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Working Party No. 2 on Competition and Regulation

REVIEW OF COMPETITION IN THE DUTCH RETAIL BANKING SECTOR

-- By the Secretariat --

4 June 2007

The attached document is a report that was presented to the Working Party No. 2 of the Competition Committee at its meeting on 4 June 2007.

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REVIEW OF COMPETITION IN THE DUTCH RETAIL BANKING SECTOR

***By the Secretariat**[*]

1.0 Introduction

1. Many retail banking products in the Netherlands are provided by a small number of competing firms. In fact, "the Netherlands has one of the world's most concentrated banking sectors. The four largest banks together hold domestic market shares in various financial retail markets between approximately 75 and 80%."[1] Despite this concentration, the Netherlands is generally considered a low cost banking market for consumers. For example, the European Commission reports that the Netherlands has low account management fees and low fees per payment transaction.[2] A report by the consultancy Oxera prepared on behalf of the British Banking Association (Oxera, 2006) documents that the Netherlands along with the UK have the lowest overall prices for consumer banking services in comparison to a large set of primarily European countries. High concentration does not appear to be linked to high prices, at least not for all product markets.

2. The Dutch retail banking sector has many positive aspects. For example, customer prices for certain products are very low, compared with other European countries. For another, customer satisfaction appears to be high. The Netherlands Bankers Association (NVB), as also reported in the Interim Report II (EC, 31 January 2007, p. 60), observes an extremely high bank customer satisfaction in the Netherlands. However, there are still areas of concern. The lack of price differentiation between different payment instruments could prevent consumers from choosing the more efficient payment means. As another example, the much publicized study on the profitability for banks of the Dutch payment services (McKinsey, 2006), commissioned by the Dutch Central Bank and the Netherlands Bankers Association, found that payment services are loss making for banks in the Netherlands, and that corporations (including SMEs) subsidize consumer payment services. Even though the prices of many services are low and customer satisfaction is high, misallocation issues and competition issues may arise in adjacent markets.

3. How does high concentration in the Netherlands retail banking sector relate to competition? First, large differences in outcomes would be expected to arise for products that are contestable compared to those that are not. Second, high concentration implies large scale. To the extent that there are significant economies of scale and scope from operating as a large bank in the Netherlands, the size and breadth of offerings may lead to greater efficiency. Assessing the implications of concentration in banking on rivalry between banks is important. For that reason, an extensive subsection in this report is devoted to

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[1] See Groeneveld and Boonstra (2005).

[2] Interim Report II (EC, 17 July 2006, Figure 33, p. 89). As will be discussed, this might have to be nuanced given potential cross subsidization.

understanding the link between concentration and competitiveness. One point emerges clearly: competition analyses are fact intensive and should not be coloured by preconceptions about the market.

4. This report explores key practices and regulatory issues for the Dutch retail banking sector. The report focuses exclusively on retail banking, which consists of consumer banking and SME-related banking activities. The report will not discuss the ABN-AMRO transaction (ongoing at the time of the drafting of this report) or the recent competition authority (NMa) raids on banks that, according to newspaper reports, are suspected of cartel activity.[3] The report consists of four sections. Section 2 discusses some key issues that are important for evaluating the Dutch banking market. These are:

- How competition is related to the structure of the banking market, in particular, to the level of concentration in the Dutch market as stated earlier (section 2.1);

- The link between competition and stability in banking, and what can be said about this trade-off in the context of the Netherlands (section 2.2); and

- Other issues that could affect the dynamics and competitiveness of the industry (section 2.3). Section 2.3 includes a discussion on several issues that warrant further investigation, including potential collaborative arrangements in the Dutch market, regulatory arbitrage and (lack of) level playing field issues (possibly outdated regulatory structures due to product innovations etc.), possibly distortive fiscal arrangements, (regulatory induced) exit barriers, and the market for intermediaries ("*tussenpersonen*"). The latter is important because a sizeable share of some products like mortgages are reportedly sold via those agents. Most of these issues pertain in particular to the consumer market.

5. In section 3, the two sectors of the retail market are analyzed in further detail, starting with the consumer market (section 3.1) and then the SME market (section 3.2). The more complicated nature of this market, in part because of its information intensity, warrants a more detailed analysis. Key issues discussed are the ease of access to financing by SMEs, and issues related to switching, bundling, and information sharing. Section 4 focuses on payment systems. Discussed are frictions and inefficiencies in the Dutch payment market (including issues related to entry), and the implications of the Single Euro Payment Area (SEPA), in particular. Section 5 provides recommendations on government policy actions arising from the analysis in the body of the report.

2.0 Understanding competition for Dutch retail banking products

2.1 Competitiveness versus concentration in banking

2.1.1 Background

6. One important characteristic of the Dutch banking market is its high level of concentration. The Dutch market measured along virtually any dimension is one of the more concentrated in Europe. The market shares of the banks in key retail markets are included in Tables 3.1 and 3.4.[4] While these shares may appear high, it must be kept in mind that for many urban customers, there are 5-6 banks within 5

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3 It is worth noting, however, that the ABN-AMRO transaction provides evidence that the Dutch government is open to acquisitions of Dutch banks by foreign-based entities. The prudential regulator appears to seek a clear line of responsibility and hierarchy in transactions to facilitate supervisory needs.

4 The markets defined here are not necessarily equivalent to markets as the word would be used for purposes of competition law.

kilometers[5], some non-banking products may not be excluded (e.g., in the category of savings) yielding a market share that is too high, and international comparisons at the national level may be misleading because some countries with low levels of national concentration (e.g., Germany) have high levels of concentration by region or city (See Boonstra (2007).

7. While market shares are high in all retail banking activities, there is variation across them. SME market shares are, for example, higher than those in the consumer market. Moreover, in the consumer market competition from the ‘Other’ category for consumer loans, mortgages, savings accounts and asset management/mutual funds might have been underreported. (See also the footnote that accompanies this table.) Some of the market shares show swings over time, particularly in the case of mortgages. What this *could* imply is that the Dutch market is heavily concentrated yet substantial activity exists that challenges the status quo in some activities. In short, parts of the Dutch retail market might be contestable.

8. Another dimension that is important in some consumer product categories is the growth and development of new types of intermediaries (‘agents’) who operate between banks and the end-customers, particularly in the market for mortgages. Boonstra and Groeneveld (2006) report – using 2002 data – that banks sell only 40% of mortgages directly to consumers, with 60% sold indirectly via agents (up from 38% in 1985). This shift at first glance could suggest an improvement for consumers if those agents essentially make the market more accessible to the consumer. The value of such agents to consumers depends on the extent to which they provide access to multiple mortgage lenders and have incentives to lead consumers to those lenders with the best offer.

2.1.2 Competition in the Dutch market

9. Where a heavily concentrated market is more or less closed, the existing players all have substantial market share and no new entry can be expected. If this characterizes the Dutch market then the typical competitive strategy of banks in the Dutch market might well be to compete for prospective new account holders rather than compete for already established customers. This choice of strategy would not be very surprising because of the cannibalization fears that incumbent banks face in consolidated banking markets. That is, once a bank has a sizeable market position, it will be reluctant to compete for established customers because this may imply that better terms need to be offered to the bank’s own existing customers as well. The term “cannibalization” refers to the latter effect. Competing only for entering new customers could then be a superior strategy.[6]

10. This cannibalization argument can also be looked at from a tacit collusion point of view. The main Dutch banks could benefit from choosing not to compete for existing customers. The similarity in market shares between ABN AMRO, RABO and ING – see Tables 3.1 and 3.4 – could help sustain such equilibrium where banks choose not to compete forcefully for existing customers.[7]

5 Nonetheless, it must be noted that not all banks would be options for all customers.

6 Note that the cannibalization argument is less important for products like mortgages and loans since for these products competition almost by definition centers on new customers (unless there is a switching possibility during the loan maturity).

7 Tacit collusion (See Bishop and Walker, 2002, pages 265-280) would lead to problems of collective dominance. Typically such a situation is more likely when a range of conditions is satisfied, but note that any one condition alone is not sufficient. The tacit collusion concern exists in oligopolistic markets. ‘Facilitating’ conditions include, symmetry in market shares, relative transparency of market conditions for each of the players (in order to “punish” deviations from the tacit agreement), stability of the market, lack of entry possibilities and absence of a competitive fringe, and limited supply side substitution and countervailing power.

11. An important caveat is, however, the assumption that was made at the very start of this subsection about the market being closed for other banks (no entry possible, only a few very big players present). But this assumption is strictly speaking false: there *may* exist a "competitive fringe", i.e. smaller existing players and potential entrants from abroad (e.g. Bank of Scotland and Argenta in the case of mortgages). With a competitive fringe such a tacit collusive equilibrium might not be sustainable.

12. A key question, however, is whether these entrants really do constitute a competitive fringe? The smaller existing players and the new entrants can only be considered a competitive fringe if they impose a noticeable restraint on pricing or quality of the large existing players. To analyze this issue, a dynamic setup is needed: do smaller players adopt different pricing strategies over time compared with larger players? Do existing players change their pricing strategy after entry or exit? Without such an analysis it should not be inferred that a competitive fringe exists, in other words that segments of the Dutch retail banking market are or may be contestable. As it turns out, it is difficult to find examples where a new entrant was successful in attaining (or threatening to attain) a significant market share that caused a noticeable competitive restraint on the incumbents. Spaarbeleg (AEGON) in the market for deposits might have been one such example, however.

13. This lack of entry cannot be explained by a difficulty in obtaining banking licenses. In fact, there are many banking licenses in the Netherlands that have been issued but have never been used to start a banking operation. As well, there appears to be very little real entry by single-branch banks in the Netherlands. To the extent that small banks may provide service competition to wide-network banks, particularly for SME services, this absence of entry is worrying.

14. The relatively low level of significant entry is a puzzle. One explanation for low entry may be low profitability, for example, as a result of low account fees. But other explanations may be related to entry barriers or costs that are disproportionately high for small banks. It would be valuable to study cost structures for essential memberships (e.g., of credit bureaus, banking association and payments systems), for regulatory reporting and capital requirements to ensure that fixed entry costs or minimum size rules are not disproportionate.

15. As is apparent from Table 3.1, the SME market is more heavily concentrated than the market for consumers. The "competitive fringe" could be defined as Fortis, SNS and the category "other". In consumer banking this fringe has on average a 30% market share while in the banking market for SMEs the average is 20%. Actually, the differences are likely to be even bigger since SMEs depend even more than consumers on local services. In particular, Internet banking for consumers has become more deeply entrenched than for SMEs. Moreover, as will become apparent in section 3.2, SMEs that need credit facilities become very bank dependent, and may have little choice but to accept the products and services of their current bank.

16. More generally, the industry structure of different bank activities and the attributes of the type of product and/or service that affect whether customers can easily substitute one product or one bank for another are not identical across the different products. As a consequence, markets for some banking products might be more contestable than others. Evidence from a questionnaire that was sent to the national competition authorities in all ECA member states (ECA, 2006) is instructive in this respect. It aimed at understanding where competition authorities perceive that competition would be more likely to be present.[8] Across the ECA member states, the mortgage markets were assessed most competitive, see Table 2.1.

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8 The ECA investigation sought to complement the EC DG Competition Financial Services Sector Inquiry (EC, 17 July 2006). The latter addressed inquiries to market participants (the former to the anti-trust authorities).

Table 2.1: Differences in perceived degree of competition

(Survey results; % of all anti-trust authorities in all member states that mentioned a particular product)

Product Market	**Percentage**
Mortgages to consumers	35
Consumer credits	12
Saving deposits	12
Financing of corporations	12
Internet banking	12
Credit cards	6
Current accounts	6
All segments	4

Source: ECA Questionnaire (ECA, 2006), page 47. A higher number indicates a higher perceived degree of competition.

17. Interesting recent research uses an approach developed by Panzar and Rosse to assess the degree of competitiveness of banking markets. Recently Claessens and Laeven (2004) have used this approach to assess banking competitiveness across countries.[9]

18. Claessens and Laeven use individual bank-level data for 50 countries over the period 1994-2001 to regress a measure of competitiveness of a country's banking system (an estimated average Panzar-Rosse statistic over several regressions) on a number of country characteristics that relate to market structure, contestability, inter-industry competition and general level of development. It is found that competitiveness thus measured is both (statistically significantly) positively related to banking system concentration (measured as the C-5), and (not statistically significantly) negatively related to the density of banks (the

9 The Panzar-Rosse methodology as applied in Claessens and Laeven (2004) has been used in several studies of the competitiveness of the banking sector. Yet, it has a number of potential peculiarities that need to be taken into account when drawing conclusions. The approach is based on the idea that the revenues of a firm with monopoly power (or a cartel) respond inversely to a firm-specific variation in factor costs of production, as a monopolist would change output more than price in response to a cost-shock, whereas a firm in competition would change price more than output, so that factor prices and revenues are positively correlated. The methodology assumes the industry to remain in long-run equilibrium, which seriously impairs the test’s power to discriminate between competitive regimes (Shaffer, 1983; Goddard and Wilson, 2006). Idiosyncratic positive cost-shocks to a firm in perfect competition with many others, for example, would drastically reduce that firm’s output when it is undercut, rather than keep it constant at a higher price level. Claessens and Laeven test for the equilibrium condition and reject disequilibrium, but this test can itself be criticized. The theoretical underpinning of the Panzar-Rosse statistic as a measure of competition further assumes constant elasticity of demand. Variations in demand elasticity along the demand curve can make for different relationships between factor costs and revenues across competitive regimes. In addition, in its specific application to banking, the test has been criticized for being distorted, structurally and significantly overestimating the level of competition, when bank revenues are scaled by total assets, as the authors do (Bikker et al., 2006). In addition, the approach ignores possible long-term coordinated effects of increased concentration. The aggregation of various effects that are likely to have opposite signs in a test that already has discrimination problems, which, in addition, is applied to a constructed explanatory variable, calls for cautious conclusions regarding cause and effect.

number of banks per million inhabitants of a country). This leads the authors both to cautiously conclude that "bank concentration may not be a good summary statistic for bank competitive environment", as well as to state in the same paragraph that "more concentrated banking systems face a greater degree of competition" (pp. 19-20). Variations in the Panzar-Rosse statistic are found to be better explained by foreign bank ownership and activity restrictions. Banking systems in countries with greater foreign bank entry, and fewer entry and activity restrictions, have higher competition measures. It is concluded that contestability, rather than concentration, determines effective competition.

19. Several remarks can be made concerning these conclusions. A crucial one is that their main insights precisely relate to the competitive fringe (including possibilities of entry) that was referred to earlier. What is crucial for competitive behavior is that such contestability is present. This point is also empirically confirmed by Barth, Caprio and Levine (2003). In particular they find that tighter entry requirements are negatively linked with bank efficiency leading to higher interest rate margins and overhead expenditures. In related work Claessens, Demirguç-Kunt and Huizinga (2001) show that foreign bank entry is typically shown to improve the efficiency of local markets and reduce margins.[10]

20. It is important to disentangle the competitive and efficiency effects of increased concentration. An increase in concentration leading to lower costs of production would affect the construction of the competition measure. Concentration may decrease production costs, through economies of scale and scope, more than the anticompetitive effects of increasing prices. Also here one would want to distinguish between these countervailing effects on various financial products. It may well be, for example, that increased concentration affects the local product markets for households and small and medium-sized firms differently than it affects the product markets for large corporations, with similar type differences across product and service lines.

2.1.3 Further implications for the Netherlands

21. Important for the concentrated Dutch banking market is that potential entry, *i.e.* a competitive fringe, might be present for products and services where a local branch system is not essential.[11] *Within* the SME and consumer product categories there might be considerable differences; some consumer products are more contestable than others, and the same applies for SMEs. In section 3 (consumers: subsection 3.1; SMEs subsection 3.2), this issue is further discussed. Concentration, contestability and entry barriers can all be linked in subtle ways.

