**Final version, July 1, 2007**

# Competitiveness assessment and key issues for the Dutch retail banking sector

by Arnoud W.A. Boot*

A report submitted to the OECD.

*Acknowledgements:* Without implicating them, the author is grateful for the extensive comments provided by representatives of the Dutch Ministry of Economic Affairs, the Ministry of Finance, the Dutch Central Bank, the AFM and the NMa (Netherlands Competition Authority). The content of the report is the sole responsibility of the author.

*University of Amsterdam, CEPR and director of the Amsterdam Center for Law & Economics, see www.fee.uva.nl/fm, contact information: secretariat +31 20 5254162, fax +31 20 5255318, e-mail: a.w.a.boot@uva.nl.

***Table of contents***

***List of Tables***



***List of Figures***

## *Summary and main insights*

The study extensively discusses how to measure and evaluate competition in the Dutch banking market. Concentration by itself is not an appropriate measure of (lack of) competition. Rather, the focus should be on whether entry is possible ("contestability" of the market) and the existence of a competitive fringe. Across banking products and services and between different types of customers considerable differences in contestability and competitiveness are likely to exist (see section 1.1).
At the same time, the heavy regulatory interventions in the banking industry, together with concerns about the public confidence in the banking market at large, tend to lead to considerable exit barriers so that poor performers do not exit the industry. This has negative implications for the competitiveness of the banking industry (section 1.3.5).

Another general observation is that competition is not only dependent on market structure but has much to do with culture as well. This is particularly relevant in a sector like banking where cooperation is sometimes needed (note the network nature of banking, e.g., the payment infrastructure) and old networks of individuals ("social clubs") and business conventions facilitate this. A careful evaluation of collaborative practices is warranted, in particular to evaluate efficiency benefits of cooperation against the competitive distortions it may create. Substantial collaborative arrangements are present in the Dutch market; some scrutiny is therefore warranted (section 1.3.3).
These mechanisms may also run via the prudential regulator that tailors arrangements to the incumbent players and in doing so could discourage entry (section 1.2.5). Similarly, regulatory practices might distort competition by creating exit barriers (section 1.3.5), and/or induce regulatory arbitrage (section 1.3.2).

While the Dutch consumer banking market is often considered low cost, particularly when it comes to payment services, several potential competitive concerns could be raised:

- As an overall observation, entry in the Dutch market is limited. The market shares of incumbent banks for many activities appear rather stable (section 1.1.1). These stable market shares manifest themselves also in limited switching of clients (section 2.2.2; Table 2.5);
- Payment services are rather low cost for consumers. However, substantial cross-subsidies exist between corporates/SME and consumers. That is, banks make substantial profits on payment services to corporates/SMEs, and "use" these to subsidize payment services to consumers (section 3.2.2). Nevertheless, there is no evidence at all that consumer banking is not profitable in the Netherlands. Cross selling is important and facilitates profitability. Moreover, further efficiency gains are possible when it comes to payment services (e.g. the facing out of paper incasso's, "overschrijvingen");
- More in general, the contestability of the SME market is a potential concern. The dependence on local branches for these businesses is (still) considerable. Particularly for such branch dependent customers, the contestability of the Dutch market is limited (section 2.2.1);
- Established practices in the SME market create strong lock-in effects. SMEs with credit facilities are almost exclusively tied to their house bank (section 2.2.3).

Moreover, while some credit information sharing via the BKR register exists in the Dutch market, this mainly applies to consumer loans. A more comprehensive credit bureau type information sharing could possibly help mitigate lock-in effects. It is crucial however that such credit bureau cannot operate as a collusive device (section 2.2.4).

The consumer market might offer a (even) more diverse picture of contestability. Entry in several activities does not require a branch network; contestability might therefore be more likely. Relative to SMEs, consumers can easier switch and also more often have multiple accounts. Nevertheless:

- Contestability for current accounts is limited. The three big players dominate this market (section 2.1.2). The low, subsidized cost of consumer payment services might be in part at the root of this (section 1.1.3);
- Incumbent banks have a strong competitive position facing low contestability for activities that are more branch dependent (section 2.1.2 and section 1.1.3). This applies to, for example, more complex, often mortgage related financial arrangements. For these mortgages, new entrants like Royal Bank of Scotland choose to focus on standard mortgages that allow for a more distant market penetration (albeit often using intermediaries);
- Extensive fiscal arrangements, often incorporated in life insurance features are prevalent in the consumer market. These involve mortgages (particularly the popular ‘spaarhypotheek’ construction), savings products (spaarloon, levensloop, etc.) and other individual third pillar pension products. Such ‘fiscal facilitation’ does not seem motivated by resolving some type of market failure, yet appears very distortive by itself. For example, the life insurance feature in the ‘spaarhypotheek’ (mortgage) product complicates switching and creates perverse incentives; e.g. the consumer may benefit from a higher interest rate. More generally, virtually all fiscally motivated products have very high (often implicit) tariffs. The fiscal benefits appear to end up in the pockets of the suppliers rather than the consumers. Apparently, the fiscal dimension adds a level of complexity that reduces transparency, and negatively affects the competitive dynamics (section 1.3.4). The negative impact on the competitive dynamics also appears to translate into a poor functioning of the distribution network of intermediaries (“tussenpersonen”, section 1.3.6).

