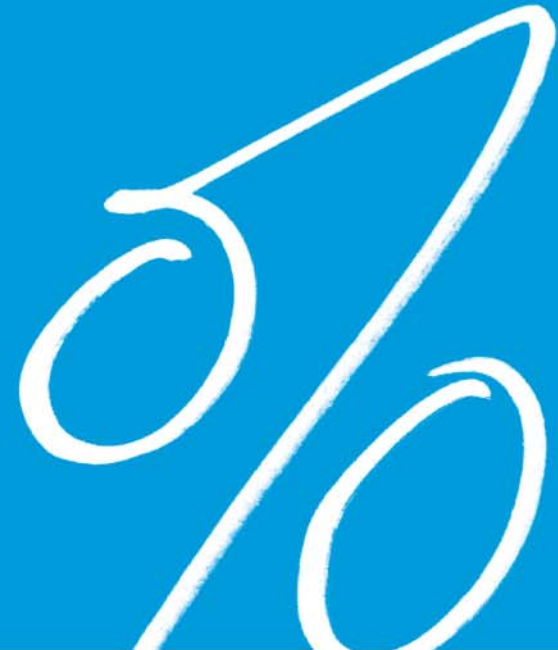


Presentation to the Competition Commission Banking Enquiry

9 November 2006



FIRSTRAND
— Banking Group —

Agenda



Introduction



Is competition in banking effective?



Are bank profits out of line?



Does the payment system function well?



Recommendations and Conclusions

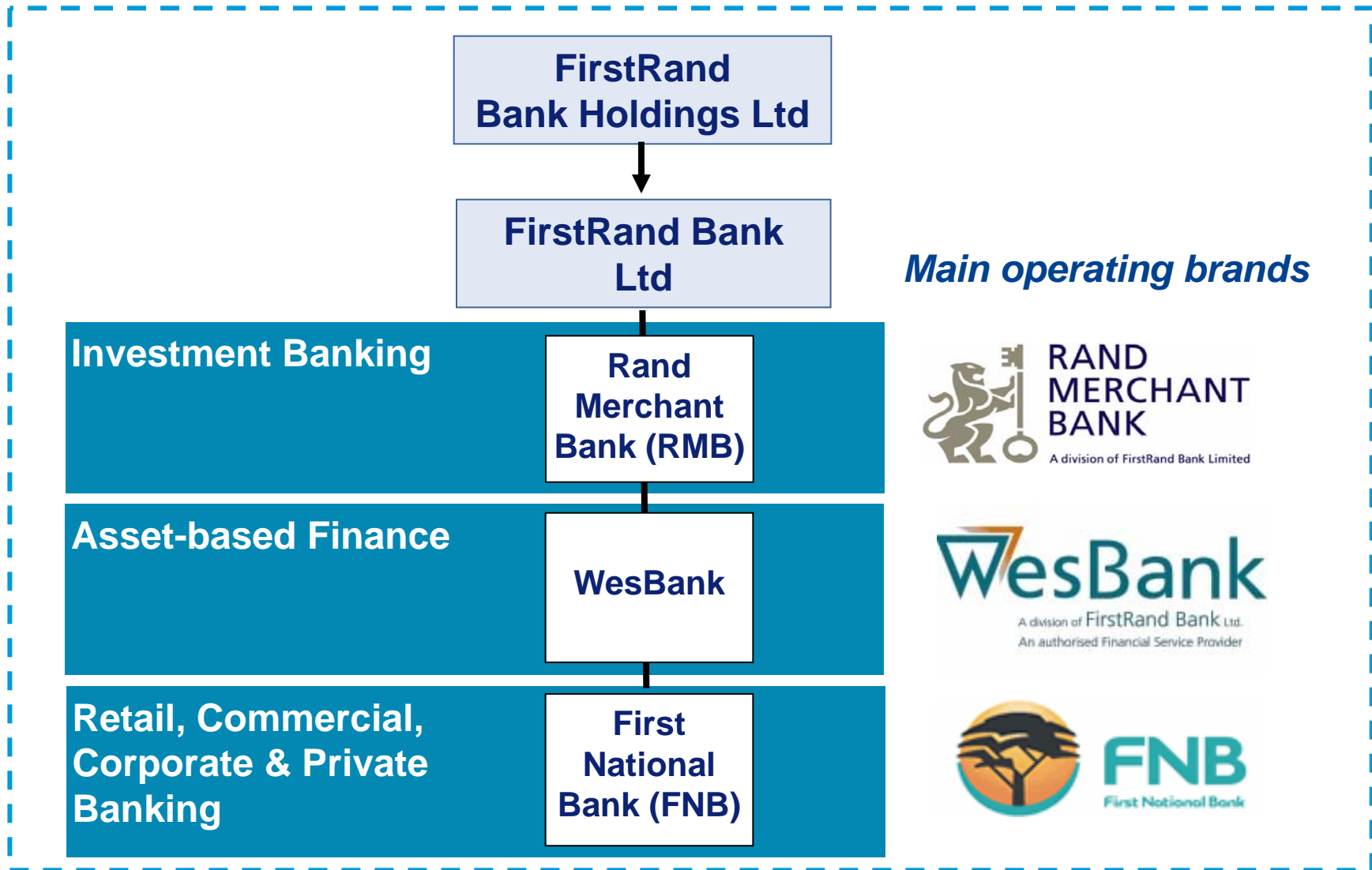


1. Introduction



FRB supports the Enquiry and makes a number of recommendations that it hopes will be of assistance

FirstRand Bank Competes with Multiple Brands



2. Competition is Intense

FNB competes against a wide range of effective rivals

Market concentration is driven by cost structure

Banks and other players compete vigorously as evidenced by:

Switching

Price

Product

Place (Channel)