2.2 The link between competition and stability

2.2.1 Overview

22. In the case of regulation, a key question is whether there is a trade-off between Dutch prudential (and systemic) regulation and the competitiveness of the banking industry. A key concern for the rivalry between banks is whether justified prudential practices might be unnecessarily constraining competitiveness.[12] The link with concentration could come about because regulatory and supervisory practices are often developed in close consultation with the existing incumbent players. The mode of

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10 Sengupta (2007) shows in a theoretical analysis that foreign banks may typically seek larger firms as clients as opposed to small and medium-sized enterprises. This result confirms the observations in section 2.2 that SMEs depend more on local providers.

11 Crucial for studies of competition is to apply a consumer perspective; an example of which is the often used SNIPP test.

12 Observe that the implicit certification by a respectable regulator/supervisor could also augment the competitiveness of new, yet unknown entrants.

operation of existing banks may then become the standard and work against new entrants that may have different practices and/or business models.[13] This question is considered to be important because banks themselves are considered "special". That is, stability and systemic issues in banking are important and have led to extensive regulatory oversight. It is important to note that the interaction between competitiveness and financial stability is complex and far from unambiguous. As a public policy objective one might take the point of view that prudential and systemic regulation should, if at all possible, be competitively neutral and not create (implicit) entry barriers.

23. A distinction can be made between the rules in place, and the implementation and execution of regulation and supervision. As for rules, much of the Dutch regulatory structure mirrors EU rules. To the extent this is true, the key to understanding the effect of Dutch practices should therefore come not from the rules themselves but from their *implementation*, *i.e.* regulatory and supervisory implementation and behaviour. The Dutch approach is more principles-based and hence discretionary than elsewhere[14], which in itself can be beneficial since it could allow for a more fine-tuned implementation of regulation and supervision (see subsection 2.2.4). This discretion puts more emphasis on the need for transparency of the regulatory/supervisory process. The same suggestion comes from considering the oligopolistic nature of the Dutch banking industry.

24. The analysis in this section supports the implementation of an approach whereby actual prudential practices, and also the certification process of new entrants, are carefully investigated. Several potential "red flags" are listed: While it is not the purpose of the current report to investigate this issue, it is important that the supervisor is aware of (and can assess) the effects of its prudential operations on competition in the industry.[15]

2.2.2 Stability issues and systemic concerns in banking

25. The banking sector is considered special primarily because of externalities that any one bank may not sufficiently internalize. Several externalities could be identified:

- The failure of individual banks may have contagion effects on other banks in the industry (systemic risk);
- Banks provide for liquid deposits and this liquidity transformation is crucially important for the economy. The withdrawable-upon-demand feature of deposits (with the sequential service constraint) facilitates such liquidity. This then "explains" why we have bank run problems and

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13 This is less likely if the regulation is developed internationally, e.g. Basel II.

14 The Dutch Central Bank is not in principle in favour of discretion. The link with principles-based regulation is crucial. In the case of Basel II the Dutch Central Bank has advocated *less* discretion to guarantee a better international level playing field.

15 In the Netherlands, as in most countries, the supervision of compliance with competition legislation is separate from financial supervision; the financial supervisors have no competences in this field. There are, however, procedures in place between the competition authority (NMa) and the prudential supervisor (DNB) for situations in which the DNB finds that a takeover is necessary to avert an acute threat of failure of a financial institution. Also, in the case of a proposed merger between two financial institutions (in a going concern situation) the NMa will assess the effects of this merger on competition; DNB's assessment (the so-called "verklaring van geen bezwaar") does not include such a "competitiveness test". The NMa and DNB have agreed, however, to inform each other of their decision if relevant.

need deposit insurance to control this[16]. Via contagion effects (e.g. confidence crisis) such runs may create systemic risks;

- Banks play a critically important role in the payment system, and a failure of any one bank could disrupt this system; and

- Banks are the primary funding source for small and medium-sized businesses; hence a bank failure could have a major negative impact on these businesses.

While a convincing case could be made that banks have become less special[17], the potential fragility of the financial system remains an important policy consideration.[18] It is also important to note that the industry structure, and particularly the size of individual institutions, is important in assessing the severity of the externalities. Large banks are more likely to be considered too-big-too-fail, and in this way may count on a rescue by the government.[19]

2.2.3 Competition and fragility

26. Competition is not responsible for the fragile nature of the banking sector.[20] The externalities and systemic concerns, and also the bank run problem (*i.e.* coordination issues associated with the dispersed nature of the (liquid) deposit base) are also present with a monopoly bank. But competitiveness and stability do interact and could be seen as joint objectives.

27. In the popular view, restrictions on competition would improve banks' profitability, reduce failure rates and, hence, safeguard stability (Keeley (1990) and also Demsetz, Saidenberg and Strahan (1996) make this point). The argument is that market power enhances the charter value of the bank, and thus acts to curtail risk taking to limit the possibility that the charter value might be lost. As such, it punishes deviant behavior more. The real trade-off between competition and stability is, however, much more complex. Recently several authors have argued that the trade-off might go the other way, or is at best ambiguous. In any case the available evidence does not give clear prescriptions; it very much depends on the particular situation at hand (Group of Ten (2001)).[21]

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16 This "explanation" is inadequate in that it does not explain the importance of liquidity transformation. If liquidity transformation is not important, money market mutual funds would be superior to the deposit contract (i.e. well organized MMMF's are not subject to runs). Some have argued however that fragile (withdrawable) deposits are an optimal funding instrument from an individual bank's perspective (see Calomiris and Kahn (1991) and Diamond and Rajan (2001)).

17 Several examples could be given for this: real time settlement in the payment system has reduced systemic risk, the better information dissemination may have improved and reduced hold-up problems, alternative vehicles for liquidity transformation may have become more prominent (e.g. securitization), etc.

18 Actually, the point could be made that the banking sector has become more difficult to define. In particular, the demarcations between banking and financial market activities and between banks and other financial institutions have become more obscure.

19 See the literature cited in the review paper by Bhattacharya, et al. (1998).

20 See, for example, Vives (2001) and Bhattacharya et al. (1998).

21 Some have argued that competition undermines a bank's incentives to invest in relationships and that this increases risk as well. What is meant is that when customers switch too often such investments are no longer worthwhile. Monitoring may then become less effective, and risks may increase. This argument is, however, incomplete. Boot and Thakor (2000) show that competition could elevate investments in relationships. In related work, Koskela and Stenbecka (2000) provide an example whereby more competitiveness does not lead to greater asset risk. Boyd et al. (2003) show that competition *could* be good

28. The historic predictability of banking and the strong control of national governments on this sector facilitated and allowed for stringent regulation. This situation, however, is no longer feasible; issues related to regulatory arbitrage have directly undermined the effectiveness of regulation, and level playing field concerns now also need to be taken into account.[22] The competitive effects of prudential regulation have a direct bearing on competitive level playing field issues.[23]

2.2.4 Prudential regulation, competitiveness and the Dutch experience

29. Traditionally, regulation was often directly aimed at limiting competition (e.g. deposit interest rate ceilings and limits on permissible activities, including geographic limits and the separation between commercial and investment banking in the US). Such controls have been largely phased out. Indirect controls are now by far the most prevalent. These primarily rely on price and non-price incentives that are designed to induce, rather than prescribe desired behavior (see Boot, *et al.* (2001)). Risk-based capital requirements are the most well known manifestation of such controls.

30. Indeed, the evolution of regulation is to move away from directly controlling the competitiveness of the industry. Nevertheless prudential regulation and the positioning of the regulatory and supervisory agencies do undoubtedly have an impact on the competitiveness of the financial sector. The focus here is on assessing the impact in the context of the Dutch case. This will be discussed at three levels:

- The EU rules (directives);
- The extent to which Dutch rules deviate from EU rules; and
- How the Dutch supervisory agencies implement the rules and arrange supervision.

It is important to distinguish between the effects on entry and on the competition between incumbents.

EU rules and directives

31. EU directives play a key role in the regulatory structure of the European financial services industry. Member countries are obligated to incorporate these directives in national legislation and rules. The BIS capital guidelines (as already mentioned) are also imposed on member countries via EU directives.[24] The aim here is not to discuss the EU directives in great detail, but a few comments highlight

for financial stability. In particular, they show that a monopoly bank will economize on its holdings of cash reserves. This elevates the crisis probability. Countering this effect is the lower deposit rate that it can choose to offer. Boyd and De Nicoló (2005) identify two more effects countering the conventional wisdom that competition is bad for stability (i.e. moral hazard with the borrower and fixed costs of bankruptcy). See also Caminal and Matutes (2002), and surveys by Carletti and Hartmann (2002), Bikker and Wesseling (2003), CPB (2001) and Cetorelli, et al., (2007).

22 Boot, et al. (2001) emphasize that bank regulation should move in the direction of certification requirements because only then can competitive distortions be mitigated.

23 It is probably justified to characterize the current state of the banking industry as one with lots of strategic uncertainty. In such a transitory situation stability concerns are paramount, and the challenges of the prudential authorities are enormous.

24 Several EU directives aim at removing entry barriers in the financial sector (e.g. the Second Banking Directive which introduces the notion of home-country control in supervision/regulation for banks; this directive is consolidated in the new Capital Requirements Directive). The focus in this section is on prudential regulation only.

some of the trade-offs between prudential regulation and competition at the EU level. EU directives have an impact on competition; for example, the minimum equity requirement on banks (5 million Euros) does restrict entry (but obviously has a potentially very legitimate prudential rationale). Other minimum requirements do so as well. With respect to the newly proposed Basel II capital framework some competitive effects can also be identified. Basel II introduces the option to opt for more advanced, internal risk model-based (IRB) capital requirements. Some commentators suggest that this option is only relevant for larger, well established financial institutions and could put *de novo* or less established (or smaller) financial institutions at a cost disadvantage. While this may occur, the Basel II proposals seek to align regulatory practice much closer to actual market behaviour. In particular, they try to build in a risk-return trade-off that mirrors the pricing in financial markets. In doing so, the Basel Committee seeks to improve market discipline.[25]

32. A more subtle and indirect effect of regulation on competition runs via standardization. Here the Basel II capital framework may again serve as an example. The construction and implementation of the models used in Basel II demand sophisticated expertise. It is conceivable that the banks' specialists and their supervisors share insights and practical experiences. Intentionally or unintended, this might lead to a convergence in the models and thereby create a harmonization of the credit risk assessments by banks. From a competition point of view, this would likely reduce the variety of offers available for potential borrowers.

Do Dutch rules deviate?

33. The main issue here is Dutch practice. As already indicated, the prudential regulations facing Dutch financial institutions are mostly determined by international practice, in particular, by EU directives. EU directives and other international standards leave limited scope for typical national arrangements. Having said this, national rules are not fully harmonized, and regulatory and supervisory arrangements also differ. For example some countries have a single regulator (e.g. the FSA in the UK) while others have fully segmented regulatory/supervisory agencies, and another group has a twin-peak model with a prudential and a business conduct regulator (e.g. the DNB and AFM in the Netherlands).[26]

34. While these arrangements could lead to different conduct by the regulator/supervisor, it is not clear what is better from a competition point of view. In the Dutch situation with its rather oligopolistic banking system one may advocate a separation of regulators by objective, ensuring that trade-offs between objectives are more transparent. The twin-peak model is an example of such a separation.[27] This description, however, refers to implementation rather than rules per se.

35. The following serves as an illustration of what kind of deviations can be found in the national rules. The weighting factors guiding the BIS capital requirements under the standardized approach (for smaller banks) are specified as 20, 50 and 100 percent in EU rules. The Dutch Central Bank, following German practice, also uses a 10 percent factor for the treatment of commercial real estate.[28] These types of minor differences are typical of the deviations between Dutch rules and EU directives. But the relevance of this for the trade-off between prudential regulation and competitiveness seems negligible.

[25] The disclosure requirements in the third pillar of Basel II are explicitly introduced to augment market discipline.

[26] Note that this does not refer to the (separate) presence of an anti-trust regulator.

[27] Again, having a separate anti-trust regulator is part of the picture. The message in the text is that also separating conduct of business from prudential regulatory/supervisory responsibilities is important (see also NMa, 2006).

[28] There are also deviations for the treatment of commercial real estate.

36. When it comes to interaction with the competition authority important differences may exist. For example, the FSA in the UK is obligated to check its new rules with the Office of Fair Trading (OFT), one of the UK's competition authorities, while such arrangements do not exist in the Netherlands.

Dutch supervisory implementation and behaviour

37. The differences in formal rules and laws are unlikely to contain the most important effects of prudential regulation on competition. Rather one would need to examine the actual behaviour of regulators and supervisors. As an illustration, the Cruickshank (2000) evaluation of competition in the UK banking sector argued that UK regulatory practice imposes unjustifiable barriers to entry by effectively requiring that 'new entrants must be linked to an established institution'. Cruickshank also pointed out informal restrictions on who could own a bank, potentially tougher restrictions on institutions without a track record, and higher capital requirements for new entrants. While the FSA (the UK regulator) has forcefully defended its approach to assessing new entrants (FSA, 2000), the Cruickshank report illustrates that the actual practices of regulators and supervisors, and their discretion, could contain the most obvious conflicts with the objective of promoting competition.

38. An example of discretion at the Dutch national level is the certification of the integrity of senior management by the Dutch Central Bank. The Dutch practice is to apply this certification mainly to the most senior management layer. Elsewhere in the EU a more intrusive certification at lower levels can be observed. This type of discretion potentially has an impact on the trade-off between prudential regulation and competition.

39. Another example of discretion can be found in how the financial distress of an individual bank is handled. Often central banks look for a quick takeover of an insolvent institution by a healthy player in the industry. This obviously has an impact on the industry structure. Whether such a merger would have an impact on the extent of rivalry depends on the extent to which the banks have mutually important operations for products that are not contestable. Since these distress situations are handled in great secrecy and with urgency, competition issues may not get the attention they deserve.[29]

40. A more fundamental difference between the Dutch "approach" and that in some other countries could be that the Dutch approach often is more principles based (i.e. guided by "*goed bestuur*" or "*gezond bankbeleid*"), as compared, for example, to Germany and France where detailed rules are more prevalent. The impact of this difference in approach on the trade-off between prudential regulation and competition is difficult to assess. One could say on the one hand that a principles-based approach leaves more discretion with the supervisor, which *could* be misused against new entrants, as well as against a more aggressive incumbent. It also seems less transparent than a rules-based system and could potentially create regulatory uncertainty.

41. On the other hand, a discretionary system may reduce compliance costs and allow for a much more fine-tuned regulatory regime. Indeed, such a system might be particularly well-placed to cater to the needs of new (innovative) entrants who might have more difficulties complying with detailed rules. In addition, too detailed rules might offer a false sense of security or transparency as such rules will need to be changed from time to time. The argument for such a system could also be put in the context of the

[29] Note that these within-national-sector resolutions are likely to become less common with the internationalization of banking. For example, the recent demise of Van der Hoop Bank, a small Dutch bank, did not lead to a takeover of this bank by one of the other players. When mergers do occur in distress situations, they need the approval of the NMa. See Carletti and Hartmann (2002) for an overview of the differences in the relative roles of competition and prudential authorities in the case of bank mergers in the G7.

necessary confidence in the financial system. Explicit rules, and the arbitrage surrounding them, might be insufficient for this. Sweden, which also has adopted the provision of *good banking* standards, finds this provision crucial because "for banks to be able to fulfil their function in the economy, it is important that confidence in the banking system is maintained".[30] The principles-based approach leaves more room, inherently, for variety in implementation.[31] In a more discretionary environment, the transparency of the regulatory and supervisory process is of paramount importance.