Developments in the payment market, and particularly the SEPA process, offer some challenges as well. A recent document by DNB/NVB/Currence (NVB, 2007) emphasizes the market-driven nature of this process. In particular, it emphasizes that the migration to ‘SEPA products’ will be dictated by the attractiveness of these services. The present study does add some warning in that such market driven process may not necessarily coincide with consumer interests. In particular, it concludes that SEPA favors established international schemes and that their typically higher fees might make them more attractive for banks, and possibly discourage these banks from developing new Pan-European schemes (see section 3.5 on debit cards and section 3.4 on broader implications of SEPA). This would be detrimental to consumers and SMEs.

## *Introduction*

While several facts are known about the competitiveness of the Dutch banking market, no assessment is available about the overall competitiveness of the Dutch banking market. Following newspaper reports one gets quite different assessments. One thing is for sure, few markets draw such strong feelings about (presumed) competitive concerns as the market for financial services. In most studies though, The Netherlands is typically considered a low cost banking market for consumers. For example, when it comes to payment services, the Dutch retail banking has been documented to have rather low tariffs. In particular, in a European comparison the European Commission reports in its Interim Report II (EC, 17 July 2006, Figure 33, p. 89) that The Netherlands has low account management fees and low fees per payment transaction. As will be discussed, this might have to be nuanced given potential cross subsidization. Nevertheless, The Netherlands does appear to have rather low cost banking services for consumers. Also 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.

While this points favorably at the Dutch banking market, it cannot be a reason for complacency. It may well imply a damming condemnation of other European countries. Moreover, as the Cruickshank (2000) report showed in the UK, an overall favorable assessment may still keep many competitiveness issues on the table, and leave room for substantial improvements. For example, some entry barriers may still be present, product offerings might be narrow and/or financial innovation low, and possibly more importantly all kinds of implicit cross subsidies might be present that could lead to misallocation of resources. For example, in the Dutch market, 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, while showing that payment services might be loss making for banks in The Netherlands, showed simultaneously that corporations (including SMEs) massively subsidize consumer payment services. So overall it might be that financial services in a particular country are low cost, it nevertheless can still imply misallocation issues and possibly competition issues in adjacent markets (e.g. the subsidy that corporations/SMEs in The Netherlands provide for payment services in general could – and I emphasize ‘could’ – imply competition issues in that market).

It is unavoidable that in discussions about the Dutch banking market the high level of concentration is raised. An important question is how this relates to competition. Is the market contestable? Some claim it is not, others point at a much more favorable picture. In any case, despite (or due to?) the level of concentration in the Dutch market low cost services are offered possibly due to efficiency gains. Also customer satisfaction might not be low. For example, the Netherlands Bankers Association (NVB), as also reported in the Interim Report II (EC, 31 January 2007, p. 60), points at an extremely high bank customer satisfaction in The Netherlands. But also this has to be interpreted carefully. It could for example imply that the Dutch consumer has a low level of expectations when it comes to the quality of financial services. Consumers may not be aware of services that are not provided, or banks might simply be very good at reducing their cognitive dissonance. Thus, again, one cannot conclude from this that the Dutch financial sector plays an optimal role in the resource allocation and functioning of the Dutch economy in general. Rigidities might be present that could seriously hamper the economy at large. More importantly, however, getting a better feeling for the implications that concentration in banking might have on the competitiveness is important. For that reason, an extensive subsection in this report is devoted to understanding the link between concentration and competitiveness (see section 1.1).

An important caveat to this report is that lack of data makes it very difficult to truly assess the competitiveness of banking services in the Netherlands. The availability of statistics in The Netherlands about customer characteristics and type of facilities that borrowers have is limited. And this particularly relates to the public availability of data.[1] Essentially only survey data are available as obtained by the European Commission and the OECD. As an opening comment, it would seem really desirable to invest resources in collecting micro-data on financing terms at the individual firm level. This would allow for a more effective evaluation of current practices. Actually, also information about market shares of banks in different product markets is not available. While in some EU countries data availability might also be problematic, in the Dutch market matters seem worse; banks appear to have successfully convinced regulators and policy makers that sharing and collecting (!) information – in whatever form – is too competitively sensitive and risks revealing proprietary information. There appears to be unwillingness on the part of banks to reveal information.

Against this backdrop, this report will assess the competitiveness and key 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 consists of three sections. Section 1 discusses some key issues that are important for evaluating the Dutch banking market. These are: i. how competition is related to the structure of the banking market, in particularly the level of concentration in the Dutch market as stated earlier (section 1.1); ii. the link between competition and stability in banking, and what can be said about this trade-off in the context of the Netherlands (section 1.2); and iii. other issues that could affect the dynamics and competitiveness of the industry (section 1.3). The latter section 1.3 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 distorting fiscal arrangements, (regulatory induced) exit barriers, and the market for intermediaries ("tussenpersonen"). The latter is important because some products like mortgages are increasingly sold via those agents and no longer via banks. Most of these issues pertain in particular to the consumer market.

[1] About the consumer there are some data, for example Gfk Intomart collects and sells data. Also the CentER household panel database contains consumer information.