Promotion

FNB is actively seeking ways of widening access amongst low income and SME customers



FNB Competes Intensively with Many Players



New Entrants

- Virgin Money
- Capitec
- Old Mutual Bank
- Kulula
- Woolworths Financial Services
- Discoverycard
- Wizzit
- MTN
- Vodacom
- EasyPay

Exits & Near Failures

- 20Twenty
- NBS
- Saambou
- BoE
- Nedbank
- ABSA

Concentration is Driven by Banking Cost Structure



- +/- 80% of banking costs are fixed
- Market only able to support a limited number of firms in competitive equilibrium
- Recovery of costs needs to cover substantial fixed costs as well as marginal costs
- Cost drivers include:

Staff

Branch and ATM network

IT systems

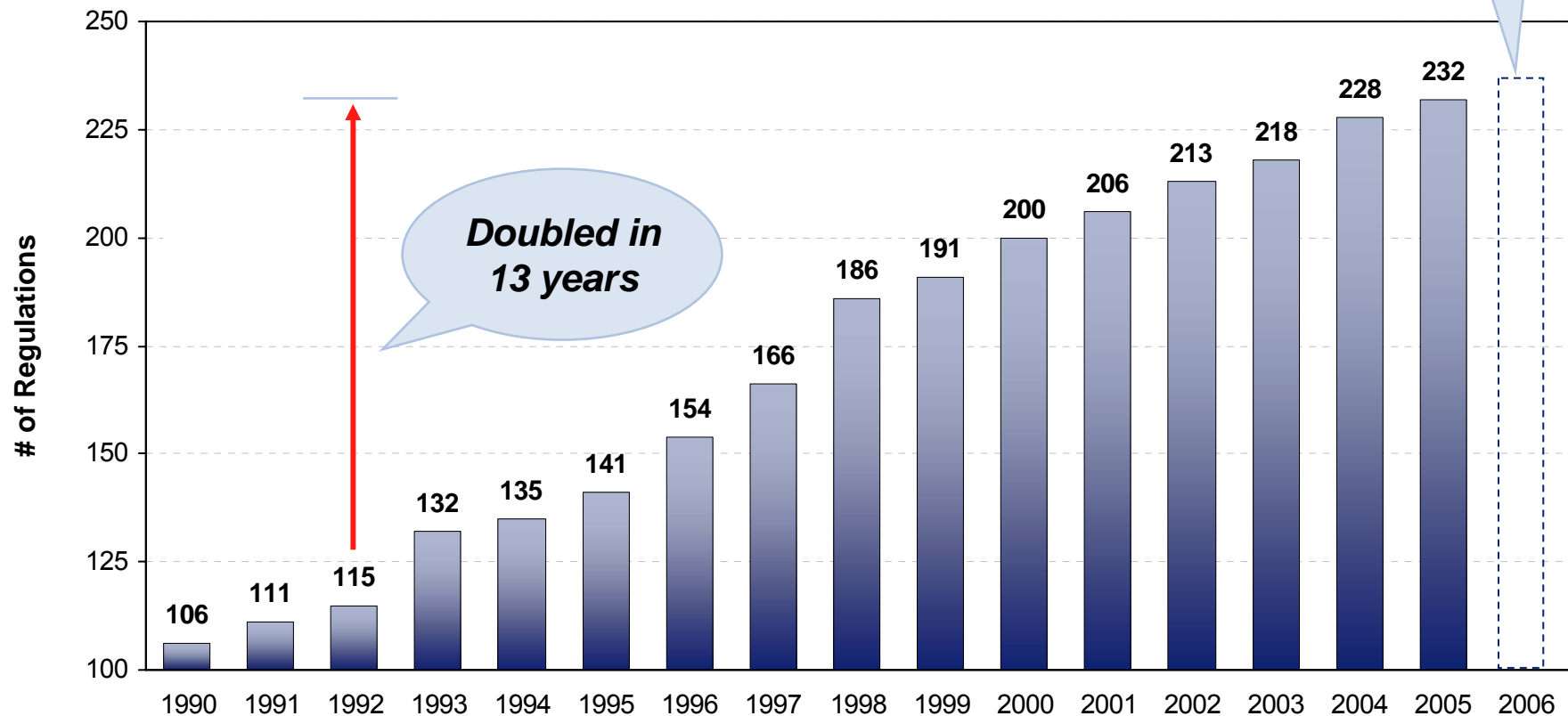
Regulatory compliance

Concentration is Driven by Cost Structure

Regulatory compliance cost FNB almost R1bn in 2005/6

NCA
R700m fees
impacted
p.a.