42. In general, potential frictions may come from the presence of regulatory discretion. Nevertheless, it is clear that some regulatory discretion is needed. What are other potential concerns relevant to entry to the Dutch market?[32]

- Established practices that are outdated and work against new operators, *e.g.* practices based on face-to-face branch banking, could be inadequate for Internet banking, and in this way discourage the latter;
- Supervisory practices and charter policy could implicitly be based on the broad universal banking strategy of incumbent players. Are the requirements sufficiently tailored to a narrower (i.e., specialized) scope chosen by a new entrant? Or do new entrants face a burden that is in total mismatch with the scope of their operations? And similarly, do players that specialize somewhere along the value chain (and do a lot of outsourcing) face a receptive supervisory regime? Or is outsourcing 'punished'?
- Administrative load at the bank level associated with prudential regulation could be excessive. This could create an entry barrier;
- Allocation of costs of the prudential regulator over market participants may discriminate against certain types of players. The industry has to pay for the costs of the prudential regulator; how are the costs distributed over the players?
- The presence of deposit insurance may affect the competitive playing field. The effect might well be that it benefits smaller, less well known players over bigger ones.

2.2.5 Potential actions in the Dutch situation

43. The highly concentrated banking sector in the Netherlands could lead to regulatory arrangements that could be efficient for the current players but effectively create barriers to entry.[33] More generally, such

30 See Riksbank (2000). This report on the new Swedish banking law casts the "good banking standards" clause also in the context of consumer protection.

31 This emphasis on rules-based versus principles-based may not be a universal distinction between the Netherlands and other countries. Several people within Dutch regulatory bodies emphasize that the Dutch "rule-book" for new entrants might actually be much more transparent than for example in Southern European countries. This points at the need for further research.

32 This is not an exhaustive list of all potential concerns related to the competitiveness of the Dutch financial sector. As potential "red flags" one could look at the ownership position of banks (cross-holdings), interbank payment system and settlement (MIV), extra debit charges ("*opslag debit rente*"), movement of senior managers from regulatory bodies to senior bank management positions, etc. Another issue is that a real analysis of competitiveness should also look at the non-bank financial service providers. These are often not at the center of systemic concerns and may face a lighter supervisory regime.

33 Given the principles of home country control and open access for EU institutions, entry barriers would be subtle.

an oligopolistic market could be prone to regulatory "shortsightedness" or regulatory capture, *i.e.* a situation in which the regulator becomes "dominated" by the vested interests of the existing players, and in this way discourages entry. An important consideration is that the intimate involvement between the supervisor and the senior management of the banks in an oligopolistic banking sector warrants a greater openness of the supervisor about its processes and procedures. This will help counter possibly misplaced suggestions of "favoritism" or regulatory capture. In this context, the supervisory agency should also be sufficiently forthcoming in providing for an advisory desk, and possibly also arranging for basic training sessions on regulatory/supervisory matters. This educational/advisory role is particularly important for new entrants.[34] It is important to note that, in fact, the Dutch Central Bank provides significant help to smaller banks in dealing with the various requirements for obtaining bank licenses and fulfilling compliance requirements.

2.3 Other key competition issues for the Dutch market

2.3.1 Overview

44. In this section several issues related to competition in the Dutch banking market are discussed that warrant further investigation. These issues include: issues related to regulatory arbitrage and the level playing field[35], possibly anti-competitive collaborative arrangements in the Dutch market, distortive fiscal arrangements, regulatory induced exit barriers, and the competitive impact of the market structure of intermediaries ("*tussenpersonen*"). The latter is important because some products like mortgages are increasingly sold via those agents.

2.3.2 Regulatory arbitrage and level playing field issues

45. The absence of a level playing field between sectors and products is one of the Dutch conduct-of-business market regulator's (AFM) primary concerns with respect to the effectiveness and fairness of competition in the retail market. This concern is shared widely within Europe by regulators and supervisors, market participants, and consumers' associations. It has come to the forefront because of the increasing speed of product innovation (see Boot, 2007a) and the wider dissemination of complex financial products to the general public, particularly structured products.

46. From the AFM's perspective there are particular concerns about the different regulatory regimes for competing sectors and substitute products in the area of retail investing. The relevance of these regime differences used to be minor as the sectors and products were seen as distinct by both suppliers and clients. The regime differences are, however, increasingly difficult to explain since sectors (asset management, investment banking, insurance) have become more and more intertwined, and products – like investment funds (collective investment schemes), structured products, hedge funds and unit-linked funds – are often designed to meet the same client needs.[36] Increasingly, the same underlying product is wrapped differently so as to optimize the regulatory regime that applies to the product.[37]

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34 Observe that supervision/regulation is not just a burden to new entrants but also has an upside, i.e. it provides for certification that gives distinct benefits in their operations. The emphasis here is on identifying potential frictions.

35 Regulatory and supervisory structures may lag behind product innovations, for example.

36 While products that have similar characteristics but are offered by different categories of service providers may be close substitutes for many customers, this does not imply they would be substitutes for all customers.

37 A recent dispute on options and futures in the US highlighted the problem of having separate regulators for futures and options. The conflict involved disputes about exchange traded versions of credit event products

47. In particular, the regulatory regime for investment funds (collective investment schemes or CIS, being either *Wtb* (now *Wft*) national collective investment schemes (Dutch), or UCITS (European collective investment schemes)) is relatively heavy compared to the regime for structured products (and other products subject to the requirements laid down in the (*Wte* Prospectus Directive, also in *Wft* now)) and unit linked funds. Investors are likely to be unaware of these differences.

48. As already indicated, the past few years have seen a marked growth in structured products, and these evolve in such a way that they increasingly resemble investment funds. Asset managers (investment funds) are losing ground to investment banks (structured products) and this might be partially due to the relatively light regulatory regime to which the latter products are subjected. In other words, a non-level playing field creates an incentive for the industry to develop products subject to the prospectus directive regime rather than CIS. As a result, investors may base their investment decision with respect to products that for them seem similar, on documentation that does not contain the same sort of detailed information. Or conversely, products that offer essentially the same trade-off of risk and return may be regarded as very different by investors owing to the different regulations to which they are subjected. Obviously, different regulatory treatments are not the sole reason for the growth in structured products. Other reasons include the high pace of innovation in structured products, quick time to market, and their ability to appeal to investor needs in response to new investment trends.

49. As an illustration of these differences in regulatory treatment, it is interesting to compare the AFM's requirements in the case of "Collective investment schemes" and "Structured products/securities":

> **Collective investment schemes**: "Important pillars on which the supervision under the Act on the Supervision of Collective Investment Schemes is based include assessments of the expertise and reliability of directors of institutions under the Act on the Supervision of Collective Investment Schemes, the requirement that such institutions must possess at least a certain level of financial guarantees, and the requirement that the institutions' business operations must be organized properly. The supervision under the Act on the Supervision of Collective Investment Schemes also aims to ensure that CIS provide proper information to their investors, to make it possible for those investors to form a well-considered opinion about the investments offered. It is also important to realise that the purpose of the supervision is not to protect investors against high-risk financial products or products with low return prospects. The AFM ensures that investors are capable of understanding the risks attached to the investments on offer. Securities institutions are responsible for fulfilling whatever promises they make to their investors." (*Wtb*, now *Wft*)
> European regulations also apply to CIS. On the basis of a 'European single passport' CIS can operate throughout the internal market of the European Union. However, only institutions that invest in securities may apply for such passports. These institutions must also fulfill several other requirements. (UCITS)
>
> **Structured products / securities**: "In the case of offers of securities, the AFM assesses whether the statutory rules are being observed and examines the *prospectus* for approval." (*Wte*, also *Wft* now)

This issue is not solely a Dutch one but arises to a large extent from EU regimes. Not surprisingly, therefore, the EC and CESR (Committee of European Securities Regulators) are now reviewing substitute products and are assessing whether changes to the regulatory regimes are required to better suit the developments in the market place, and what changes might be needed. The AFM, as the Dutch conduct-of-business supervisor for all of the above mentioned products, tries to manage the differences in regimes as well as it can. For instance, the AFM has recently reviewed the structured

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like credit default swaps. See also "Regulators play different notes on same instrument", *Financial Times*, April 17, 2007, page 27.

products market in the Netherlands, voiced its concerns and has seen market players (NVB) take the initiative to establish best practices.

50. The Dutch regulatory regime with respect to CIS does not contain provisions on eligible assets and investment policy. The result is a more general regulatory regime that covers all sorts of collective investments and does not create a distinction between, for example, equity funds and hedge funds, thus creating a level playing field for collective investment funds and reducing the regulatory arbitrage within this specific market. This does not, however, level the playing field between CIS-regulation and the Prospectus Directive.

51. The Dutch regulatory regime creates a framework in which Dutch CIS (non-UCITS) have to comply with requirements to ensure investor protection and transparency of information. For example, the transparency of costs and risks (simplified prospectus), the trustworthiness and know-how of the fund manager, and internal control mechanisms.

52. Another example to consider is the regulation of payment systems. Increasingly, mobile phones are operating as payment mechanisms. In some countries they are being used to purchase train tickets and at vending machines. But their potential to serve as payment instruments is actually much greater. Despite the increasing popularity of mobile phone payments, mobile phone payments do not yet fall under the supervision of payment rules and policies. There is a risk that as mobile phone payments evolve, there will be regulatory asymmetry. The Netherlands Bankers Association suggests that mobile payments may already outnumber the 1.45 billion annual PIN payments.[38]

53. The problems of regulatory arbitrage and level playing field are, however, much broader than just the above cited example of CIS and structured products. The increasing dynamics of the financial services industry opens up many more of these potential problems. In essence, the problem is that traditionally regulation was heavily linked to institutions. For example, banks and insurers faced, and to some extent still do, separate regulatory and supervisory structures. The move from sectoral supervision to a "twin-peaks model" with separate prudential and conduct of business supervisors[39] could constitute a step towards more harmonized supervision and regulation. The dynamics of the industry make these institutions offer products that can easily been seen as substitutes (e.g. pension type products) and the increasing diversity of institutional forms (including entry of players outside the traditional banking/insurance domain; e.g. supermarkets that offer financial services) makes institutionally based regulation increasingly distortive and suggests the need for a more functional approach to regulation. The Dutch supervisory approach seeks to move in this direction.

54. Although financial regulation and supervisory practices are increasingly internationally determined[40], national elements continue to be important. Thus, it is still desirable to critically evaluate existing regulatory and supervisory practices in the Netherlands in light of potential competitive concerns stemming from regulatory arbitrage and level playing field considerations.[41] The government has already

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38 See Lieleveldt, Simon, Letter to Mr J.. Bruin of the Ministry of Finance, concerning response to the consultation of the Dutch tax authority on the VAT-treatment of phone-cards, 'phone-payment-lines' and mobile phone subscriptions (draft DGB2006/4909M), May 21, 2007.

39 The move to the twin-peak model started in 2002, and was concluded with the coming into force of the *Wft* on January 1, 2007.

40 More and more areas of financial regulation face European harmonization, e.g. investment firms due to the Markets in Financial Instruments Directive and public offerings due to the Takeover Directive.

41 While financial regulation in general continues to have national elements, it is less so when it relates to financial market related activities. But also there national elements are important. See for example the separate committees in the Netherlands that have looked at the mutual funds (the Winter-Committee, 2004)

announced and consulted on new legislation in this field. Specifically it concerns the conceptbesluit to change the Besluit gedragstoezicht financiële ondernemingen (Bgfo). Among other things it aims at regulating 'beleggingsverzekeringen' more strictly by providing more cost transparency. Next, the government announced a national regime under the Markets for Financial Instruments Directive (MiFID) for a group of intermediaries. This regime will aim at adressing level playing field issues that arise because some products and services will as of november 1, 2007 be regulated by MiFID, whereas some other, competing products and services, will not.

2.3.3 Collaborative arrangements in the Dutch market

55. Collaborative agreements are quite common in banking, and have deep roots in banking practice. Historically, correspondent banking was crucial for banks to operate cross-border, particularly for having access to the payment network in other geographic markets. Desirable diversification and placement capacity make it necessary that banks operate in syndicates when offering large facilities. More generally, one could say that banks are part of networks and do depend on implicit reciprocal arrangements with other financial institutions. For example, the syndicates coming about in syndicated loans are not random; to the contrary, a careful implicit reciprocity agreement defines the composition of such syndicates over time. Many bankers will attest to the notion that a bank cannot succeed without having a good working relationship with other banks. The key question then is when do such reciprocity agreements and/or the importance of good working relationships with competitors become anti-competitive and thus a concern for the competitiveness of the financial sector?

56. Collaborative arrangements in general could make good business sense and are not necessarily designed to impede competition. An example is the opening up of a bank's distribution network to products from others. In such an arrangement, institutions could exploit their local presence by capitalizing on their distribution network; simultaneously, product specialists may emerge that feed products into these distribution networks.

57. Nonetheless, if collaboration is over-broad, competition can be impeded. A general question is whether the culture of banking in the Netherlands is truly focused on competition. A competitive attitude in the market for financial services depends on cultural habits and standard practices as well as structure.[42]

58. What concerns may exist about collaboration in the Dutch market? A potential concern is whether there is an over-dependence on industry-arrangements. In a concentrated banking system one might be tempted to have the incumbents provide for the necessary coordination in public goods/services. The initial approach to put incumbent banks jointly in charge of Interpay – essentially a monopoly provider of essential payment services – may have affected competition in the relevant market. It is important to distinguish sharply between the tasks where potential efficiency gains dominate competitiveness concerns, and those tasks for which efficiency gains do not dominate.

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and life insurance with investment characteristics (*beleggingsverzekeringen*; the De Ruiter-Committee, 2006). Both Committees recognized a need for a level playing field yet were confronted with substantial differences in supervisory and regulatory arrangements.

42 Competition culture is not easy to define. Examples can also often be interpreted in different ways. For example, if in a local town with two banks, one bank calls the other for information when it is approached by a customer coming from its competitor, this could easily be interpreted as being anti-competitive. However, information problems might be such that the 'new' bank would never be willing to serve the competitor's customer because the 'new' bank knows that it may not have access to essential information that its competitor has. In that case some (informal) information sharing may actually help and possibly make the market more competitive. In section 3, the point will be made that a more neutral type of credit bureau that allows for access to credit information is probably a better option.

59. In general, this trade-off should be carefully evaluated in the Dutch market. Cost-benefit analyses (i.e. regulatory impact analyses) are appropriate instruments for this, but, as of yet, have not been deeply applied.[43]

60. Examples of collaboration in the Dutch market include:

- The SEPA migration plan currently being developed;
- The Interpay case;
- The fact that the NMa turned down the three most recent requests for exemption under Article 81.3 (article 6.3);
- Cross-shareholding and interlocking directorships (see NMa, 2004, chapter 7);
- The strong coordination of guest-use of ATM's in the SOGA participation board (SOGA *deelnemersraad*).[44]

2.3.4 Fiscal arrangements that create a non-level playing field

61. Government intervention with extensive fiscal arrangements for certain financial products is quite common in the Dutch market. Initially the focus is on consumer products. Key arrangements affecting consumers include:

- Mortgage interest deductibility on the primary residence; and
- Various favorable life insurance-based capital accumulation schemes linked to mortgages.

Subsequently, fiscal arrangements will be discussed that affect competition between suppliers, notably VAT implementation.