In section 2, the two sectors of the retail market are analyzed in further detail. First, the consumer market (section 2.1). Here I will primarily add some relevant data and discuss some further issues that characterize this market. Most relevant aspects pertaining to this market will already be covered in section 1.3. Second, the SME market will be analyzed (section 2.2). The more complicated nature of this market, in part because of its information-intensity, warrants a more detailed analysis of this SME market. Key issues discussed are the ease of access to financing of SMEs, and issues related to switching, bundling and information sharing. Finally, section 3 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 1: UNDERSTANDING COMPETITION IN THE DUTCH RETAIL MARKET

## 1.1 Competitiveness versus concentration in banking

### *1.1.1 Background*

One important characteristic of the Dutch banking market is its high level of concentration. The Dutch market measured along virtually any dimension belongs together with the Nordic (Scandinavic) countries to the most consolidated in Europe. The market shares of the banks in the Dutch market in key retail markets in The Netherlands are included in Table 1.1.

While market shares are high along all retail banking activities, there is variation. SME market shares are higher than those in the consumer market. Moreover, in the consumer market competition from ‘Other’ for Consumer loans, Mortgages, Savings accounts and Asset management/mutual funds might have been underreported.  See also the footnote that comes with this table. While many market shares are rather stable over time, some of the market shares show swings, particularly that for 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. What I have in mind is that parts of the Dutch retail market might be contestable. Whether this is indeed true will be further elaborated on in subsection 1.1.2.

Another dimension that is important is that in some consumer product categories new type of intermediaries (‘agents’) have come up that put themselves in between banks and their customers. This happens particularly in the market for mortgages. Boonstra and Groeneveld (2006) report – with 2002 data – that banks sell only 40% of mortgages directly to consumers, and 60% indirectly via these agents (up from 38% in 1985) . This at first glance could suggest a strengthening of the position of the consumers (in competition terminology, the demand originating countervailing power could be reinforced) if those agents essentially make the market more accessible to the consumer. The discussion in section 1.3 will analyze this and come to a less favorable conclusion.

***Table 1.1: Market shares in the Dutch retail market[2]***

| Consumer banking | 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 management/ mutual funds* | *25* | *20* | *15* | *15* | *-* | *25* |

| SME | 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* |

[2] Note that these market shares are based on an expert survey of ECORYS-NEI. It cannot be expected that these market shares are totally accurate. Nevertheless, only these data are available and can be used. Two caveats I would add to these data. 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 the 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.

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

### *1.1.2 Understanding competition in the Dutch market*

Let's focus first on a situation where a heavily concentrated market is more or less closed, i.e. the existing players all have substantial market share and no new entry can be expected. This is just as a starting position to frame the argument, not (necessarily, see later) as a description of reality. If this is what would characterize 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 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 for entering new customers could then be a superior strategy.[3]

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 ABNAMRO, RABO and ING – see Table 1.1 – could help sustain such equilibrium where banks choose not to compete forcefully for existing customers.[4]

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.

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

[4] Tacit collusion (See Bishop and Walker, 2002, pages 265-280) would lead to problems of what is called, collective dominance. Typically such situation is more likely when a range of conditions is satisfied, but note not any condition is sufficient by itself. 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 competitive fringe, and limited supply side substitution and countervailing power.

in mortgages, Royal Bank of Scotland and Argenta). With a competitive fringe such tacit collusive equilibrium might not be sustainable. A key question however is whether these entrants do really constitute a competitive fringe? The smaller existing players and the new entrants can only considered to be a competitive fringe if they impose a noticeable competitive restraint on the large existing players. To analyze this, a dynamic setup is needed: do smaller players have different pricing strategies over time from larger players? Do existing players change their pricing strategy after entry or exit? Without such an analysis it cannot be suggested that a competitive fringe exists, in other words that segments of the Dutch retail banking market are or may be contestable. To further elaborate on this point, contestability might well be limited. 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 of those examples, but in general, the large three or four incumbents in the banking sector seem to mainly take into account each others behavior when they set prices.

As is apparent from Table 1.1, 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 that it plays a role for SMEs. Moreover, as will become opparent in section 2.2, SMEs that need credit facilities become very bank dependent, and may have little choice then to accept the services of their house bank.

More generally, the industry structure of different bank activities and the attributes of the type of product and/or service that impact 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 would be more likely to be present.[5] Across the ECA member states, the mortgage markets were assessed most competitive, see Table 1.2.

***Table 1.2: 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.

Interesting recent research uses an approach developed by Panzar en 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. Since this study was mentioned in the response of the Netherlands Bankers Association to the EU (2006), it might be relevant to include an analysis of this study and the Panzar-Rosse approach in particular.

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 regrressions) on a number of

[5] 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).

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 number of banks per million of 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.

Several remarks can be made to 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, Demirguc-Kunt and Huizinga (2001) show that foreign bank entry is typically shown to improve the efficiency of local markets and reduce margins.[6]

Another issue that is important is 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. If there are unilateral effects from reduced competition, concentration may decrease production costs more than the anticompetitive effects of increasing prices. But it can also be the other way around. Also here one would want to distinguish between these countervailing effects on various financial products. Whereas it may well be that increased concentration

[6] Sengupta (2007) shows in a theoretical analysis that foreign banks may typically go after larger firms, and not so much after small and medium sized enterprises. This confirms the observations in section 2.2 that SMEs depend much on local providers.

affects the local markets for households and small and medium-sided firms structurally differently than it affects the market for large corporations, with similar type differences across product and service lines.[7]

### *1.1.3 Further implications for The Netherlands*

Important for the concentrated Dutch banking market is that entry might be feasible, and a competitive fringe might be present for products and services where a local branch system is not essential.[8] As stated already, this clearly points at a more complicated situation for SMEs than for consumers. However, this is only a relative statement even at a too global level. *Within* the SME and consumer product categories there might be considerable differences; some consumer products are more contestable than others, the same applies for SMEs. In section 2 (consumers: subsection 2.1; SMEs subsection 2.2), this is further discussed.