Legislation and compliance requirements have grown significantly

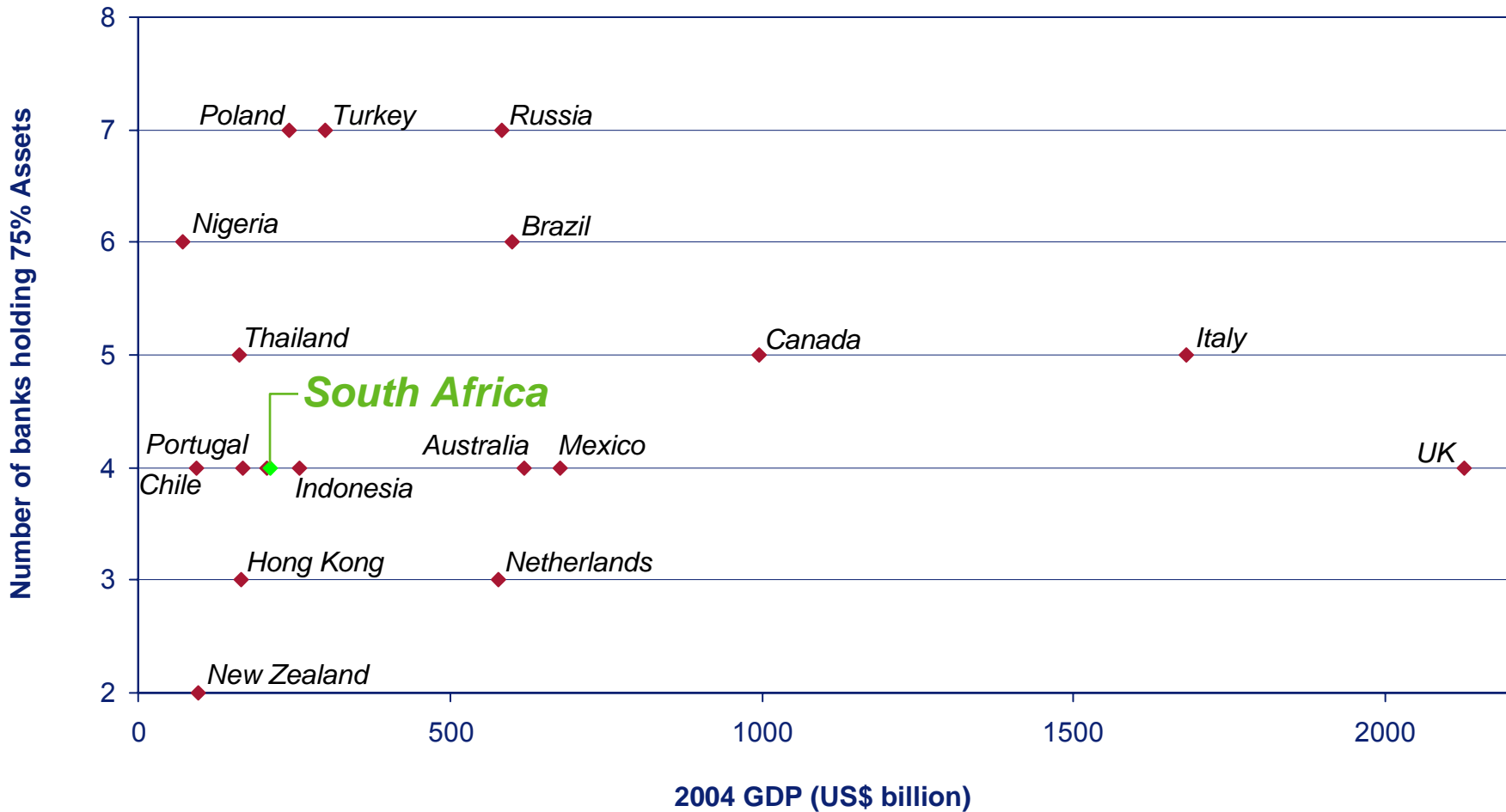


Note: Data from FNB
internal analysis



Concentration in Banking Widely Observed

SA not out of line in terms of number of banks holding 75% of banking assets



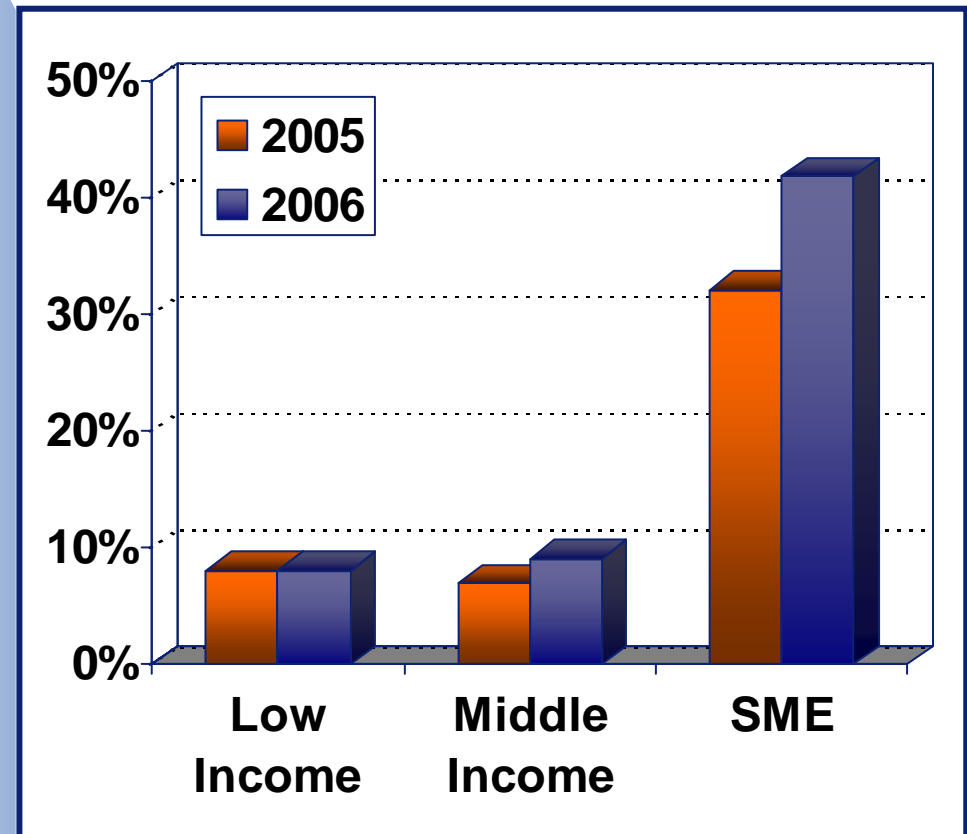
Note: Data from The Banker 2005



Intensive Rivalry is Reflected by Switching

- Switching in SA is higher than observed internationally
- FNB survey reasons why customers switch banks:
 1. Dissatisfied with overall service delivery
 2. Personal/professional recommendation
 3. Product/service not at current bank
 4. Bank charges
- FNB assists customers with switching e.g. free debit order switching