Fiscal arrangements affecting consumers

62. The first two arrangements affecting consumers are clearly linked, and will be discussed jointly. The mortgage with life insurance linked refers in particular to '*spaarhypotheken'*, a standardized, very popular life-insurance linked mortgage in the Netherlands. In such a mortgage, the life insurance component guarantees repayment of the principal, and repayments towards the principal accumulate separately from the nominal loan outstanding. This accumulation is only matched with the principal at maturity. In between the accumulation on the separate account is tax-free while the interest payments over the total initial principal amount remain fully tax deductible until maturity.[45] For the bank the separate accumulation is not different from a normal repayment on the mortgage, and *spaarhypotheek*-contracts link these two explicitly; also the interest rate paid on the accumulation is identical to the interest rate charged

43 To make a case for a Article 81.3 (Article 6.3) exemption, the burden of proof lies with the banks.

44 SOGA: *Samenwerkingsovereenkomst Geldautomaten*.

45 This structure, which is a very common mortgage arrangement in the country (not special at all, not surprising given the implicit magnified tax subsidy), is subject to a few conditions. One is that the arrangement has to run for at least 15 or 20 years depending on the amount of the principal that could be put under this favorable construction. The general deduction for mortgage interest payments on the primary residence is unlimited.

on the principal. This construction is distortive from a purely efficiency point of view. The customer benefits from a higher mortgage interest rate as soon as the accumulation surpasses some lower bound, and obviously the bank involved always benefits from a higher interest rate. This however also has competitive implications. One is that the life insurance link, with the particular accumulation rules, makes it difficult to migrate the mortgage loan from one bank to the other. This is costly since it reduces the bargaining power of the customer at the interest-rate reset moments during the lifetime of the mortgage. The other issue concerns the peculiar incentive that the customer has with respect to the level of the interest rate during the life time of the mortgage. He/she may actually benefit from a higher rate (depending on the accumulation).

63. The lack of transparency of the product results in difficulties for evaluating the pricing of the life-insurance part of this mortgage arrangement, particularly in combination with assessing the attractiveness of the interest rate offer. Thus, at the start of the arrangement (deciding between competing offers upon financing a house) and during the life time of the mortgage, comparisons are very difficult. This may also help explain why intermediaries ("*tussenpersonen*") have obtained a large market share in the activity of providing for mortgage financing, and have managed to grab substantial market share with potentially sub-par offers to the consumer. The CPB (2003) reports that intermediaries manage to offer consumers an enormous dispersion in mortgage rates (124 basis points), which suggests a potential lack of transparency in this market.[46] In section 2.3.5 further thoughts are included about the role of intermediaries.[47]

VAT Implementation

64. It is agreed by some that the Netherlands' implementation of the VAT system results, in certain circumstances, in the asymmetric treatment of firms producing substitute products. For example, Dutch banks are VAT exempt for many of their activities, while alternative providers may have a different VAT treatment. One type of company (banks) may not be able to recover input VAT. Examples include:

- Bank decisions whether to outsource for payment processing (e.g., credit card issuing and transaction processing). The VAT exemption applies to services provided within a bank. However, if the bank outsources for card processing and settlement services, for example, it loses the VAT exemption. This in turn reduces the willingness of banks to engage in competitive outsourcing, as outsourcing will be significantly more expensive, including VAT, than internal provision.[48]

- Banks that acquire merchant transactions and issue cards versus telecom companies that issue prepaid SMS services. Dutch banks are VAT-exempt while telecom providers may be covered by the full VAT regime, based on a draft decision of the Dutch Tax Authority, DGB2006/4909M.[49]

65. The VAT regime should ideally seek to promote competition-neutral policies that do not provide a VAT-based rationale for firms to prefer one type of provision method over another. There are many potential advantages of competitive outsourcing, but if VAT schemes disadvantage outsourcing for some

46 Banks, in contrast, only show dispersion across consumers of 60 basis points. See also Boonstra and Groeneveld (2006).

47 A more positive role of the network of intermediaries is that they may have facilitated the entry of foreign players into the market for mortgages, see also subsection 1.3.6.

48 ECJ jurisprudence may provide the government with little room for exempting outsourced services, as according to ECJ-Sparekassernes Datacenter (Judgment, Case C-2/95 of 5 June 1997), outsourced activities can only be VAT exempt if the transactions are distinct in character and are specific to, and essential for, the exempt transactions.

49 The final decision has not yet been issued.

types of companies (banks) compared to others (non-banks), cost reductions from efficient outsourcing may be unduly limited. Similarly, if VAT schemes give different treatments to distinct technologies that accomplish the same goals, the costs of production, the product prices and ultimately consumer decisions may be distorted from those that would occur under a tax regime that was neutral with respect to technologies.

2.3.5 Intermediaries ("tussenpersonen")

66. In the Netherlands, the functioning of intermediaries ("*tussenpersonen*") has received close attention (e.g. NMa, 2004, 2005). The mis-selling scandals in the market for third pillar pensions (life insurance: "*beleggingsverzekeringen*", "*koopsommen*", "*lijfrentes*", etc.) are probably one of the main causes. The role of intermediaries in the market for mortgages has been questioned.[50] There seems to be a close correlation between the activities of these intermediaries and the fiscal/tax incentives that are provided by the government. Several measures have been taken to improve this situation, in particular, improving the transparency in the ownership structure and commission structure of agents to reveal potential conflicts of interest, no-front loading in the fee structure, transparency about products ("*financiële bijsluiter*"), augmenting the responsibilities of distributors, and suggesting improvements in consumer financial education.

67. What is the impact of the highly developed market of intermediaries on the competition for retail banking products? On the mortgage market intermediaries offer highly dispersed mortgage rates. Some interpret this dispersion as evidence that competition is not working. However, price dispersion may actually be greater when competitive rivalry is increased. Intermediaries offer an alternative type of distribution network that potentially could help entrants get access to the market. In the market for mortgages this is to some extent observed. But what impact do intermediaries have on banks? Banks now sell considerably more mortgages via agents than via their own distribution networks. The ability of banks to forge relationships with their customers would clearly be reduced and could suggest a commoditization of banking services. This suggests that bank relationships with their customers may become less close and switching costs lower, provided that the intermediaries serve as agents for many different banks and steer customers towards offers best suited to the customer. Agents also facilitate entry into the market by foreign providers.

3.0 Retail banking for consumers and SMEs

68. This section examines the consumer and SME retail banking sectors.

3.1 Consumer banking

3.1.1 Overview

69. This section focuses on the Dutch consumer banking market.[51] The Netherlands is generally considered a low cost banking market for consumers. Assessing the contestability of the Dutch banking market is relevant. As will be emphasized, activities for which a branch network is important may lack contestability in the Dutch market. For the consumer market, contestability concerns might be more limited *relative* to the SME market because the branch network might be less important for consumers than for SMEs. While consumers highly value the physical presence of branches, the Netherlands has one of the

50 See section 2.3.4.

51 The key analysis of this market was already contained in section 2, particularly the subsections 2.1 on the measurement of competitiveness (in relation to concentration measures) and 2.3 that listed the key concerns pertaining to the Dutch banking market, and the consumer market in particular.

highest levels of usage of Internet banking services, with 7.3 million reported Internet users in the Dutch Central Bank's 2006 annual report, with probably about 60% of these being primarily users of Internet banking, based on a 2007 *Heliview* survey. However, for certain client segments such as the elderly, bank branches are likely to be important. Furthermore, reputation and trust are important competitive advantages in the banking market, both for the consumer market and the SME market. Potential entrants may lack reputation and trust.

3.1.2 Data on the Dutch consumer market

70. In Table 3.1 the market shares of the relevant players on the Dutch consumer market are shown. Note the earlier caveat relating to the potential inaccuracies in reported market shares (see footnote). A key insight from Table 3.1 is that concentration is high, yet substantial market share is in the "Other" category. Experiences and interviews with various participants in the Dutch market point to the presence of some elements of a competitive fringe (see section 2.1) when it comes to many of the consumer banking services. The exception, based on these interviews, is the current account. Potential entrants and smaller players may be imposing pricing discipline on the large incumbent Dutch banks. Based on data from W. Boonstra of Rabobank, HHIs in the Netherlands for consumer loans, savings accounts and mortgages were 1040, 1652 and 1321 in 2006, respectively.[52] These HHI figures are lower than those that would arise from the data in Table 3.1, suggesting that the market shares in that table may overestimate the shares of larger firms.

Table 3.1: Market shares in consumer banking [53]

	ABN AMRO	Rabobank	ING	Fortis	SNS Bank	Other
Current account	20	30	40	5	5	-
Consumer loans	25	20	25	10	5	15
Mortgages	15	25	20	10	10	20
Saving accounts	20	30	25	10	5	10
Asset managements/ mutual funds	25	20	15	15	-	25

Source: Estimates ECORYS-NEI, NMa (2004)

71. Several banks have changed policies over time for decisions on how to provide local services, *i.e.* services via the branch network. Most banks dramatically cut back on the number of branches, yet some

52 Data from W. Boonstra of Rabobank suggests that the shares of the top 5 banks for consumer loans, savings accounts and mortgages are 63%, 76% and 69% in 2006, respectively.

53 Note that these market shares are based on an expert survey of ECORYS-NEI. Two caveats should be noted. First, the 'Other' category for saving accounts (and to a lesser extent consumer loans, mortgages and asset management/mutual funds) might be underreported. In particular, insurers are rather active on the savings market (with Spaarbeleg/Aegon being a rather big player). Second some other inaccuracies may exist, in particular in the relative market shares reported for Fortis and SNS. As Boonstra and Groeneveld (2006) report, Fortis' share in consumer loans might be somewhat overstated, and SNS' shares in both consumer loans and asset management/mutual funds are possibly somewhat understated.

have realized that the branch-network could offer competitive advantages. While no data are available, it is claimed that the banks that cut branches most drastically suffered losses of market share. Indeed, this trend seems to be in line with one of the strategic shifts in banking: banks have increasingly started re-emphasizing the importance of their local markets. *The Economist* rightfully concluded that "Banks have rediscovered the virtue of knowing their customers"[54]. Not so long ago, widespread branch closures were typical for Europe and not just a Dutch event. The relative low profitability of domestic Dutch consumer banking (in part because of the low consumer prices) may have induced more heavy cost cutting via branch closure (Boonstra and Groeneveld, 2006).[55]

72. An important question in the context of section 2.1 is for which consumer banking services the branch network plays an essential role. Such activities may suffer from lack of contestability since the Dutch consumer market is rather concentrated and new players cannot be expected to easily build up a branch network. However, all activities reported in Table 3.1 can be obtained at a distance without visiting a branch. This suggests a somewhat mixed picture about the contestability of the Dutch market. For the current account itself, contestability seems questionable. The three biggest players have larger shares in this market than in any other segment. A question is whether banks could take advantage of this, for example, via tying arrangements. So far, however, this is not observed. Bank accounts are accessible without consumers being forced into tying arrangements. Many Dutch consumers also have multiple accounts, in part, because of the low cost. The recently announced integration of Postbank into ING may possibly have some impact on this situation. Until now, the alternative payment infrastructure provided by the Postbank offered for many Dutch consumers an extra payment account.

73. As regards bundling in the Dutch market, the following can be said. The model to make consumer banking profitable is one of cross-selling (see Table 3.3). Given the low cost payment services in the Netherlands, this might be even more relevant. In the Dutch market most cross-selling in the consumer market is of a soft variety, that is, price inducements are offered to accept a bundle of services rather than exclusive tying arrangements. Table 3.2 and 3.3 give some perspective on this. SME loans are discussed in section 3.2. From Table 3.2 it appears that consumer loans/current account and mortgage/life insurance are the two most common types of bundling.

74. The mortgage/life insurance combination is a direct artifact of the fiscal arrangements that were discussed in subsection 2.3.4, and essentially may have to be looked at as an integrated product. Many players are active in this market, and given the role of agents, a branch network does not appear to be essential for success in this market. The bundling arrangement for the consumer loan/current account does not appear problematic either. As already noted, current accounts are available without consumers having to accept other products. So there does not appear to be any "leveraging" stemming from the big banks' potentially stronger hold on current accounts. Those banks typically force consumers upon accepting a consumer loan to open a current account. However, a separate market for consumer loans exists as well that does not run via the main banks. Thus consumers appear to have a choice of whether to accept the

54 *The Economist, "*A Survey of International Banking", April 17th, 2004, p. 3. As Citigroup's retail banking head Steven S. Freiberg put it, Citi should think "locally" (see, "Thinking Locally at Citigroup", *Business Week*, October 24, 2005, p. 50-51). Or, just wandering the streets of New York City, one cannot escape HSBC's billboards exclaiming, "HSBC, The world's local bank". New entry, for example, the entry of Washington Mutual in the Chicago area, helped fuel a massive increase in branches in that market. Actually, all over the US, the number of branch offices is on the rise. Indeed also many European banks are now redirecting resources to expanding their branch network realizing that their branch closures over the last decade might have been gone too far.

55 Expanding on the branch network may help local banks secure their position, and reduce the contestability of the market.

consumer loan as part of a bundle or to obtain a consumer loan only from more specialized finance corporations.

75. Apart from their strong hold on current accounts, the main banks may also have a strong competitive position (typically linked to their branch network) when it comes to more complex financial arrangements. With standardized products, Internet offers may be perceived as satisfactory and new entrants may be better able to attract customers. For example, while Bank of Scotland has entered the Dutch market for mortgages, it has focussed exclusively on standard arrangements. For more complex arrangements the local banks seem indispensable.

Table 3.2: Bundling in the retail market

	Mortgage + Current account	Consumer loan + current account	SME loan + current account	Mortgage + life insurance
Belgium	44%	0%	73%	0%
France	86%	71%	91%	0%
Germany	5%	0%	11%	0%
Italy	48%	58%	73%	2%
Netherlands	0%	55%	58%	38%
Spain	67%	65%	91%	0%
Sweden	1%	17%	13%	0%
UK	1%	1%	0%	0%
EU25	39%	35%	63%	6%

Source: EC, 31 January 2007, Report on the retail banking sector inquiry (Commission services retail banking sector inquiry, 2005-2006)

Sampled banks reporting product bundling, weighted by banks' combined % share of customer numbers in the lead product market

Table 3.3: Bundling, cross selling

Cross-selling ratio. Weighted average. Year 2005. Consumers

	Hook product: Current accounts	Hook product: Deposits accounts	Hook product: Mortgages	All hook products
Belgium	2.99	2.33	4.53	2.71
France	3.15	2.16	4.27	2.63
Germany	2.10	1.42	2.22	1.63
Italy	1.99	1.79	2.54	2.01
Netherlands	2.29	2.17	3.41	2.31
Spain	1.89	1.98	3.63	2.07
Sweden	2.65	2.70	3.55	2.79
UK	2.08	1.70	2.65	1.94
EU-15 average	2.24	1.86	3.07	2.07

Source: EC, 17 July 2006, Interim report II: current accounts and related services (Commission's Retail Banking Survey, 2005-2006)

3.1.3 Switching costs

76. In the past few years, the Dutch banks introduced a service to aid those who switch their accounts from one bank to another. The Netherlands is one of very few OECD countries that have implemented a service to make switching easier. This service was introduced among telephone numbers to introduce account number portability following a general policy discussion on reducing switching costs across a number of different sectors.[56]

77. The bank account switching arrangement in the Netherlands is called "*overstapservice*". The Netherlands Banking Association introduced this service in January 2004 to facilitate current account switching. A website was erected to provide information to the public. What does the "*overstapservice*" do? The service:

- Ensures during 13 months that transfers to the old account are automatically forwarded to the new account;
- Direct debits are directly taken from the new account; companies directly debiting the account are (i) informed about the client's new account number, and (ii) do not need to obtain permission in order to be able to directly debit the new account;
- The old bank provides an overview of all the existing "contracts and standing orders" about regular payments related to the old account;
- Provides information about all payments that took place through the "*overstapservice*"; and
- Sends the account switcher a reminder one month before the automatic forwarding period of 13 months comes to an end.