The cross-subsidization of consumer payment services at the expense of corporates/SMEs might be facilitated by the more complicated competitive position of banking services for SMEs. However, cross subsidization of the consumer payment services (and thus the inherent losses that banks face on these services) might well negatively affect entry in these services. Hence, it could induce distortions in the consumer banking market (see also section 2.1.2 and section 3.2.2).

---

7 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 tests 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.

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

Another important issue is whether concentration in the Netherlands effectively creates entry barriers. In the next subsection 1.2 I will argue that regulatory and supervisory practices may create entry barriers, and that this could in part be caused by the underlying concentration in banking in The Netherlands. Whether this is actually the case is an open issue. As in general statement, I would say, it is definitely false. However, a key concern to the competitiveness of a banking market is whether justified prudential practices are not unnecessarily hurting competitiveness.[9] The link with concentration could come about because regulatory and supervisory practices are often developed in close consultation with the existing incumbent players. Their mode of operation may then become the standard and work new entrants that may have different practices and/or business models.[10] This is what is being discussed in the next subsection.

In section 3, a link will be made to the collective ownership of the domestic payment system by local banks and whether that could entail entry barriers. These links could be more relevant in a more concentrated banking system since coordination among shareholders is easier and could unduly favor these incumbents over new comers. Hence, concentration, contestability and entry barriers could al be linked in subtle ways.

## 1.2 The link between competition and stability

### *1.2.1 Overview*

A key question is whether there is a trade-off between Dutch prudential (and systemic) regulation and the competitiveness of the banking industry. And if so, whether this trade-off can be (further) optimized. This question is considered important because banks are considered “special”. That is, stability and systemic issues in banking are important and have led to extensive regulatory interference. Such regulatory interference may either directly or indirectly affect the competitiveness of the industry. It is important to note that the interaction between competitiveness and financial stability is complex and far from unambiguous. In general, regulation that addresses financial stability concerns may

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

[10] This is less likely if the regulation is developed internationally, e.g. BIS II.

impact the competitiveness of the industry. 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 lead to (implicit) entry barriers.

A distinction can be made between the rules in place, and the implementation and execution of regulation and supervision. If it comes to rules, much of the Dutch picture mirrors EU rules. Key to understanding the effect of Dutch practices should therefore come from the *implementation*, i.e. regulatory and supervisory implementation and behavior. The Dutch approach is more principle-based and hence discretionary than elsewhere[11], which in itself can be beneficial since it could allow for a more fine-tuned implementation of regulation and supervision (see subsection 1.2.4). However, 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. "Coziness" of the regulator/supervisor with existing players is more likely in such oligopolistic situation, and, if really present, could discourage entry. Again transparency is key to counter possibly misplaced suggestions of "favoritism".

The analysis in this section supports the implementation of a Cruickshank (2000) type of approach where actual prudential practices, and also the certification process of new entrants, are carefully investigated. Several potential "red flags" are listed. In this context, it is also important to consider the necessary awareness of competition issues at the level of the prudential supervisor (DNB). It is of paramount importance that the supervisor is aware of (and can assess) the effects of its prudential operations on the competitiveness of the industry.[12]

[11] The Dutch Central Bank is not by definition in favor of discretion. The link with principle-based regulation is crucial. In the case of BIS II the Dutch Central Bank has advocated *less* discretion to guarantee a better international level playing field.

[12] 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 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.

The analysis asks for a four step approach:

i. What are the stability issues and systemic concerns in banking? That is, what makes the banking sector potentially fragile?
ii. What is the impact of competition on the fragility of the industry?
iii. How do regulatory solutions to the fragility issues affect the competitiveness of the industry?
iv. How could we characterize the industry structure and stability of the Dutch banking sector? And how could the twin objectives – stability and competitiveness – be (further) optimized?

This four step approach is based on two main insights. First, a critical understanding of the stability and competitiveness issues is needed. The banking sector is special; thus insights from other industries cannot be automatically applied to banking. Second, much of the analysis is not special to the Dutch banking sector; the essential trade-offs are universal. Moreover, the regulatory latitude at the national level might be limited. Nevertheless, the regulatory and supervisory responsibilities have remained at the national level, and as such, an analysis of these questions in the context of the Netherlands is legitimate.

Addressing all these steps in detail is clearly beyond the scope of the present analysis. Potential critical issues will be stressed that could warrant further scrutiny. The focus is exclusively on the link between prudential regulation and competitiveness.

### *1.2.2 Stability issues and systemic concerns in banking*

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

i. The failure of individual banks may have contagion effects on other banks in the industry (systemic risk);
ii. 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 need deposit insurance

to control this[13]. Via contagion effects (e.g. confidence crisis) such runs may create systemic risks;

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

iv. 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[14], no one should (and could) deny the potential fragility of the financial system.[15] 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 often considered too-big-too-fail, and in this way may count on a rescue by the government. For further observations I refer to the literature cited in the review paper by Bhattacharya, et. al. (1998).

### *1.2.3 Competition and fragility*

In line with Vives (2001) and Bhattacharya et.al. (1998), observe that competition is not responsible for the fragile nature of the banking sector. 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.

To see this let's step back and note that the primary function of the financial system is to facilitate the transfer of resources from savers to those who need funds. The objective is to have an efficient allocation and deployment of resources. Efficiency in this

---

[13] 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 an Kahn, 1991, and Diamond and Rajan, 2001).