FNB's Annual Churn Rates



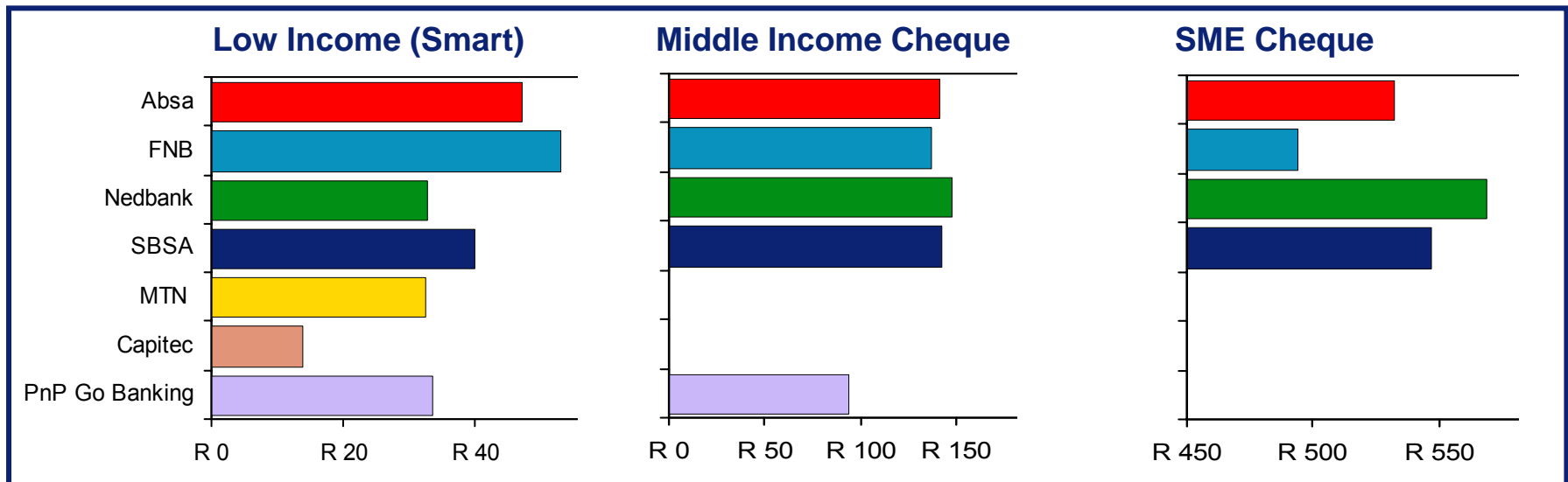
How FNB Competes: Pricing

- FNB policy of simple and transparent pricing
 - Banded pricing
 - Flat rates
 - Simple monthly account fee to reduce complexity
- Pricing hotline and calculator to help customers choose the right options
- First to market with pricing options:
 - Electronic Pricing Option (2004) - fees capped at R85
 - Fee Saver - 35 free transactions if balance is over R8,000
- Rivalry produces competitive prices and encourages innovation; also results in differentiation



Pricing is Only One Dimension of Competition

Average Monthly Bank Charges based on FNB Customers' Average Transactions



- FNB is competitively priced, relative prices differ in the markets it serves
- Fee comparisons do not capture the entire value proposition for customers
- Customers buy for a number of reasons, including:
 - Quality of service
 - Product features and value adds
 - Access
 - Credit extension (including, amount, speed, rate and security)

Note: Data from FNB
internal analysis



How FNB Competes: Product Innovation

Product Innovation – Individuals	Product Innovation – Businesses
<i>eBucks</i>	<i>eBucks for Business</i>
<i>inContact (sms messaging)</i>	<i>inContact Pro</i>
<i>Restart fixed deposit</i>	<i>New Business Solutions</i>
<i>Flexi Fixed deposit account</i>	<i>FNB leveraged finance</i>
<i>Equity linked fixed deposit</i>	<i>Biznetwork</i>
<i>Million a Month Account</i>	<i>Pre Plant Finance</i>
<i>Instant Credit Card approval</i>	<i>Agri-Pro</i>
<i>FNB One account</i>	<i>Franchise Solutions</i>
<i>Islamic Products</i>	<i>BEE Solutions</i>
<i>Discovery, Kulula and Clicks branded credit cards</i>	<i>Affordable housing development finance</i>
<i>Smart Bond</i>	<i>Enterprise Support</i>
<i>Smart Housing Plan</i>	



How FNB Competes: New & Innovative Channels

Mini ATMs



Community Banks



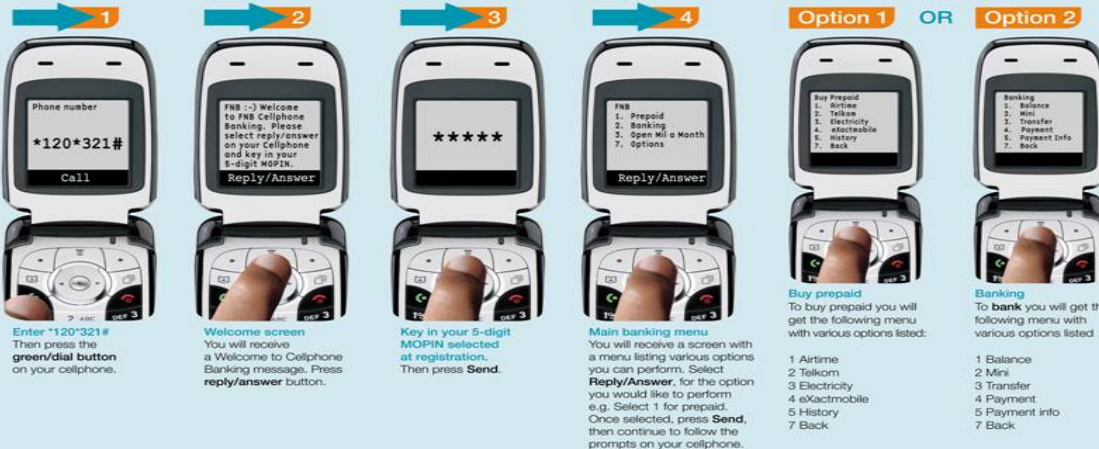
Mobile Banks



Cellphone Banking

How it works:

Once registered, Dial *120*321# and you can buy prepaid airtime or do your banking and much more all from your cellphone - it really is that easy!