Account switchers still have to directly inform all parties that transfer funds to them (e.g. their employer). The "*overstapservice*" was used by 45,000 consumers in 2004, 65,000 consumers and 5,000 SMEs in 2005 and about 75,000 consumers and about 5,000 SMEs in 2006.

78. While some market research reported that parties who had actually chosen to switch found it easy, perceived barriers to switching (real or imaginative) are present and number portability might offer further benefits. It is, however, not costless.[57] NVB (2007) suggests the difficulty of maintaining a switching service in the future because of its dependence on using a central processor with one database of all bank account numbers that is in charge of processing all inter-bank transactions.

3.2 SME banking

3.2.1 Overview

79. Banking services directed at small and medium enterprises (SMEs) warrant special attention. SME success is often viewed as a key to generating national economic growth. But if SME access to

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56 The discussion resulted in a 2002 report *Kosten noch moeite*. *Drempels slechten voor de switchende consument*.

57 The Netherlands Bankers Association estimates that the introduction of account number portability, which has occurred with telephone numbers but not bank account numbers, would cost between \$300 to \$500 million. They also note that the IBAN numbering system for accounts in Europe includes a bank code as part of the account identifying information which is not compatible with number portability (Lieleveldt, Simon,"The Dutch Interbank Switching Support Service", October 24, 2006.)

finance is unduly constrained, there might be follow through effects on productivity and SME-generated growth.

80. Data on the status of SME financing are difficult to find in the public domain. In one recent survey, SME customers in 2005 were found to have a number of concerns about SME financing, even if, overall, SMEs in the Netherlands are among the better performing SMEs in the EU-15. At the time of the Eurobarometer 2005 SME Financing survey, SME managers in the Netherlands stated that obtaining loans had become more difficult in the last few years much more frequently than SMEs from other countries, with only 18% saying it was easier versus 51% saying it was more difficult (European Commission, Eurobarometer: SME Access to Finance, October 2005, p. 23).[58] The EU-15 averages were 33% finding it easier, versus 42% finding it more difficult. Perceptions among SME managers about Dutch banks' willingness to take risks are close to the EU-15 average. But the Netherlands has the second lowest reported perception of banks supportiveness of the SME firm's financial needs, with only 59% reporting agreement compared to an EU-15 average of 68% (Eurobarometer, p. 28)[59] The reported perception among SME managers of banks' understanding of their sector of activity placed it among the lowest three in agreement with the statement that their banks understand their sector, with 31% disagreeing.[60] The Eurobarometer study further suggested that SME managers in the Netherlands were among the most frequent in the EU-15 to perceive that the offers from banks were not suited to their needs. With 43% agreeing with statements that offers are suited to their own needs compared to an EU-15 average of 50%.[61] Interestingly, the SME managers in the Netherlands report more frequently than average that they are able to pursue projects without bank financing, which could help to explain the better performance of Dutch SMEs compared to those in many EU-15 countries, despite their relatively low reported ratings concerning banks in the Netherlands.

81. The Eurobarometer 2005 SME Financing survey does not extensively explore the origin of concerns by SME managers about banking. The differences in the Netherlands could arise from differences in cultural norms, from differences in competition, or from other factors that are difficult to explain. This report will focus on potential competitive explanations for issues with SME services in the Netherlands, but it should be emphasized that other explanations could potentially be at the source of the Dutch low ratings.

82. For a variety of reasons the SME market is more complex from a competition point of view than the consumer market. One of the reasons is that a bank that serves SMEs obtains potentially valuable proprietary information about its customers. In consumer lending, lending standards can be based more readily on verifiable information (employment conditions), and possibly linked to mortgages. Also, as noted in ECA (2006), concentration ratios in SME lending and deposit taking are high compared to consumer banking (loans, deposits and mortgages). A further complication is that *local* access to banking services appears generally to be even more important for SMEs.

58 The survey question was: "Would you say that compared to a few years ago it is easier or not as easy to obtain a bank loan?"

59 The survey questions was: "Please tell me if you totally agree, tend to agree, tend to disagree or totally disagree with the following statements? Your banker is sufficiently supportive of your company in terms of its financing."

60 The survey questions was: "Please tell me if you totally agree, tend to agree, tend to disagree or totally disagree with the following statements? Your banker understands the specifics of your sector of activity."

61 The survey questions was: "Please tell me if you totally agree, tend to agree, tend to disagree or totally disagree with the following statements? The offers from banks are not suited to your needs."

83. Potential frictions might be substantial. This does not necessarily mean that the frictions are caused by the structure of the financial sector or that financial institutions are responsible for them. In particular, the information intensive nature of a bank-SME relationship might not make it cost effective for banks to invest sufficient resources to take away financial constraints. For example, empirical evidence from Fazzari *et al*. (1998a, 1998b, 2000) shows a strong dependence between investments and cash flows.[62] One would interpret this as evidence that the firms examined experienced external financial constraints. That is, with smooth access to external funding no dependence would be expected since good investment opportunities could always be funded regardless of the level of internal cash flow. This does not, however, necessarily suggest a competition problem in the financial sector since high costs of serving SMEs could also explain such financing constraints.

84. While empirical evidence is scant, research has shown that both effects are at work. In particular, there is some evidence that large financial institutions are less able to serve smaller SME bank clients. If entry of new and/or smaller lending institutions is depressed this could lead to finance constraints and easing entry conditions would be of high priority for macroeconomic performance. But why would larger institutions be less able to serve smaller customers? Apparently, the soft information that is needed to adequately evaluate these smaller businesses can be used less effectively in bigger institutions. Instead, they may depend more on hard, credit-scoring information (see Berger et al. 2005, Stein, 2002; Sapienza, 2002). A reason might be that in a larger organization decisions are made further away from the market, and hence more standardized information is used. U.S. evidence seems to point at entry of new institutions when banks merge and become less adaptive to smaller customers (see Berger et al., 1998). Entry is typically observed much less in Europe which might imply that mergers and increasing scale of financial institutions in general might cause a bigger financing problem for SMEs in Europe than in the U.S.

85. Theoretical developments have been dominating the field. Relationship banking has been shown to potentially facilitate the financing of smaller companies. Simultaneously, such potentially strong relationships between bank and borrower might make it difficult for the borrower to leave their lender. Hold-up problems may follow as the incumbent bank uses privileged information that it obtains about the borrower, as extensively discussed in the literature (see Rajan, 1992, and Boot, 2000). Typically, this leads to the insight that *ex ante* borrowers may receive a more favourable interest rate than a “competitive” rate, but once they are hooked to the bank, the bank can exploit its information advantage and raise prices. More information sharing could be very important to limit the ex post “hold up” power of the incumbent bank, by reducing the informational advantage of the current lender. This need for wider availability of information points to the importance of credit bureaus, or other information sharing mechanisms to prevent hold-up problems (subject to privacy and competition concerns).

86. The effects of competition in general on bank lending are favourable, yet examples can be constructed that show that excessive competition might be detrimental. For example, Petersen and Rajan (1995) have shown that too much competition makes it difficult for banks to recoup potential upfront costs, and could make banks stricter in their initial credit assessment. The typical result, however, is that competition benefits borrowers because more competitive pricing is available and hold-up problems might be easier to contain.

3.2.2 Market structure of banking services for SMEs

87. The Dutch SME lending market is primarily served by four banks, ABN AMRO, ING, Rabobank and, to a lesser extent, Fortis. The total market share of these four banks in SME lending is roughly 95%

62 Kaplan and Zingales (1997, 2000) provide some nuances to this conclusion.

(see Table 3.4, and also NMa (2004), p. 122). Foreign banks are largely absent, and, if present, only observed in serving larger corporations.[63]

88. Considering the importance of proximity for many SMEs and the sporadic presence of Fortis in many local markets in the Netherlands, Dutch SMEs often have a realistic choice of between only two or three providers. The analysis in section 2.1 would then clearly indicate a potential lack of contestability of this market both in terms of limited competitive fringe and absence of widespread potential entry (considering the importance of branches).

89. As is apparent from Tables 3.5 and 3.6, SME customers do not switch frequently.[64] The profitability of SME banking is difficult to assess given the lack of data. Table 3.7 does provide some information, but it is difficult to interpret. The SME market like the consumer market is highly concentrated. If, as argued in section 4, the costs of payment services in the Netherlands are relatively low, then that in conjunction with Table 3.7 suggests pricing practices that are linked to loans. Table 3.7 suggests that banks center their fees on loans.[65] SME branch organizations seem to confirm this. Having a loan from a bank appears to have some lock-in effects for borrowers.

90. There is somewhat more mixed evidence on other types of frictions that Dutch SMEs face when it comes to the type of loans. Bureau Bartels (1999) and Boer & Croon (2002) have pointed at a relatively strong dependence on shorter term bank finance, suggesting possibly that long-term bank loans are not readily available. Researchers from Rabobank (Rabo, 2005) have disputed these claims using proprietary information. Also Duffhues (2003) questions whether long-term financing is truly low. As argued in Boot and Schmeits (2004), it is likely that where long-term financing is observed, this is owner-related mortgage financing, reflecting the difficulty of businesses to directly secure long-term financing.[66]

63 As an illustration, Deutsche Bank did try to get a position in the mid-cap domestic market. Banks such as BNP, Citi and JPMorgan-Chase are involved only in serving the very largest Dutch corporations.

64 SMEs point at the difficulty of comparing between banks. The 2005 Code of Conduct between the Netherlands SME’s Association (MKB Nederland) and NVB (www.nvb.nl/scrivo/asset.php?id=11730) should have made it easier for companies to compare between banks. This code of conduct obliges banks to indicate which information they need from the company for judging a loan application and which aspects are relevant for the granting of the loan. The same applies for the contractual conditions. Moreover, banks have to disclose the reasons for not granting a loan.

65 Data limitations prevent a strong conclusion in this regard.

66 Not discussed in this report are government guarantee facilities. The Dutch government has various credit guarantee facilities to facilitate the funding of SMEs and innovative initiatives. The primary instrument of the government (the Ministry of Economic Affairs) for SMEs is the BBMKB facility. As argued in the main text (see subsection 2.2.1) some type of government support for SME financing can be warranted given the relative high cost of serving this client base. See Boot and Schmeits (2004) for an evaluation. Recently, some amendments have been made, in particular to make the BMKB facility available for slightly bigger facilities.

Table 3.4: Market shares in the Dutch SME market

	ABN AMRO	Rabobank	ING	Fortis	Other
Loans + current account	35	25	25	10	5
International payment services	35	25	25	10	5
export financing	35	20	30	10	5
Deposits/savings	15	25	25	15	20

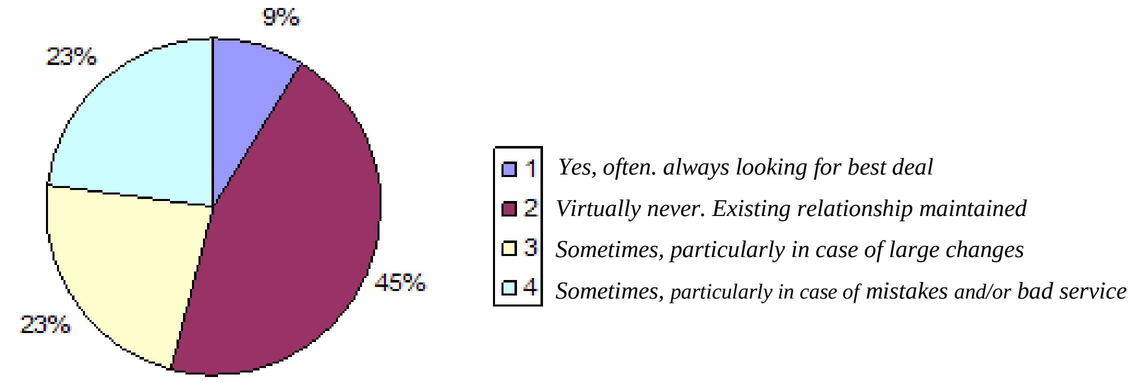
Source: Estimates by ECORYS-NEI, NMa (2004)

Table 3.5: Growth rates and switching
Number of current accounts growth, Churn and Longevity. Weighted average. 2005

	Growth		Churn after control		Longevity	
	consumer	**SME**	**consumer**	**SME**	**consumer**	**SME**
Belgium	3.39%	-1.67%	5.27%	8.90%	10.04	9.99
France	1.82%	2.31%	6.84%	12.26%	11.06	8.39
Germany	2.55%	0.01%	8.46%	15.15%	11.55	9.85
Italy	-1.54%	1.45%	7.68%	11.23%	9.39	8.23
Netherlands	0.24%	1.71%	4.17%	8.88%	14.33	10.45
Spain	3.61%	1.58%	12.12%	10.34%	6.91	6.02
Sweden	1.66%	1.55%	5.62%	8.80%	11.82	12.33
UK	3.64%	0.81%	5.07%	13.72%	10.66	7.66
EU-15 average	2.08%	1.42%	7.55%	12.21%	10.40	8.56

Source: EC, 31 January 2007, Report on the retail banking sector inquiry (Commission Retail banking sector inquiry, 2005-2006)

Table 3.6: SME and bank relationships. Do SMEs shop around?



Source: NMA, 2004

Table 3.7: Income from SME services

Gross Income per customer by SME product line in Euros, 2004, weighted average

	SME current accounts	**SME term loans**
Belgium	380	738
France	632	876
Germany	478	2,474
Italy	1,155	1,533
Netherlands	-	5,471
Spain	299	3,494
Sweden	156	2,936
UK	715	2,006
EU-15 average	638	2,331

Source: EC, 17 July 2006, Interim report II: current accounts and related services, page 71 (from Commission's Retail Banking Survey, 2005-2006)

3.2.3 SMEs and bundling

91. The NMa has looked at product bundling and tying[67] in the Dutch market for SMEs (NMa, 2004). As a general conclusion, bundling of particular products to have a current account is commonly

67 Bundling refers to products that can only be obtained as part of the bundle (and not separately); mixed bundling refers to a situation where all the bundled products can be obtained separately; and in the case of tying only one of the products can be obtained separately. Tying however is most common, and refers to situations where, for example, one is forced to select a current account when taking down a loan.

observed, particularly for payment services (e.g. trade finance and bank guarantees) and credit facilities. Also soft inducements ("package discounts") are quite common. SMEs that feel most bank-dependent are those with credit facilities (NMa, 2004).

92. While bundling could strengthen lock-in effects, it can also be aimed at better serving customers. Assessing the extent to which packages are offered with an ability for customers to break out services and obtain them from other suppliers is difficult, particularly to the extent that bank standards and practices for opening accounts may not be written down.

3.2.4 Credit registries and SMEs

93. The Netherlands currently has an arrangement for sharing credit information, *Stichting Bureau Kredietregistratie* (BKR). This credit registry collects information on the payment obligations of all Dutch consumers who have or had a loan with a duration of three months minimum or a subscription to a mobile phone in the past five years. If a participant is granted a loan or a mobile phone subscription, this has to be reported to BKR. A mortgage will only be reported to BKR if the consumer has not paid an instalment in over 120 days. BKR only provides information to its participants and the consumers themselves. BKR has no legislative basis, but credit providers are legally obliged to participate in a credit registration system. At this moment only BKR is legally considered to be such a system. A foreign credit provider who is active in the Netherlands can also become participant of BKR and get access to the shared information.

94. It is important to note that BKR only registers information about loans to consumers, although some loans to firms without legal structure ("*eenmanszaken*") are included.[68] Credit information sellers like Dun & Bradstreet do have coverage of the Netherlands. Given the frictions (particularly hold-up problems, see subsection 3.2.1) that characterize the market for SME loans, it seems clearly desirable to expand on the information sharing arrangements in the industry to achieve a more thorough coverage of loans to SMEs.[69] Setting up information sharing via a "credit bureau" warrants careful scrutiny to ensure that the sharing will not promote collusive actions.