[14] Several examples could be given for this: real time settlement in the payment system has reduced the 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, etc.

[15] 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.

context is interpreted broadly and presumes both stability and competitiveness of the financial system. Stability is needed to facilitate the orderly flow, allocation and deployment of resources. It is generally recognized that fragility of the financial system would come with great cost, since disruptions have potentially severe consequences for the economy at large.

An efficient financial system should also minimize transaction costs, where these costs should be interpreted broadly as the resources that dissipate or evaporate in the process of allocating resources. This generally necessitates a certain degree of competitiveness. Indeed competition is generally found of critical importance for allocative and productive efficiency (X-efficiency). But stability and competitiveness are often seen as *conflicting* rather than complementary objectives, thus presenting public policy makers possibly with a difficult trade-off.

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 that this would curtail risk taking because by taking risk 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).[16]

[16] 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 end Thakor (2000) show that competition could elevate investments in relationships. In related work, Koskela and Stenbecka (2000) provide an example where more competitiveness does not lead to more asset risk. Boyd, et. al. (2003) show that competition *could* be good 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).

On market power increasing mergers, one may conclude that regulatory and supervisory authorities in many countries have generally been lenient, with several “national champions” as a result. Apart from the question whether the creation of such national champions leaves enough competition[17], three reservations could be postulated. First, banks are rather opaque institutions that combine many activities with, as a result, very limited market discipline (Bhattacharya, et al., 1998; Merton and Perold, 1998). If facilitating a competitive financial system is an objective, and it should be, market discipline is in my view indispensable. Market discipline effectively “punishes” or rewards institutions for their behavior, e.g. risk choices of institutions should ideally be reflected as perfectly as possible in the funding costs of such institutions, and if this is the case, the institutions internalizes the consequences of its own behavior. This mechanism helps keep the behavior of institutions in check. This is meant by market discipline. Without market discipline, the burden falling on regulation and supervision would be excessive. Improving market discipline should then be a key public policy objective. Market power enhancing mergers create more rather than less opaqueness, and from this perspective are undesirable. Second, the efficiency of large institutions with considerable market power is questionable (Boot, 2007a). While this is not a public policy concern by it self, the ultimate survival of such large institution is. Policy makers often refer to desirable diversification effects that could be captured in larger institutions. This should however not be taken for granted. Such institutions might be encouraged to take more risk which together with the inefficiencies could put that survival at risk. This could add substantial risk to the financial system.[18] Third many European financial institutions are considered too-big-to–fail. This reduces market discipline even further. The dominant “national” champion attitude in many countries may not help.

[17] An important issue to assess this is how to define the “relevant market”. For many services at the retail and SME level these are local, and do not encompass the whole of the EU.

[18] On a more theoretical level one could envision large, yet efficient fully diversified financial institutions competing in many (all) product and geographical markets but facing perfect competition. If this would be possible, distinct value is created (i.e. such institutions face smaller expected dissipative default cost). While some, see Vives (2001), seem to believe in the feasibility of such industry structure, my view is that that is highly unlikely. Nevertheless, in some activities a global diversified play might definitely be feasible for some (e.g. a few top-tier investment banks).

A more subtle question is whether current prudential regulatory practices have a negative impact on competition. In particular, do they limit entry and/or soften competition between incumbent players?

As caveat, note that the regulatory design has been scrutinized mostly in a precisely reversed causality, i.e. how to continue to maintain some grip on a rapidly changing (and globalizing) sector in light of the rapid changes in the sector. The historic predictability of banking and the strong control of national governments on this sector facilitated and allowed for stringent regulation. This 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.[19] The competitive effects of prudential regulation have a direct bearing on the latter.[20]

### *1.2.4 Prudential regulation, competitiveness and the Dutch experience*

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, and arguably the most important tool of prudential regulation. While capital regulation may have an impact on the competitive structure of the industry, the regulation does in no way try to aim for stability by directly controlling the level of competition in the industry.

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

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

[20] It is probably justified to characterize the current state of the banking industry as one with lots of strategic uncertainty. In my view, we are in a period of transition; unclear is what the exact new steady state will be, and when it will be reached. In such transitory situation stability concerns are paramount, and the challenges of the prudential authorities are enormous.

context of the Dutch case. This will be discussed at three levels: i. the EU rules (directives), ii. the extent Dutch rules deviate from EU rules, and iii. how the Dutch supervisory agencies implement the rules and arrange supervision. In doing so, I will distinguish where possible between the effects on entry and on the competition between incumbents.

*EU rules and directives*

EU directives play a key role in the regulatory structure of the 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.[21] The aim is not to discuss here the EU directives in great detail, but a few comments could highlight 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 Euro) 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 BIS II capital framework some competitive effects can also be identified. BIS II introduces the option to opt for more advanced, internal risk model based (IRB) capital requirements. It is perceived that that option is only relevant for larger, well established financial institutions and could put *de novo* or less established (or smaller) financial institutions at a competitive disadvantage. This is definitely a valid concern. But, more in general, it is hard to argue against the underlying premise of the new BIS proposals. The BIS II proposals seek to align regulatory practice much closer to actual market behavior. In particular, they try to build in a risk-return trade-off that mirrors the pricing in financial markets. In doing so, the BIS hopes that market discipline will improve.[22] The jury is still out on whether the detailed approach by the BIS will succeed. If it would succeed in bringing more market discipline to banking, the discussion in Section 1.2.3 suggests that this could enhance competitiveness.