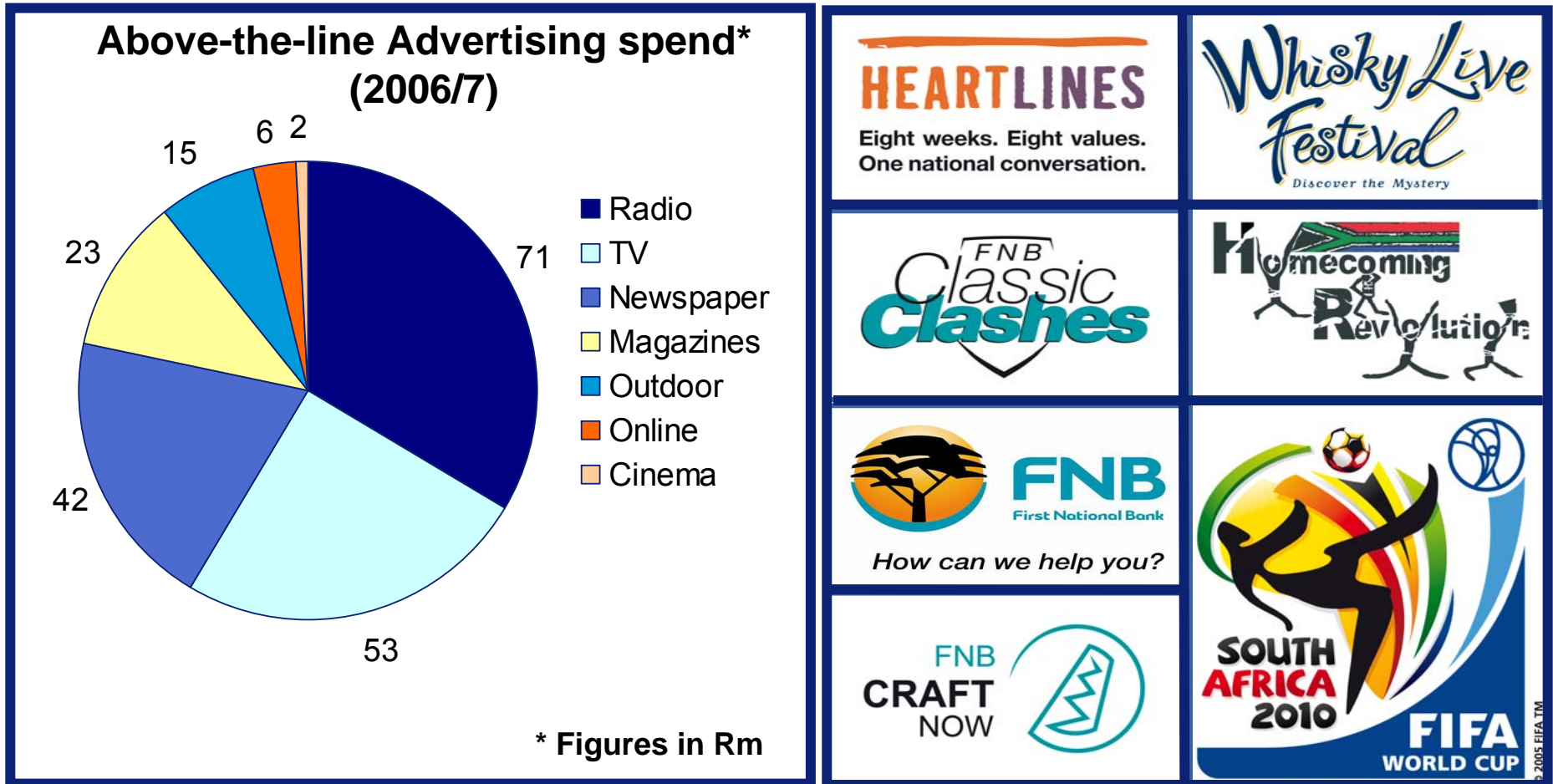
Cash Back at POS

- Draw cash from merchants
- Reduces retailer cash holdings



How FNB Competes: Promotion

In order to gain customers and build its brand, FNB invests extensively in marketing



Competing in the Low Income Market

- FRB concurs with Falkena* that the market works well for “high end” consumers
- Same competitive conditions apply to low income consumer banking
- High reliance on fee income as interest margins are narrow and offset by high bad debts
- Relatively low provision due to challenging economics
 - Low balances
 - High churn
 - Constrained consumer demand
 - Low financial literacy
 - Use of cash and high cost channels (often in low density areas)
- No such thing as “Free” banking - costs need to be recovered

* *Competition in South African Banking: Task Group Report for the National Treasury & the SARB* by H Falkena et al



Competing in the Low Income Market

Banks and other financial services firms are actively exploring ways of serving the low income market

➤ **Access:**

- Mobile banks; 1,500 mini ATMS; 2,650 ATMs; cash back at POS; 240,000 cellphone banking users