4.0 Payment systems

4.1 Introduction

95. In this section the payment system is the central focus. Two related areas are examined:

- The Dutch payment system and possible improvements; and
- The opportunities and threats SEPA poses for the Netherlands?

96. Several advantages related to SEPA can be identified, yet it might have some unintended consequences especially in well developed and relatively low cost payment systems such as the Dutch one. It is worth noting that cross-border card payments account for less than 2% of total payments.

97. The analysis proceeds as follows. Section 4.2 describes the basic characteristics of the Dutch payment system. Section 4.3 focuses on inefficiencies and frictions in the Dutch payment market. Section 4.4 analyzes the impact of SEPA on the Dutch payment system. Section 4.5 considers interchange fees.

68 For some time there has been an initiative of market players, supported by the government, to enlarge the scope of credit registries, including rent and energy debts, debts to social services and debts from fraud.

69 See also the empirical analysis of Djankov, McLiesh and Shleifer (2007) on the importance of information sharing institutions in 129 countries.

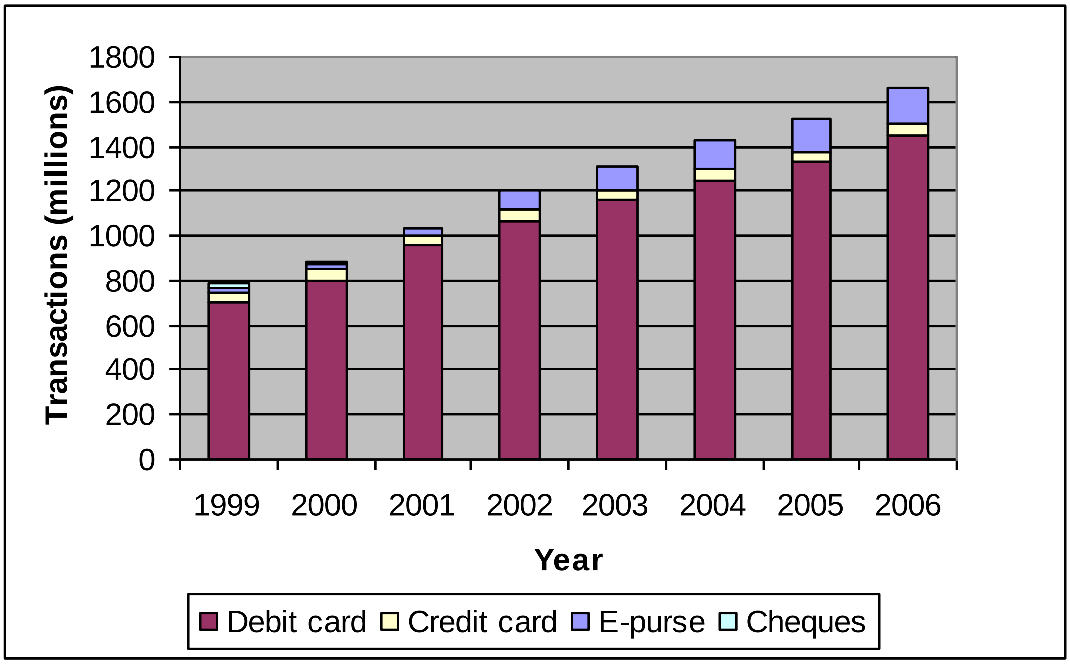
4.2 Description and data on the Dutch market for payment services

4.2.1 Organizational structure

98. The Dutch payment system is highly centralized with basically one privately operated payment processing facility dealing with virtually all non-cash payments – transfers and points of sale (POS). This organization, called Interpay, recently merged with the German processor TAI to create a pan European payment processor, known as Equens.

99. In general, the Dutch payment market is considered relatively efficient and low cost compared to other countries. It has one of the highest rates of non-cash payment transactions usage in Europe. As can be seen from Figure 3.2, there is a strong dependence on debit cards for POS transactions; credit cards are rather unimportant. Relative to many other EU countries, the Netherlands seems to be ahead in its migration to non-cash and paperless means of payment. Figure 3.2 shows the migration in payment means over time.

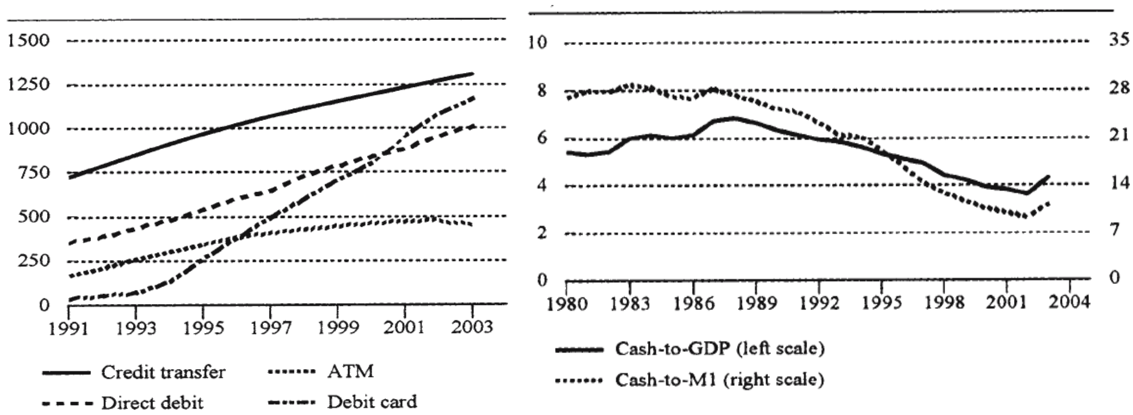
Figure 4.1: The number of point-of-sale transactions in the Netherlands (in millions[70])



Source: DNB, 2004, DNB 2006.

70 The numbers for 2003-2006 (see DNB, Annual Report 2007), show a continued growth of transactions with a more than 80% share for debit cards (debit cards from 1157 in 2003 to 1451 in 2006; credit cards from 44 to 50; E-purse from 109 to 165; cheques remain at zero).

Figure 4.2: The use of non-cash payment instruments and cash in the Netherlands



Source: Bolt, 2006.

100. The Dutch payment system has recently gone through several changes in governance structure.[71] Before 2002 there existed a single, industry-owned and operated scheme/infrastructure organization – Interpay. Subsequently, Interpay was vertically disintegrated. Responsibility for debit card merchant acquiring arrangements was transferred to the individual financial institutions in order to allow for competition between banks in offering merchant acquiring services. Scheme responsibilities, such as rules and standards on transaction processing, access (licenses), compliance and product development, were transferred from Interpay to a new industry-owned organization, called Currence. Interpay (now Equens) retained ownership of the underlying payment processing infrastructure.

101. The ownership of the payment instruments – PIN debit cards, Chipknip, Acceptgiro, Incasso (direct debit) and iDeal – is with Currence. Together with its responsibilities for licenses, compliance and standards, it essentially "controls" the primary national payment instruments.

4.2.2 Further Data

102. A characteristic of Dutch payment practices is the high use of non-cash payments compared to other EU countries, see Figure 4.3. Most noteworthy is the high use of debit cards (note in Figure 4.3 card payments refers to both debit and credit cards). As is apparent from Figure 4.1 credit cards are hardly used in the Netherlands. Consequently, the Netherlands is among the EU countries with the highest use of debit card transactions. Two other important payments means are direct debits and credit transfers, see Figure 4.2. The Netherlands is also quite strong on the use of E-purse payment transactions compared to other EU countries (Figure 4.3), yet relative to the use of debit cards it remains very small. The most widely spread form of E-purse payment is Chipknip.

71 The changes were initiated by the review of the structure of the payment system by the Wellink Working Group, comprising the Governor of the Dutch Central Bank, the Chairs of several major Dutch financial institutions and two observers from the Ministry of Economic Affairs and the Ministry of Finance (DNB, 2004a).

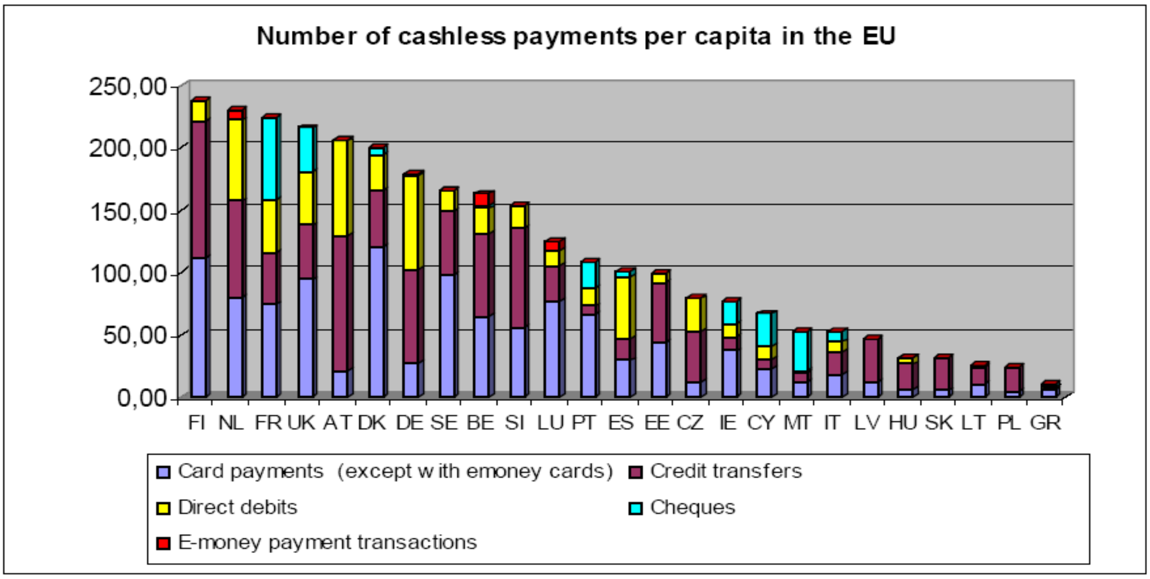
103. Figure 4.2 shows that cash payments are being replaced by non-cash payment methods, apart from an anomaly during the cash changeover to the Euro. Cash instruments grew temporarily during this period, as they did in other EU countries (Figure 4.4).[72]

104. It is worthwhile to focus in more detail on how the market shares of different payment instruments in the Netherlands have evolved through time. Figures 4.1 and 4.2 show considerable growth in the use of e-purse and debit cards. The use of other payment instruments has increased as well but at a slower pace.

105. When comparing cash to debit card, cash has been estimated as more cost-efficient for payments below EUR 11.63, while the debit card were estimated to be cheaper for higher amounts. Cost savings would be most pronounced if more payments were made by e-purse, irrespective of the specific transaction amount. A scenario where the number of electronic payments would double, replacing 1,500 million cash payments (1,000 million by debit card payments and 500 million by e-purse payments), is claimed to provide a cost saving of over EUR 100 million (DNB, 2004a).

106. Other important data pertain to the profitability of payment services to banks in the Netherlands. In Figure 4.5 some results are reported from the McKinsey study (McKinsey, 2006) commissioned by the Dutch Central Bank and the Netherlands Bankers Association. The key result of this study was that in the aggregate banks lost €23 million (in 2005) on payment services.[73] Figure 4.6 shows that there was a considerable cross-subsidization. In particular, banks made profits on payment services to companies, yet made losses on services provided to consumers.

Figure 4.3: Comparison of cashless means of payments in the Netherlands with other EU countries



Source: Commission services retail banking sector inquiry, 2005-2006.

72 The phasing out of the guilder may have caused a very steep drop in notes in circulation in 2001. Following 2001, people started building up their cash balances again. Also, the increased use of the Euro outside the Euro-area contributed to a temporary growth in cash payment instruments. Note also that following the introduction of the Euro one can no longer assess the magnitude of banknotes and coins in circulation in individual Euro-countries.

73 Note that the study was based on one year of data and one interest rate, and, thus, may not be representative of all years.

Figure 4.4: Annual number of non-cash transactions per inhabitant vs. coins and notes in circulation (2003 vs. 2004)

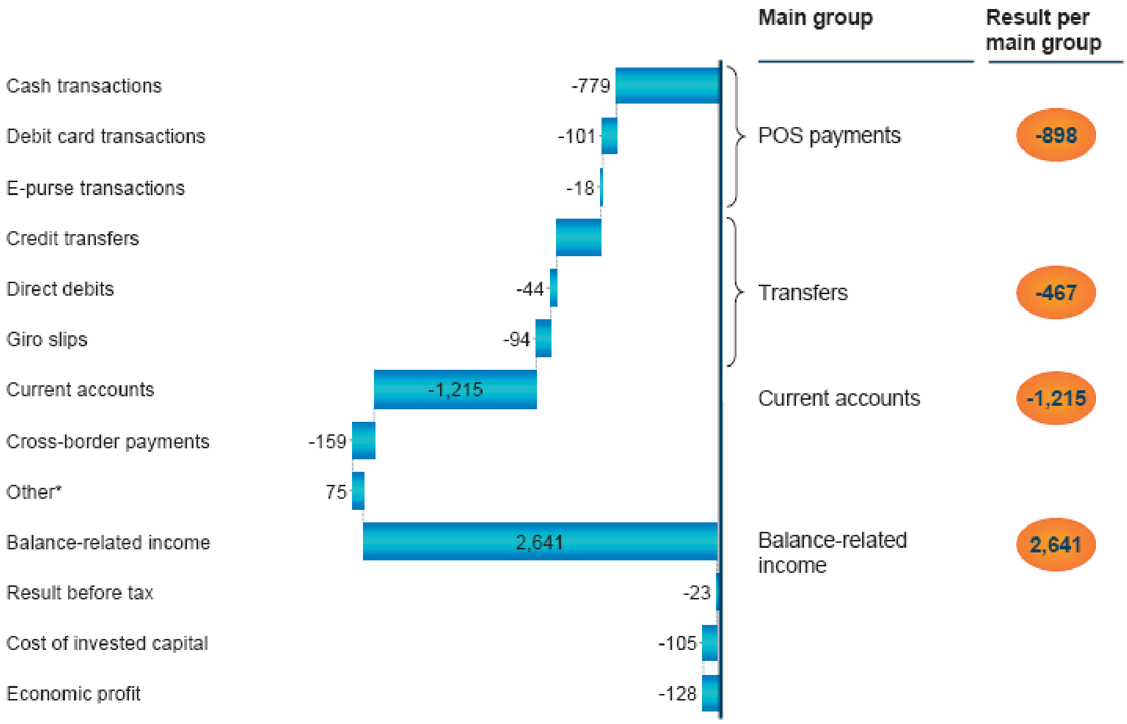
Source: ABN AMRO/Capgemini 2006.