[21] 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.

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

A more subtle and indirect effect of regulation on competitiveness runs via standardization. Here the BIS II capital framework may again serve as an example. The construction and implementation of the models used in BIS 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 could be an inferior situation, because this limits the room for shopping by potential borrowers (e.g. innovative SMEs then possibly face one and the same evaluation process by all banks).

*Do Dutch rules deviate?*

The main focus is however on Dutch practice. As already indicated, the prudential regulation facing Dutch financial institutions is mostly determined by international practice, in particular, 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 also regulatory and supervisory arrangements 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).[23]

While these arrangements could lead to a 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. What I have in mind is that in that way trade-offs between objectives are more transparent which could counter regulatory capture that may more readily exist in such oligopolistic market. The twin peak model is an example of such separation.[24] This however refers to implementation rather than rules per se.

[23] Note that this does not refer to the (separate) presence of an anti-trust regulator. Including the NMa one could call this a three-peak model.

[24] 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).

The following serves as an illustration of what kind of deviations can be found in the national rules. The weighing 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.[25] These types of minor differences are typical of the deviations between Dutch rules and EU directives. The relevance of this for the trade-off between prudential regulation and competitiveness seems negligible. No (obvious) examples could be found that are material.

When it comes to the authority that various regulatory agencies have 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), while such arrangement does not (yet) exist in the Netherlands.

*Dutch supervisory implementation and behavior*

Thus, these 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 behavior of regulators and supervisors. As an illustration, the Cruickshank (2000) evaluation of competition in the UK banking 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 at informal restrictions on who could own a bank, potentially tougher restrictions on institutions without 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 competitiveness objective.

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

An example of where discretion at the Dutch national level is present, 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 could also observed. This type of discretion potentially has an impact on the trade-off between prudential regulation and competitiveness.

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 the insolvent institution by a healthy player in the industry. This obviously has an impact on the industry structure, and for the competitiveness of the market it could make a big difference who takes it over. Since these distress situations are handled in great secrecy and with urgency, the competitiveness issues may not get the attention they deserve.[26]

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

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 for the needs of new (innovative) entrants who might have more difficulties complying with detailed rules. In addition, too detailed rules might offer a

[26] 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.

false sense of security or transparency as such rules will need to be changed from time to time. The argument for such system could also be put in the context of the necessary confidence in the financial system. Explicit rules, and the arbitrage surrounding it, might be insufficient for this. Sweden, which also has adopted this provision of *good banking* standards, finds this provision crucial because "for banks to be able to fulfill their function in the economy, it is important that confidence in the banking system is maintained".[27] Assessing what the real effect is, is purely speculative. The way it is implemented is key.[28] For sure, in such more discretionary environment the transparency of the regulatory and supervisory process is of paramount importance.

In general, potential frictions may come from the presence of regulatory discretion. Nevertheless, it is clear that some regulatory discretion is needed. But indeed established practice *may* cause competitive distortions. What are potential other concerns relevant to entry to the Dutch market?[29]

i. established practices that are outdated and work against new operators, e.g. practices based on say face-to-face branch banking could be inadequate for internet banking, and in this way discourage the latter;
ii. related, but important to put separately: supervisory practices and charter policy could implicitly be based on the broad universal banking strategy of incumbent players. Are the requirements sufficiently tailored to the more narrow (i.e. specialized) scope of new entrants? Or do they face a burden that is in total mismatch with the scope of their operations? And similarly, players that specialize somewhere in the value chain (and do a lot of outsourcing), do they face a receptive supervisory regime? Or is outsourcing 'punished'?

[27] See Riksbank (2000). This report on the new Swedish banking law casts the "good banking standards" clause also in the context of consumer protection.
[28] This emphasis on rule-based versus principle-based may not be an 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.
[29] 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.

iii. administrative load at the bank level associated with prudential regulation could be excessive. This could create an entry barrier;

iv. allocation of costs of the prudential regulator over market participants may discriminate against certain type of players. The industry has to pay for the costs of the prudential regulator; how are the costs distributed over the players?

v. 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 the bigger ones. But this is complicated since too-big-to fail-concerns might actually help bigger players.

### *1.2.5 Potential actions in the Dutch situation*

Whether or not prudential regulatory practices in this country hamper competition, it should be on the agenda. In the Dutch situation we should be at least as concerned about potential informal distortions as in the UK. Particularly the highly concentrated banking sector in this country could lead to regulatory arrangements that could be efficient for the current players but effectively create barriers to entry.[30] More generally, such 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. A similar effect could then be anticipated on the competition between incumbents. The same regulatory focus may effectively soften this competition. Moreover, the mere presence of perceived entry barriers in itself also reduces the intensity of competition between incumbents.

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" (i.e. the regulatory capture referred to earlier). 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

[30] Given the principles of home country control and open access for EU institutions, the entry barriers are subtle, but ample possibilities remain.

regulatory/supervisory matters. This educational/advisory role is particularly important for new entrants.[31] It is important to note that in talks with some smaller banks, generally one appreciated the help that the Dutch Central bank provided in dealing with the various requirements for obtaining bank licenses and fulfilling compliance requirements.