➤ **Targeted products:**

- Smart Account, Smart Spend, Smart Housing Loan, Mzansi account, Million a month account

➤ **New entrants and niche providers:**

- Capitec, African Bank, Postbank, retailers



Competing in the SME Market

High costs associated with servicing the SME market



- High cash usage, high failure rate, reliance on physical infrastructure and face to face contact
- Initial failure of SME leveraged finance unit based on misjudgment of costs and risks

FNB continues to innovate in the SME segment



- New products, e.g. Agri-Pro and Pre-plant Finance, New Business Transact, Leveraged Finance
- New solutions, e.g. Franchising, BEE pairing and funding, New Business Solutions, BizNetwork, eBucks for business, Enterprise Support

Agenda



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Recommendations and Conclusions



3. Intense Rivalry Keeps Profits in Line

Analysis of profitability is complex



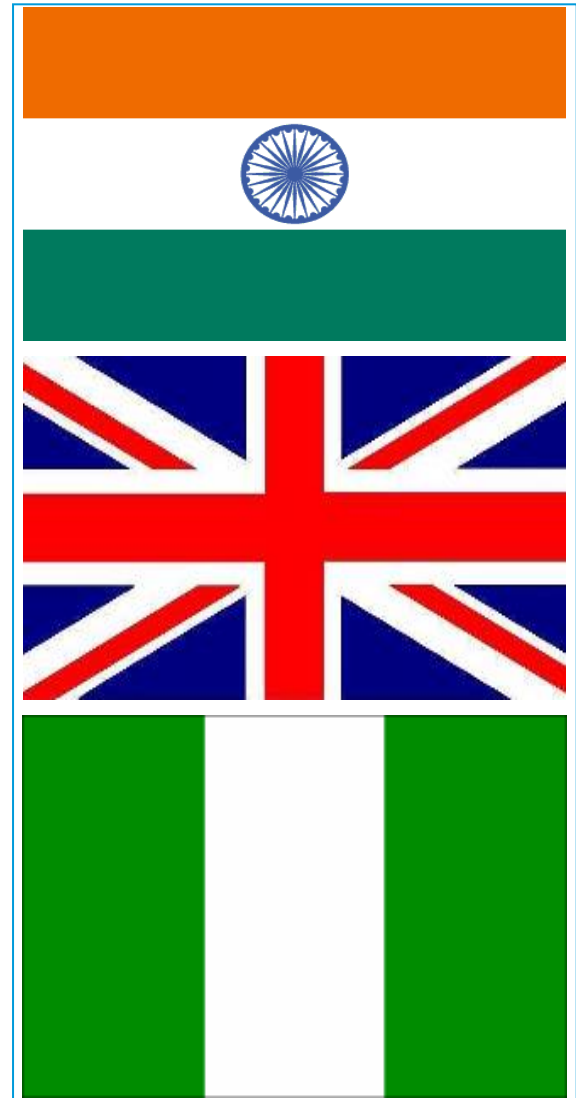
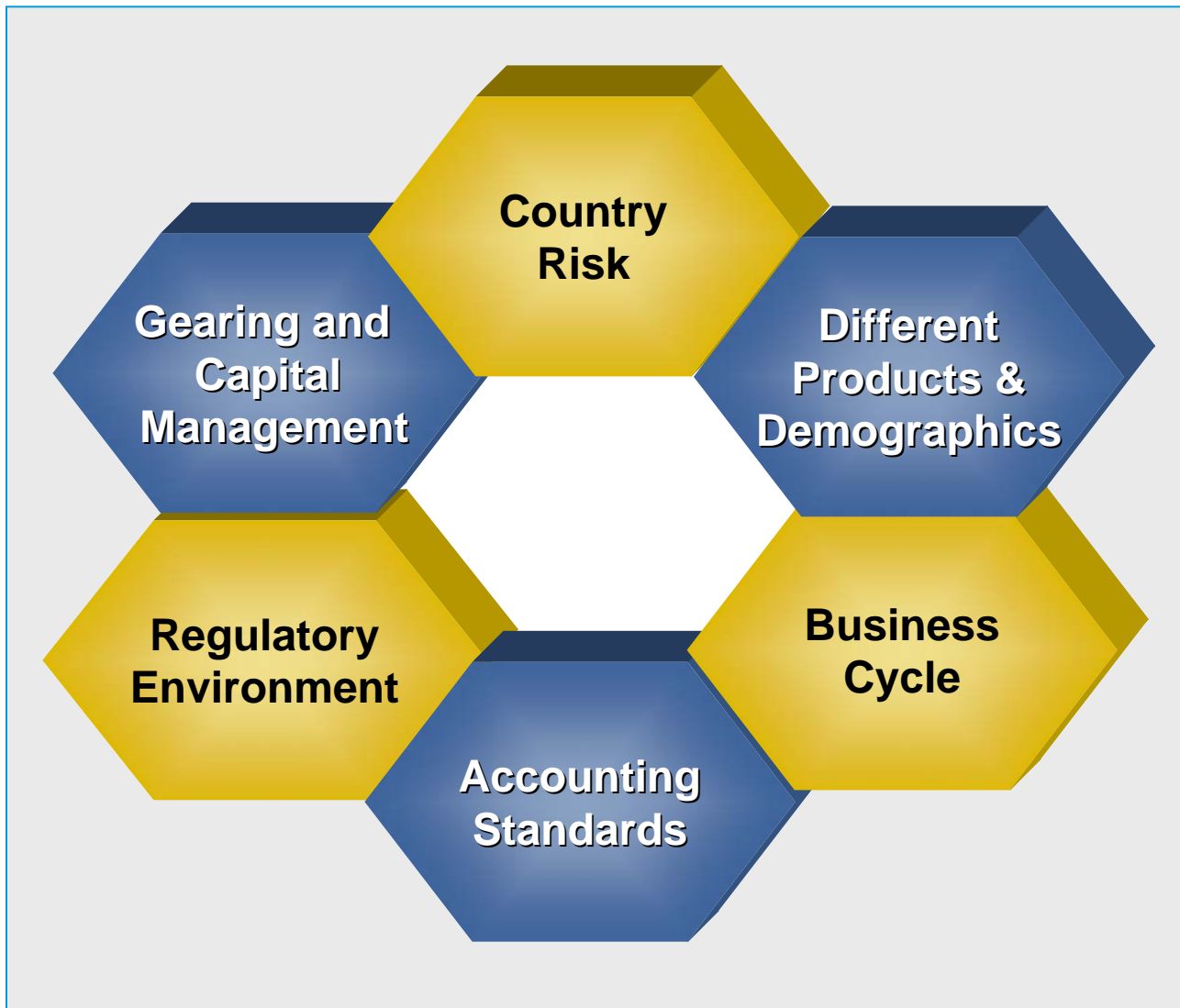
- Correct valuation of intangible assets
- Allocating common costs
- Cost of capital
- e.g. “The Banker” figures differ substantially from audited ROEs