4.3 Frictions and inefficiencies in the Dutch (pre-SEPA) payment market

4.3.1 Overview

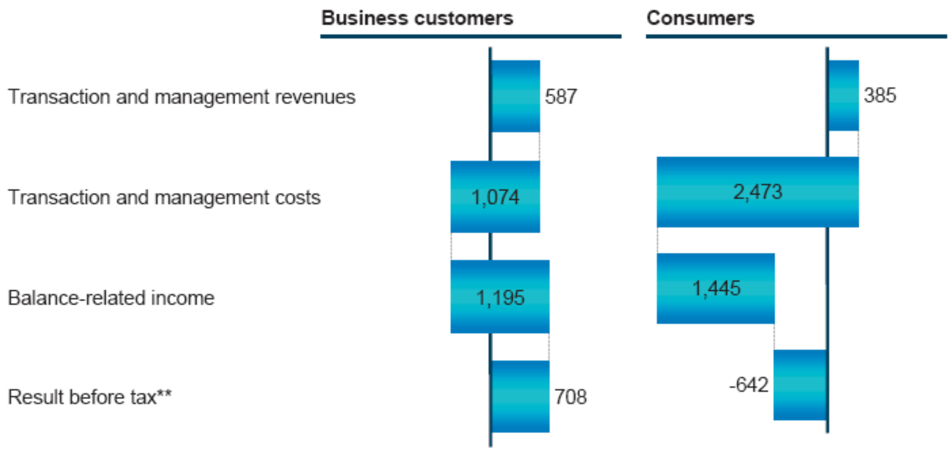
107. The focus in this section is on the current state of the Dutch payment market. The impact of SEPA and its implications for existing barriers to entry and inefficiencies are discussed in section 4.4. The section starts out with some observations about entry barriers in the Dutch payment market (subsection 4.3.2). Subsection 4.3.3 focuses on other potential inefficiencies, in particular, the consequences of the lack of transaction pricing in the Dutch payment market. In subsection 4.3.4 the focus is on a particular recent change imposed on the Dutch payment market structure, *i.e.* the transfer of merchant PIN-contracts from the collectively owned industry-wide payment organization (then Interpay, now called Equens) to individual banks. Merchants can now directly negotiate their PIN-contracts with individual bank.

Figure 4.5: Overview of revenues and costs for banks from payment services (in million €)



Source: McKinsey, 2006.

Figure 4.6: Comparison on total profits on business customers and consumers



Source: McKinsey, 2006.

4.3.2 Evidence on entry

108. As stated in OECD (2006a), pg. 4: "Since the establishment of Currence, banks must obtain a license from Currence in order to carry out issuing and acquiring with regard to collective payment products in the Netherlands. Currence also certifies third parties (such as processors, terminal and card suppliers) who want to offer other services within the Dutch electronic payments system. Currence also

sets the (technical) standards for point-of-sale terminals that are supplied in the Netherlands by specialized companies, such as CCV and Alphyra." The OECD (2006a) concludes that "Currence is the sole institution in the Netherlands that can give market parties (banks, payment product providers…) access to the market of collective payment products".

109. The actual conduct of Currence is key to assessing its impact on competition. Currence was established to create a level playing field for incumbents and entrants to the Dutch payments market by setting up a transparent rules and licensing structure while maintaining quality and safety, see Currence website (www.currence.nl; only in Dutch language). It has been established as an independent organization with transparent, objective, and non-discriminatory criteria. While incumbent Dutch banks are the actual shareholders of Currence, these shareholders are not permitted to impact Currence's policies and actions directly or indirectly.

110. A survey by the European Commission is instructive in this respect (EC, 2006a). Potential entrants indicated that the most popular type of cross-border entry in Europe was to offer acquiring services under a cross-border license.[74] Attempts to enter were made by directly opening branches/subsidiaries in another country through either the purchase of an existing foreign bank, by offering services under a cross-border card acceptance programme, or through a joint venture with a local acquirer. The respondents mentioned the Netherlands among countries with strong barriers to cross-border entry. One entry barrier may be that payments are a loss-making activity (see McKinsey, 2006).

111. Cross-border acquiring refers to the acquiring of transactions from merchants located in a country other than the country in which the acquiring bank is physically established. Cross-border acquiring licenses are currently issued only by the international payment networks, essentially only MasterCard and Visa. In the past, both MasterCard and Visa allowed cross-border acquiring only for specific merchant categories, i.e. international airlines, car rentals agencies and hotels. Currently, according to some responding acquirers that hold a cross-border license for both MasterCard and Visa, cross-border acquiring efforts are mainly directed at the e-commerce industry, *i.e.* various groups of merchants offering goods and services through the Internet. It might be noted, however, that credit cards account for a small part of total transactions in the Netherlands.

112. In several Member States, acquiring of Visa and/or MasterCard transactions is done by a single player. Such acquirers act as *joint ventures* of incumbent banks that at the same time issue cards on that market. In the Netherlands, PaySquare BV – a joint venture of Dutch banks for acquiring merchants for MasterCard and Visa credit card and a 100% subsidiary of Interpay – services basically the entire market.[75]

113. The investigation by the European Commission identified several barriers to entry in the payments markets (EC, 2006a, 2007). These barriers are of a structural, technical or behavioural nature. Focusing on structural barriers, the most relevant for the Netherlands are the diverging technical standards that exist between the Netherlands and the EU that may hinder acquirers, processors and terminal vendors from operating in the Netherlands. Note that similar problems also exist in other Euro-area member states. Such barriers are one of the rationales for the SEPA initiative (see section 4.4).

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74 Acquiring services can be defined as follows. The acquirer writes contracts with merchants who wish to provide their customers with the possibility to pay with a card. The merchant pays for this service a merchant fee to the acquirer. The merchant may also have to pay an interchange fee to acquirer, which is a per transaction fee levied by the issuer.

75 Some marginal cross-border acquiring kept the HHI index in this market actually at 8000 (and not 10000 as would be the case in a total monopoly), see EC (2006a).

114. Even though the fees for entering the PIN scheme (the domestic debit card scheme) are relatively low in the Netherlands (approximately €50000, among the lowest in the EU, see EC, 2006a), cross-border acquiring is still difficult because a local bank account is needed. That is, in the Netherlands the national system rules require the *local presence* of a foreign entrant, by means of establishment of a local branch and/or a subsidiary (ECB, 2006b). This requirement may present a substantial barrier to entry. For instance, when a foreign retail company starts doing business in the Netherlands, it possibly needs to allow for payments using the PIN debit card. This forces a foreign company to open a bank account at a bank in the Netherlands.[76] Consequently, a foreign bank without access to the PIN scheme cannot follow its clients to the Dutch market. Of particular importance is also that non-banks cannot get access to the payment market as an issuer of acquiring services since a bank license is needed for this. They can – and do – offer other services, such as acting as payment transaction processors.

115. The Dutch PIN debit card is co-branded with Maestro (a debit card of MasterCard). While domestic payments are processed using the PIN scheme, the international payments are processed through MasterCard. Yet, a foreign Maestro card (without PIN) cannot be used in the national Dutch payment system unless Dutch merchants choose to accept Maestro together with the necessary investment. This in effect forces foreigners wishing to use payment cards to open a bank account at a Dutch bank.[77]

4.3.3 Other frictions in the Dutch payment market

116. A particular problem in the Dutch market is the lack of transaction pricing. Banks are reluctant to lose deposit market share by being the first (and perhaps only) bank to implement explicit prices for consumer payment services. In addition, antitrust authorities would be suspicious of industry efforts to coordinate such pricing. While businesses typically pay directly for their payment services via explicit transaction fees or compensating balances, consumers have traditionally paid implicitly through lower (or no) interest on transaction balances or lost float (see Bolt, 2006).

117. The Dutch national payment system is relatively efficient if considered as a closed system. Dutch banks appear not to be earning excessive rents on payment transactions. While consumer payment services are essentially free (and thus impose losses on banks), the practice of "value days" (lost float) and no interest payments on current accounts provided for some compensation, as did sizable positive profits on payment services to corporations (see Figure 4.6). Value dating will, however, be prohibited under the Payment Services Directive.

118. More explicit and transparent pricing might improve the choice of payment instrument among consumers. Similarly, Brits and Winder (2005) conclude that the current tariff structure of payment instruments in the Netherlands does not provide sufficient incentives to stimulate the use of the most efficient payment instruments. Due to the non-transparency and absence of direct tariff structures, large-scale cross-subsidization is likely to be present in the Netherlands. The authors also claim that the reason why banks do not implement a more cost-based pricing strategy is because they are locked into a prisoner's-dilemma type of situation. Increased competition in the market for acquiring might lead banks to stop cross-subsidizing more costly means of payments.

119. Surcharging may also help, and is allowed in the Netherlands. Yet, surcharging not linked to cost might also distort incentives to use the most efficient payment method, i.e. surcharging debit card

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[76] This problem will disappear with the introduction of SEPA.

[77] One can expect initiatives that bilaterally link electronic cash systems between countries. For example, a recent pilot seeks to link the PIN system to the German electronic cash system. This would allow a German debit card to be used in a Dutch store (see the Dutch language *Banking Review,* May 2007, pages 10-11.

payments without at the same time surcharging less efficient payment methods by their costs will stimulate consumers to use less efficient payment methods rather than their more efficient debit payment cards.

120. Dutch banks also suggest another distortion. Suboptimal fees due to the cost of data communication (telecommunication company fees) in case of POS-transactions might induce merchants to encourage less efficient modes of payment among their customers. In the Dutch market, merchants bear a relatively high cost for this part of a POS-transaction, and are inclined to minimize this cost by surcharging customers if they want to use their payment card for low payment amounts (below €10-€15), again favouring cash transactions (NBA, 2006). Recently, market parties in the retail payment market have come up with all-in packages for PIN acceptance which focus on the needs of SMEs and are intended to small retailers to accept PIN. [78]

4.3.4 Is the transfer of merchant contracts effective?

121. The migration of merchant acquiring contracts from Interpay to the individual banks has been evaluated by NMa (NMa, 2005). The central question is what effect the change in the structure of payment services had had on the prices that retailers pay for PIN transactions. In 2004, 78% of the PIN-contracts passed over from Interpay to individual banks and retailers had the chance to renegotiate for better conditions. Only 4% of retailers (mainly the bigger ones) contacted their banks to get a better deal, yet 83% of the retailers knew about the institutional changes in the market and 65% of the retailers knew that the changes made contractual conditions negotiable. Actual switching between banks was negligible (NMa, 2005).

122. In the end only a very few retailers entered into a new PIN contract with a bank other than their house banker. Various possible reasons can be given for this. In cases in which the retailer negotiated a new PIN contract with the bank, the purchase of other services was often required as a condition for a PIN contract. Nevertheless, the average difference between the first and the final offer in the negotiations on payment tariffs was 7.4% (OECD, 2006b).

123. This evidence on switching confirms that the transfer of PIN contracts from Interpay to the individual financial institutions led to some limited increase in competition between acquiring banks. Some savings were realized despite limited actual switching. In particular, large retailers have made some gains. SMEs do not appear to have sought alternative providers.

4.4 SEPA

4.4.1 Definition and objectives of SEPA

124. The ECB states that the definition and objectives of SEPA are as follows (ECB, 2007). The Single Euro Payments Area (SEPA) “aims at advancing European integration with facilitating a competitive and innovative euro area retail payment market.” In such markets, “consumers and companies will be able to make and receive payments in euro, whether between or within national boundaries under the same basic conditions regardless of their location.” SEPA focuses on credit transfers, direct debts and card payments. It provides common technical standards and business practices on a harmonized legal basis that will lead to efficient processing infrastructures for euro payments.

125. European banks have organized themselves (in the European Payment Council) in order to realize the standards and business rules for European credit transfers and European direct debits, in order to

[78] “*Stichting Bevorderen* Efficient *Betalen*”, a joint initiative by retailers and banks, had asked telecom providers, banks, processors and POS terminal vendors for such “all-in packages” for PIN acceptance.

be able to efficiently and safely process credit transfers and direct debits between participating banks. Rulebooks lay the cooperative basis (business practices, standards and rules) for banks to develop their concrete product offering to their clients. These rulebooks contain for instance a minimum service level in terms of execution time, liability rules and technical standards. (For card payments, these rulebooks already exist as developed by MasterCard and Visa, who operate global systems on that basis.)

126. European banks have defined a framework that clarifies the rules and procedures for infrastructure providers (i.e. ACHs, card scheme processors and other processors that handle, transfer and exchange payment-related information for financial institutions) facilitating the emergence of a pan-European market for payment instruments and providers. It is hoped that this “SEPA environment” will allow providers to compete and offer their processing services to any bank or card scheme provider, regardless of their country of origin. Competition and cross-border ease of transactions are not the only goals of SEPA, however. Security is also an integral part of all payment systems and justifies restrictions on the ability to connect directly into the payment systems.

127. The envisioned advantages of SEPA include

- Benefits of economies of scale;
- Enhanced competition in retail banking markets;
- More efficient use of payment instruments; and more controversially,
- Enhanced opportunities for new innovations and propositions for cardholders (EPC, 2007; ECB, 2006c; and NMa, 2006, Chapter 6). The latter advantage is more controversial since the standardization inherent in SEPA could also stifle innovation.

128. To facilitate the emergence of an integrated European payment market the European Parliament adopted the proposal for the Payment Services Directive that includes specific requirements for suppliers of payment services that seek to augment transparency of pricing and speed of transactions (NMa, 2006). Measures to smooth access to licenses for non-bank suppliers of payment services are intended. SEPA is meant to be a market-led self-regulatory initiative, thus leaving financial service providers, not governments and/or policymakers, to propose and establish mechanisms.

4.4.2 Standardization for cards

129. An essential element of SEPA is that it seeks to harmonize cards and standard for payment instruments. To ensure that cardholders can use their SEPA cards across the euro area, it is important to ensure that merchants can in principle accept all SEPA cards. To secure this objective, there should be no technical barriers to competition. Standards are the basis for open and fair competition. They should cover every phase of the transaction chain (cardholder-to-terminal, terminal-to-acquirer and acquirer-to-issuer), the security evaluation and the certification of devices. Concerning terminals in particular, standardization and the definition of an adequate and independent certification body is essential to ensure that any card can be accepted at any terminal. Participation in the definition of standards should be open to all stakeholders. In addition to technical standards, additional requirements in terms of business rules and practices are needed to ensure that cardholders have access to as many POS terminals as possible. This will also contribute to creating a level playing-field for inter-scheme competition (ECB, 2006c).

130. The objective is that enforcing common technological standards should lead to considerable economies of scale and more competition. Currently a terminal must not only be separately certified in each country, but separate software must also be written for each separate country. Thirty or more

protocols are currently supported across the EU (Dialogue, 2007). The current situation that separate software must be developed in each country makes terminals much more expensive than they need to be (PDHN, 2006). Obviously, this current state of affairs has clear implications for the (cross-border) competitiveness of the payment market.

131. The transformation of an existing infrastructure (at least 350 million cards, 6.7 million POS-terminals, 326,000 ATMs in the EU27 countries, multiple acquiring and issuing operators, multiple networks and multiple banking infrastructures) will take time and, even when specifications or best practices are promoted, ultimately market forces will decide on the actual choice of interoperable solutions and the pace of transformation (EPC, 2006b).

4.4.3 Cooperation, competition and self regulation

132. An important issue is how to have market forces at work (i.e. competition) but simultaneously allow for a certain degree of collaboration and cooperation. The business architecture of SEPA is intended to allow for competition and cooperation at the same time. First, there will be the competitive financial institutions layer in which financial institutions provide SEPA products and services for customer use. The second layer relates to the scheme cooperation. This defines the basis on which financial institutions cooperate to provide standards, rules and interoperability. The third layer relates to the processing infrastructure. This layer is primarily competitive, although communities of financial institutions can and do cooperate to meet common needs.

133. The implementation of SEPA is meant to lie with market forces (primarily banks and existing payment schemes), yet, national central banks, payment associations, and public authorities may play an important facilitating, if not coordinating, role. While competition concerns might interfere with coordinated collective action, it is not obvious how SEPA will develop when banks are left on their own. First, banks may be reluctant to implement SEPA since its implementation may bring high costs. The national and EU regulators may then have to step up the pressure on banks to meet selected deadlines in SEPA implementation. Second, banks may opt for such a development of the payment system that gives them the highest rents, but that need not be the most efficient. To prevent this, several other stakeholders have to be drawn more closely to the implementation of SEPA. In the Netherlands, the merchants' association, The Platform Detailhandel Nederland, expressed a wish to be involved in the SEPA implementation (PDHN, 2006). The current process does indeed explicitly incorporate merchant participation via the creation of a platform called "Afstemgroep SEPA Nederland". The consultation on the national migration plan has identified a set of serious concerns that the migration to SEPA could bring. Of particular concern is that SEPA may lower the efficiency of the Dutch payment system. More specifically, the enforced standardization might dismantle the efficient Dutch national payment system and replace it by possibly less efficient international payment systems.