Another concern is whether the prudential regulator is sufficiently aware about the impact that its practices could have on competition. It is interesting to see that the UK supervisor – the FSA – is very explicit in acknowledging the potential presence of this trade-off. It explicitly states "The FSA will seek to insure that its rules and guidance [….] do not distort competition…". The FSA also builds in some assurances, ".. the FSA has added to its team of economists and given them responsibility for contributing to the policy making process in areas where competition issues are likely to arise". Also "a series of training courses have been run for policy staff in the FSA so that they understand the economic issues relating to competition in financial services" (FSA, 2000).

The presence of competition issues should be an important concern for the Dutch prudential regulator (the DNB). What effects do its prudential operations have on the competitiveness of the industry? Thinking about these effects will undoubtedly impact its operations. In any case understanding the market structure has also become of immediate importance for its concerns about systemic stability. The proliferation of non-bank financial institutions and the fading demarcations between the various financial institutions makes the stability question quite broad. Where do stability concerns start and end?

## 1.3 Other key competitiveness issues for the Dutch market

### *1.3.1 Overview*

In this section several issues related to the competitiveness of the Dutch banking market are discussed that warrant further investigation. These issues include: regulatory arbitrage

[31] 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.

and (lack of) level playing field issues (possibly outdated regulatory and supervisory structures lagging behind product innovations etc.), possibly anti-competitive collaborative arrangements in the Dutch market, distorting fiscal arrangements, (regulatory induced) exit barriers, and competitive impact of the market structure of intermediaries ("tussenpersonen"). The latter is important because some products like mortgages are increasingly sold via those agents and no longer via banks.

### *1.3.2 Regulatory arbitrage and level playing field issues*

The issue of 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.

From the AFM's perspective there are in 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. Increasingly, the same underlying product is wrapped differently so as to optimize the regulatory regime that applies to the product.[32]

In particular, the regulatory regime for investment funds (collective investment schemes or CIS, being either *Wtb (now Wft)* national collective investment schemes (Dutch), or

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

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.

As already indicated, the last few years have seen a marked growth in structured products, and these evolve in such a way that they start to resemble investment funds more and more. Asset managers (investment funds) are losing ground to investment banks (structured products) and this might be partially due to the relatively light regulatory regime that the latter products are subjected to. In other words, the 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 which for them seem similar, on documentation which does not contain the same sort and detailed information. Or conversely, products that offer essentially the same trade-off of risk and return may be regarded as very different by investors due to the different regulations they are subjected to. Obviously, different regulatory treatments will not be the sole reason for the growth in structured products. Other reasons include the high pace of innovation in structured products and quick time to market, and their ability to appeal to investor needs in response to new investment trends.

As an illustration of these differences in regulatory treatment, one could compare on the AFM website the various requirements, and get a quick feeling some of the differences. In the case of “Collective investment schemes” and “Structured products/securities” one finds respectively:

> **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 CISs 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 CISs. On the basis of a 'European single passport' CISs 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)

Obviously, this is not a sole Dutch issue. 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 products market in the Netherlands, voiced its concerns and has seen market players (NVB) take the initiative to establish best practices.

It is important to note that the Dutch regulatory regime with respect to collective investment schemes does not contain provisions on eligible assets and investment policy. The result is a more general regulatory regime which 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 however doesn’t remove the non-level playing field between CIS-regulation and the Prospectus Directive.
The Dutch regulatory regime creates a framework in which Dutch collective investment schemes (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.

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 increasing popularity neither the EU nor the

Dutch government appear to include consideration of mobile phone payments within the general category of payment rules and policies. There is a risk that as the mobile phone payments evolve, there will be regulatory asymmetry. The Netherlands Bankers Association suggests that mobile payments may outnumber the 1.45 billion annual PIN payments.[33]

The problems of regulatory arbitrage and level playing field are however much broader than just the above example of collective investment schemes 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 each faced (and to some extent still do) (and to a very large 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[34] could constitute a step to more harmonized supervision and regulation. Since, much as in the above example of collective investment schemes and structured products, both type of institutions traditionally operated in different markets serving different needs, such institutionally focused regulation was not much of a problem. However, the dynamics of the industry that makes 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 suggesting a more functional approach to regulation. The Dutch supervisory approach seeks to move in this direction.

Although financial regulation and supervisory practices are increasingly internationally determined[35], national elements continue to be important. Thus, it is still desirable to

---

[33] 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.

[34] 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.

[35] 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.

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.[36] Moreover, not only the regulatory framework itself will be decisive, but also the positions taken by regulators and supervisors, see also the discussion in subsection 1.2.3.

### *1.3.3 Collaborative arrangements in the Dutch market*

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 in general, 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 importance of good working relationships with competitors become anti-competitive, and thus a concern for the competitiveness of the financial sector?

Collaborative arrangements in general could make good business sense and may not be designed to impede competition. An example is the opening up of a bank's distribution network to products from others. In that way, institutions could exploit their local presence by capitalizing on their distribution network; simultaneously, product specialists may emerge that feed products into these distribution networks. To a large extent it is also not special to banking. For example, alliances and joint ventures appear to have become more important in banking just like in other industries. Yet, the network orientation of banking

[36] 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) 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.

does offer some special challenges to competition. Note also that the systemic concerns that were discussed in section 1.2 are rooted to some extent in the inter linkages between financial institutions.

Having said all this, the collaborative attitude in banking may very well impede competition. 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 is as much, or probably even more about culture than about structure.[37] What I mean by this is that an exclusive focus on structures and rules might be insufficient. In section 1.1 the main message was that competition does exist in concentrated markets as long as the market is sufficiently contestable via possible entry and the presence of a competitive fringe. As will be analyzed in section 2 such contestability might be present in some product markets, and not in others.