Effective competition keeps profits in line



- Competition will result in new entrants and exits, with the survivors earning greater returns
- Short run effects of business cycle, product life cycles
- Proposed legislation encourages participation: Co-operative and Dedicated Banks Bills

Cross-Country Profit Comparisons are Problematic



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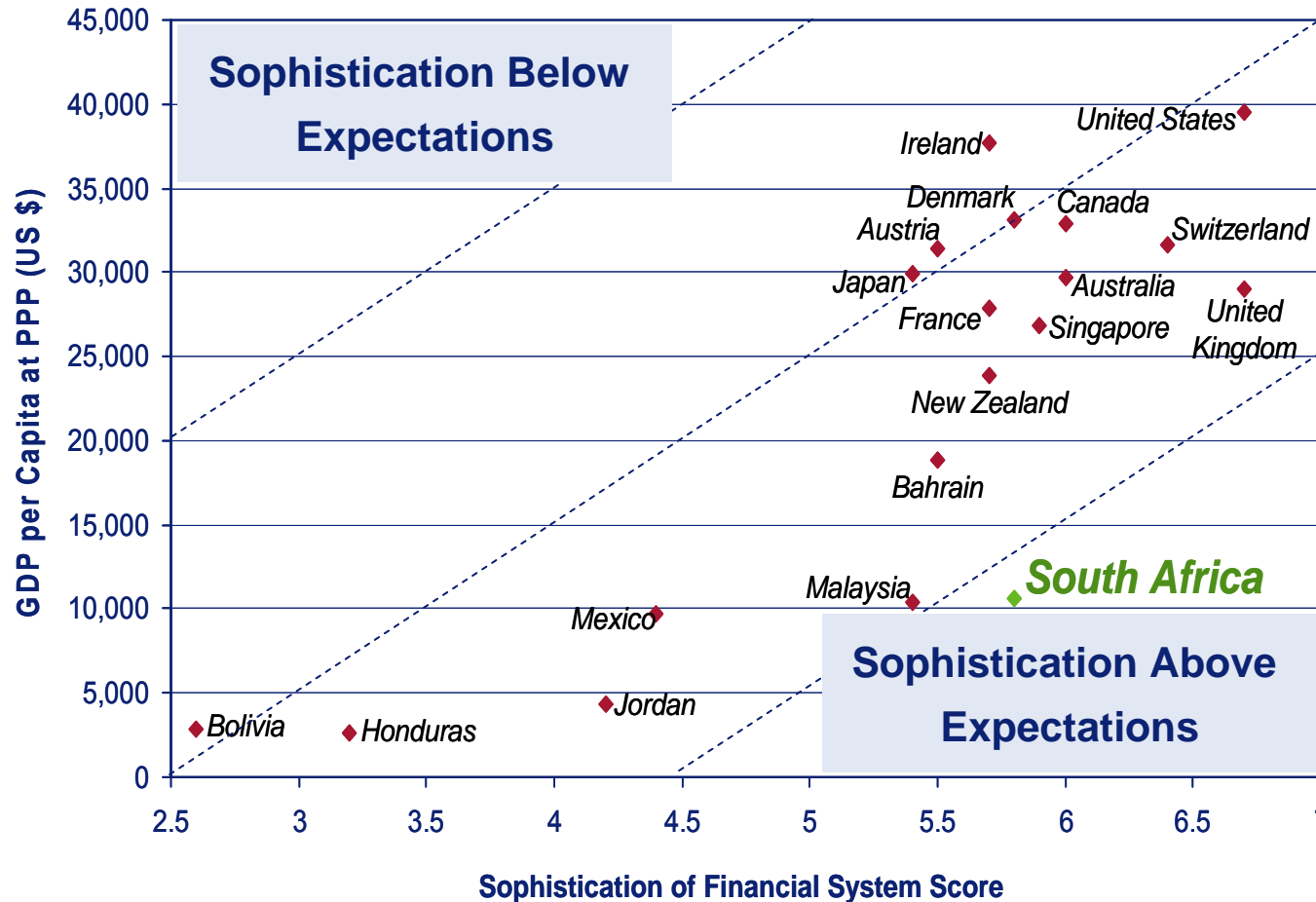