134. An example of a positive role of cooperation that leads to innovation in payment services might be the recent implementation of the common Internet platform by ING, ABN AMRO, Postbank and Rabobank. They introduced a common standard for Internet payments called iDeal.[79] The ownership of iDeal has now been transferred to Currence so that other banks can also offer this payment product. Customers are able to pay electronically using iDeal through the website of their own bank, a variant of internet banking. (NMa, 2005).

79 Press Release, Ministry of Economic Affairs, 9 March 2005, http://www.ez.nl/dsc?c=getobject&s=obj&objectid=142912&!dsname=EZInternet&isapidir=/gvisapi/

4.4.4 Analysis of implications of SEPA for debit cards in the Netherlands

4.4.4.1 SEPA compliant?

135. The migration of SEPA means that the existing payment instruments for credit transfer, direct debit and debit card payments are substituted by European corresponding payment instruments. As it stands, approximately 92% of all domestic payments can be migrated to SEPA payment instruments. Credit transfer, direct debit and cards roughly represent equal thirds.

4.4.4.2 Replacement of PIN by an international scheme

136. A potential key policy concern is that the implementation of SEPA for cards may paradoxically lead to increases in fees and thus be possibly detrimental to European citizens and merchants. Particularly in the Netherlands with its relatively low cost and rather efficient PIN debit card system, SEPA might be detrimental if it leads to the phasing out of the domestic debit card system and a convergence to the on average higher fees in the rest of Europe or towards cross-border fee levels.[80]

137. The decision to close national card schemes and replace them with an international one has non-trivial competition implications. It is not clear how this may even be allowed as a concerted coordinated action. Nevertheless, market forces could push in that direction. The temptation might be there because it represents a quick and easy way to adapt to the SEPA Cards Framework (SCF). Replacing the national scheme with an international scheme largely shifts the burden of SEPA implementation to the international scheme owners. However, international scheme companies have already made their schemes SEPA compliant and the PIN scheme is close to being SEPA compliant as well.

138. However, the expected proliferation of international card schemes with their typically higher interchange fees could induce banks to choose and promote such schemes over their national schemes. Competition between schemes has the potentially perverse effect of driving up interchange fees in order to attract banks to join a scheme.[81] The Eurosystem is concerned about such an evolution, as this could lead to an increase in the fees paid, in particular by merchants, which directly contradicts the objectives of SEPA. While the Eurosystem welcomes the willingness of Visa and MasterCard to offer domestic card services for the euro area, it is deeply concerned about a possible evolution whereby the two international card schemes progressively become the only providers of card payment services offered by banks in the euro area (ECB, 2006c).

139. Up to now, the two schemes have functioned with very similar business models, with relatively high cost structures and high interchange fees, which leads the Eurosystem to fear that competition limited to these two systems would be insufficient to maintain the present low level of fees in some domestic markets. Additional worries are triggered by uncertainties about the governance of the two systems. MasterCard has abandoned the user-driven model in favor of a shareholder-driven solution, and Visa has recently announced similar intentions. Indeed, the fall back multilateral and actual interchange fees are higher with Visa and MasterCard than with national schemes. Therefore the extension of the use of these two schemes at the domestic level creates the risk that merchants could have to pay higher fees. For this reason, merchants have expressed significant concerns about the side-effects of SEPA migration (ECB, 2006b).

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80 Note that low levels of tariffs, and the prisoner's dilemma that might have preserved them, may induce inefficiencies as well. For example, it was already pointed out that corporate clients subsidize the payment services for consumers in the Netherlands. This cross-subsidizing could induce distortions. Also low tariffs may go at the expense of introducing innovations.

81 When there is one scheme, this potentially perverse effect of system competition is absent.

140. One could counter that the unbundling of activities (as with Interpay and Currence) should create the opportunity for new players, such as payment processors, to start offering authorization and clearing and settlement processing services, competing against the existing processing infrastructure of the international card schemes. However, the strong market position of the international card schemes may prevent such competition from emerging. For them, processing is a core business, and they will compete very hard to protect their franchise. In the case of the Netherlands, the processing company Interpay (now Equens) could have a hard time surviving if banks decide to abolish the PIN scheme. Note that SEPA does not require a separation like that of Currence and Interpay. It might be desirable to amend SEPA if otherwise a duopoly of Visa/MasterCard is unavoidable.[82]

4.4.4.3 Co-branding a domestic card with an international card scheme

141. To make their debit systems SEPA compliant and protect their continued existence, banks may decide to co-brand with an international card scheme (as is already the case in most countries today), provided that both schemes in question are SCF-compliant.

142. Co-branding offers banks the possibility of providing a single service to cardholders and merchants throughout the euro area. However, Eurosystem fears that co-branding would merely perpetuate the present situation, whereby a multiplicity of schemes is protected from competition by national borders. If most schemes were to opt for co-branding and if this situation were to become permanent, SEPA may neither benefit from economies of scale nor from competition, as national schemes could possibly retain national business, and only cross-border transactions would be routed through international card schemes.

143. However, co-branding may also offer distinct competitive benefits if it could prevent a duopoly of Visa and MasterCard. An advantage of co-branding is that banks could possibly retain the efficient national (PIN) payment system, help contain market power with Visa/MasterCard and could possible also give a better strategic position to the national processing company Interpay (Equens).

4.4.4.4 Alliances and/or introducing a new EU scheme

144. An alternative is to leverage the existing European national schemes. Domestic card brands can become SCF-compliant internally, and then enter into alliances with one or more other SCF-compliant domestic debit card schemes. Most German banks have taken this route. For example, ZKA is making its EC Cash brand SCF-compliant, and plans to hook up with Multibanco in Portugal. The medium-term objective is to link existing national debit card schemes to allow mutual technical acceptance of payment cards, but the overall objective is to create a new pan-European network ("Euro Alliance of Payment Schemes", EAPS).

145. EAPS comprises as its founding members Electronic Cash and Deutsches Geldautomaten-System (Germany), the Convenzione per la Gestione del marchio Bancomat (COGEBAN, Italy), Eufiserv (a European supplier of processing services for ATMs, based in Brussels), Link (the UK's ATM switch), Euro 6000 (Spain) and Multibanco (Portugal). (EAPC, 2006).

146. Initiators of EAPS maintain that the EAPS approach offers the possibility to enhance pan-European reach at lower costs, since it relies on existing infrastructures and national market acceptance,

82 NMa (2006, pg. 173) points also to the potential positive effects of vertical disintegration for innovation.

simply enabling interconnectivity. EAPS may therefore offer a way to maintain the efficiency of existing national card payment systems within SEPA.[83]

147. An alternative step would be to create a new European scheme. A group of banks could seek to create a new European card scheme. Several banks are sceptical about the viability of such a third international payment scheme.

4.5 Interchange fees

148. The theory of two-sided markets which is at the core of the discussion about interchange fees does not yet allow for unambiguous conclusions and policy implications when it comes to the desired levels of interchange fees.[84]

149. The empirical evidence on the interchange fees in the EU shows that there exist substantial differences between interchange fees across the EU countries. Furthermore, issuing appears highly profitable, particularly when it comes to credit cards, and continues to be profitable even with a zero level of interchange fees. Also the levels of interchange fees seem not to be negatively correlated with the cost of card owners. This shows that interchange fees are likely to be retained by banks and are not (fully) transferred to card owners.[85]

150. In the Netherlands, the interchange fees are relatively low. The NMa has examined closely banks' suggestions to introduce a multilateral interchange fee (MIF). Over the past years the NMa was frequently asked for an exemption of Section 6 (1) of the Dutch Competition Act[86] with respect to the introduction of a MIF for different payment products. Since 2003 the NMa has been looking closely at the setting of MIF, in the light of the two-sided market theory. In recently handled cases the NMa has requested the parties to give quantitative information e.g. about demand curves and the assignment of costs, to prove that the set MIF was necessary in these specific cases. As they could not deliver sufficient evidence for the necessity or the level of the MIF, the NMa has not exempted any MIF since 2003. There is considerable uncertainty about this issue, not unlike the ambiguous theoretical results. It is not even clear whether interchange fees are at all needed in the Dutch market.

151. The discussion on interchange fees is also important for the viability of domestic payment schemes. A potential danger is that possibly higher levels of interchange fees in certain schemes might

83 However, some national card schemes have so far declined the invitation to join EAPS because they consider that the cost and level of complexity of establishing bilateral arrangements are too high, in conjunction with the perceived lack of a business case (see ECB, 2006b).

84 For recent developments, see Baxter (1983), Schmalensee (2002), Rochet and Tirole (2002) and Wright (2004). The various arguments are summarized in NMa (2005), OECD (2006a), and EC (2006a).

85 On a pan-EU scale, credit card issuers had a weighted average profit-to-cost ratio of 65% in 2004 while debit card issuers had a weighted average profit ratio of 47%. In most EU Member States, the weighted average profit ratios remained fairly stable over the period 2000 to 2004. It therefore appears that in most countries the magnitude of profit ratios is not related to different stages of the business cycle in each market but rather follows a medium-term trend. Interchange fees appear to magnify these profits. It appears that 62% of all banks surveyed would still make profits with credit card issuing even if they did not receive any interchange fee revenues at all. In 23 EU Member States, at least one bank participating in the survey was able to make a profit from issuing credit cards without interchange fees. The weighted profit-to-cost ratio of all respondents for credit card acquiring was 15.9% in 2004 and for debit card acquirers 5%. In a large number of EU Member States, profit ratios remained fairly stable over the period 2000 to 2004 (EC, 2006a).

86 The equivalent of Article 81(1) EC.

distort banks' strategic decisions in payment markets and make them inefficient. In particular, high levels of interchange fees in international schemes might make them more attractive for banks and might induce banks to abandon their domestic payment system.[87]

152. Market forces may therefore be insufficient to "penalize" card systems with relatively high interchange fees, at least as far as fees for cross-border payments are concerned. The analysis of *cross-border interchange fees* on the evolution of MasterCard and Visa fees between 2001 and 2004 raises the question why the weighted average of MasterCard cross-border interchange fees for credit cards increased from 2002 even though Visa's weighted average interchange fees for cross-border payments decreased from that year onwards. In other words, does inter-system competition between MasterCard and Visa act as a disciplining market force on bodies setting interchange fees in these networks? The development of MasterCard cross-border interchange fees could suggest that inter-system competition did not restrain MasterCard from maintaining higher cross-border interchange fees than those of Visa over more than three years (2002 to 2004, see EC, 2006a).[88]

153. This report does not take a stance on the level of interchange fees or the desirability of MIFs in particular. It is clear, however, that introduction of a European MIF in the Netherlands would exert upward pressure on prices of direct debits and card payments.

5.0 Recommendations

5.1 Entry

Ensure that regulatory provisions for small financial service providers do not act to discourage entry, e.g. by a bank with only a few branches.

154. There appears to be very little real entry by single-branch banks in the Netherlands, although issuance of banking licenses is active. To the extent that small banks may provide service competition to wide-network banks, particularly for SME services, this absence of entry is worrying.

155. It may be that banking is not particularly profitable, which reduces incentives for entry. But there are indications that some areas of banking activities in the Netherlands are profitable, such as SME services. Therefore the relative absence of significant entry is a puzzle. The government should study cost structures for essential memberships (e.g., of credit bureaus, banking association and payments systems), for regulatory reporting and for minimum capital requirements to ensure that fixed entry costs are not disproportionate to the size of new institutions.

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87 Obviously in such evaluation banks will (and should) also take into account the effects this has on the choice by consumers between payment instruments.

88 The lack of responsiveness of card fees with respect to market forces can in part be attributed to blending. Acquiring banks frequently use blending, that is they bundle prices for their cards. In nine countries, Czech Republic, Estonia, Greece, Italy, Latvia, Netherlands, Poland, Slovakia and the UK, domestic and foreign acquirers reported, to some extent, partial blending. Dutch and Slovak acquirers reported that they practiced blending less frequently for smaller merchants than for larger ones (EC, 2006a). Allowing for higher competition in acquiring markets might change this situation. If acquirers compete fiercely for their markets, they may be forced to price discriminate between different card schemes. True cross border issuing and acquiring could then possibly put additional pressure on the level of interchange fees (PDHN, 2006).

156. The government should review its own regulations of banks and other small, specialized institutions to ensure that regulations do not unduly burden small banks and make small-scale operations shoulder high fixed costs of regulatory burden.

5.2 Switching

Introduce legislation and regulation to support existence of credit registries with fine-grained information about clients that respects privacy laws and does not contain information that would facilitate collusion, such as price of services being offered.

157. The current credit registry that applies to SMEs and consumers has very thin data. Banks that do not have an existing relationship with a prospective customer face an adverse selection risk. Thus, customers who seek out new banks are subject to risks of being considered lemons, which makes them less attractive to a potential new bank. This risk can be countered through the production of detailed credit registry information that would allow credit scoring of many SMEs. Laws and regulations on information sharing might need to be changed to promote such registries. Any such changes should involve consultation with the NMa, to ensure that shared information would not promote or support potential collusive arrangements. Notably, price information (such as interest rates) should be excluded from such registries.

Increase mobility of specialized insurance products linked to mortgages.

158. Mortgage origination is highly competitive in the Netherlands. But refinancing is likely less competitive. One reason is that if special insurance products have been purchased in conjunction with the mortgage, it may not be possible to move these over to a refinanced loan. This lack of mobility can have the effect of locking people into high interest rate loans, reducing refinancing to a level below that which would otherwise exist. The government should take action to ensure that the special insurance products related to mortgages are portable from one mortgage loan to another.

5.3 Payments

Do not accept SEPA proposals that would have a likelihood of significantly raising the combined consumer and retailer cost of payments in the Netherlands, including implicit costs. Posted prices for services to the combined consumer and retailer are likely to rise after SEPA, however, to the extent that implicit subsidies from other parts of the banking process are eliminated to create more transparent pricing of payment cards or that SEPA creates additional cost burdens.

159. The Netherlands currently has one of the lowest cost card-based payment systems in Europe. Potential debit and credit card proposals linked to SEPA may have the impact of raising costs for the purchaser/merchant combination higher than they are now. Competition between payment systems can, at times, raise the costs for the purchaser/merchant combination, because banks will seek out the most profitable options and the purchaser will not always choose the lowest-cost means of payment. Less efficient card payment systems may become more common as a result of SEPA. Such an outcome is not desirable. The government's efforts to maintain at least the current level of efficiency are worthwhile and should be maintained. The European Commission should also keep a close watch on the local effects from implementing SEPA and avoid creating a system that has detrimental effects on efficiency, particularly given that international payments likely account for less than 2% of total payments.

5.4 Regulation and supervision induced frictions

Change laws and regulations so that functionally equivalent products have same regulations.

160. The existing regulatory structure for financial products has been modernized in recent years, notably with the creation of the AFM and the new supervisory legislation. However, there are still a few areas in which substitute products are subject to different regulatory requirements. These different requirements may at times give a competitive advantage to one product over another, purely as a result of regulation. The asymmetric regulations apply to different types of investment products, different types of payment products, and different taxation structures. The government should continue its efforts to level the playing field, through actions such as passing the change of the Besluit gedragstoezicht financiële ondernemingen.

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