Recommendations and Conclusions



4. Sophisticated Payment System

SA has a relatively sophisticated financial system



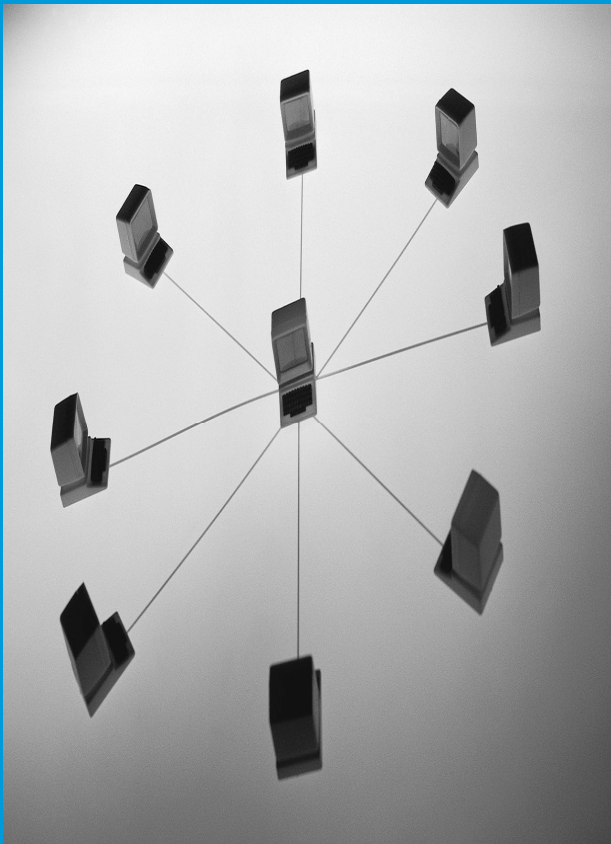
Interbank Clearing & Settlement Stats:

- 1.5 bn transactions per annum
- R 46,800 bn value per annum
- R41,400 bn per annum settled real time
- Almost R1,000 bn in cash handled by SBV per annum

Note: Data from WEF, SARB, Operator



There is Strong Participation in the NPS



- *Everyone has access to the National Payments System via the participants*
- *Direct participation governed by SARB and PASA to safeguard stability and security*
- *Participants have the ability to draw funds from any South African bank account (under customer instruction)*
- *Non-banks have wide choice of access points - 19 participating banks*

BankServ Charges Constrained by Market Forces

- BankServ has high fixed costs (likely >80%) primarily driven by technology and people
- Current pricing scheme
 - Allows smaller banks to benefit from infrastructure and scale
 - Incentivises large banks to remain in the system, reducing average cost to all
- BankServ pricing constrained by
 - Present competition, e.g. from Visanet and MasterCard
- BankServ costs minor component of total banking costs – e.g. for FNB R45m out of R10bn



On Interchange - Clarity is Needed

- Rationale for Interchange?
 - Cost recovery mechanism that encourages investment in infrastructure and products
- How should Interchange be set and at what level?
 - Bilateral negotiations cumbersome and adversely impact smaller banks
 - Multilateral approach requires regulatory clarity
 - International precedent for objective third party studies



Agenda



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5. FRB Recommendations (1 of 4)

Issue	Recommendation
1. Optimise Regulation	<ul style="list-style-type: none">➤ Further regulation may be counter-productive; risks of intervention likely to outweigh benefits➤ Deliberations must factor in the impact of NCA➤ Speed up Dedicated and Co-operative Banks Bills



FRB Recommendations (2 of 4)

Issue	Recommendation
2. Empower Consumers	<p><i>Rivalry & Customer Switching</i></p> <ul style="list-style-type: none">➤ Establish a ‘switching code’ & guidelines to share non-proprietary information<ul style="list-style-type: none">– e.g. KYC central hub, debit order switching services➤ Revise rules for explicit comparative advertising <p><i>Improve transparency of pricing and the ability to compare across banks</i></p> <ul style="list-style-type: none">➤ Establish guidelines to improve comparison➤ Banks to offer service to help customers➤ Banks to develop a service for consumers to compare prices and offerings <p><i>Address, together with relevant stakeholders, the financial literacy of the banking population</i></p>



FRB Recommendations (3 of 4)

Issue	Recommendation
3. Address Industry challenges	<p><i>Access to Banking</i></p> <ul style="list-style-type: none">➤ Guidance in order to <i>eliminate SASWITCH fees</i> <p><i>Reduce the costs of servicing customers</i></p> <ul style="list-style-type: none">➤ Costs of cash and security➤ Servicing low density areas➤ Regulatory capital requirements, liquid asset requirements➤ Reduction of telecommunications costs



FRB Recommendations (4 of 4)

Issue	Recommendation
4. Participation, openness and fairness of NPS, BankServ and Interchange	<p><i>Access to the National Payment System</i></p> <ul style="list-style-type: none">➤ Open to further participation to the NPS as long as risks are managed <p><i>Control of BankServ</i></p> <ul style="list-style-type: none">➤ Appoint non-executive members to the board➤ Promote competition of operators <p><i>Interchange</i></p> <ul style="list-style-type: none">➤ Return to multilateral negotiations, and / or an objective 3rd party study to set the default rates in the Card and ATM environments



Conclusion

Industry is functioning well with high levels of rivalry and innovation

Rivalry keeps prices and profit in line

South Africa has a highly participatory and sophisticated payments system that is of great benefit to consumers

Like all dynamic industries there are opportunities for further improvement. FRB hopes its recommendations aid the Enquiry



Annexure



Why Debit Cards Attract Fees & Interchange?

- Concern raised regarding why debit cards attract both interchange from the acquirer as well as transaction fees from the cardholder .
 - Current account has far greater reliance on transaction fees as less of the costs can be funded by interest turn (vs a credit card)
 - Debit card should not be seen in isolation – one access mechanism of many to a current account
 - Debit card developed as safer and more economical alternative to cheques and cash
 - More costly to service current account holders (particularly in the mass market) – use more expensive channels

**Evans-Schmalensee “The Economics of Interchange Fees and Their Regulation: An Overview” April 2005*



SASWITCH SLIDE