What particular concerns could one highlight when looking collaboration in the Dutch market? A potential concern is if there is an over-dependence on industry-arrangements. As the Interpay discussion in section 3 shows, 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 incumbents banks jointly in charge of Interpay – essentially a monopoly provider of essential payment services – may have affect the competitiveness of the market. Key is, as the discussion in section 3 will show, is to distinguish sharply between the tasks where potential efficiency gains dominate competitiveness concerns, and those tasks for which efficiency gains do not dominate. To some extent this discussion also relates to the scope of self-regulation; self regulation by being potentially more informative might be efficient, yet those efficiency gains might be dominated by anti-trust problems.

[37] 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 2, 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.

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 have as of yet not been deeply engraved in Dutch government and (public) regulatory policy.[38]

More specifically, one should also look at the role that branch-organizations play. For example, the Netherlands Bankers Association has numerous (over one hundred) standing committees that meet regularly. Again there are several reasons why a certain degree of coordination and/or knowledge sharing might be crucial. However, this efficiency type argument should be carefully contrasted with potential anti-trust concerns. It might be a good idea to have a neutral investigation in the type of topics that are discussed and agreements that are struck in these committees. This could lead to a better defined mission for several of these committees and alleviate anti-trust concerns.

Other examples of collaboration in the Dutch market are:

- The SEPA migration plan currently being developed;
- The Interpay case;
- The fact that the NMa turned down the three most recent requests for a Article 81.3 (article 6.3) exemption;
- 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).[39]

### *1.3.4 (Distorting) fiscal arrangements*

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: i. mortgage interest deductibility on the primary residence; ii. various favorable life insurance-based capital accumulation schemes linked to mortgages; and iii. fiscal arrangements for second- and third pillar pension arrangements, including rather sophisticated life-planning

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

[39] SOGA: Samenwerkingsovereenkomst Geldautomaten.

("levensloop") and simpler savings-type ("spaarloonregeling") arrangements. Subsequently, fiscal arrangements will be discussed that affect suppliers, notably VAT implementation.

The first two arrangements affecting consumers are clearly linked, and will be discussed jointly. The mortgage with life insurance link refers in particular to 'spaarhypotheken', a standardized, very popular life-insurance linked mortgage in The Netherlands. In such mortgage, the life insurance component guarantees repayment of the principal, and repayments towards the principal accumulate separately from the nominal loan outstanding. And 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.[40] 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 on the principal. This construction is very 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, make 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 life-time of the mortgage. The other is that the peculiar interest that the customer has with respect to the level of the interest rate during the life time of the mortgage. He/she may benefit from a higher rate (depending on the accumulation).

Another competitive implication comes from the lack of transparency of the product. The pricing of the life-insurance part of this mortgage arrangement is hard to evaluate,

[40] 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 subjected 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.

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), pointing at a potential lack of transparency in this market.[41] In section 1.3.6 further thoughts are included about the role of intermediaries.[42]

As stated, the pension market is another area of considerable fiscal involvement. However, in principle, the tax treatment of pensions is "only" delaying the moment of taxation. Nevertheless, this is not purely neutral. The tax rates at the moment of taxation might be different from what they would have been in case of immediate taxation. Moreover, the return on wealth tax (the "forfaitaire vermogensrendementsheffing"; essentially a wealth tax) does not apply to qualifying pension accumulations. Competitive distortions play a role for both the second and third pillar pension provision, however they are of a very different nature.

The third pillar fiscal arrangement is subject to much of the same criticism as has been expressed in the context of mortgages with life-insurance links above, but even worse. Being able to suggest a favorable tax treatment of third pillar pensions (which is overblown, essentially it is a delayed tax treatment) has undoubtedly helped providers and intermediaries to get consumers to buy high cost products. Scandals are currently still occupying the Dutch courts as well as several government agencies and consumer advocate organizations. As is typical for many tax-driven products, transparency is low and consumers appear eager to be tricked in opaque fiscal-motivated products. While the Dutch government has, over the years, limited the fiscal advantages of third pillar pensions as well as the life-insurance mortgage linked fiscal benefits, political realities seem to stand in the way of a further containment of such arrangements. The current

[41] Banks only show a dispersion across consumers of 60bp. See also Boonstra and Groeneveld (2006).

[42] A more positive role of the network of intermediaries is that they may have facilitated the entry of foreign players on for example the market for mortgages, see also subsection 1.3.6.

emphasis is on improving transparency in the ownership structure (and commission structure) of agents to reveal potential conflicts of interest, the structure of fees (no front-loading), transparency about products ("financiële bijsluiter"), augmenting the responsibilities of distributors (mainly insurers in case of third pillar pensions[43]), and suggesting improvements in consumer financial education.[44]

The fiscal savings-arrangement ("spaarloonregeling") also allows for third pillar pension build-up, but is much more flexible. After four years the funds become available tax free, despite the before-tax build up of the savings. It is interesting to see that despite funds being blocked on accounts for such four year periods the interest rate offered on a spaarloonregeling is typically substantially less than that offered on a freely available internet savings account. The "levensloopregeling" is a more sophisticated before tax accumulation of savings with more restricted use and less generous fiscal benefits (most of it will be taxed when ultimately used). While the spaarloonregeling again suggests that the fiscal motivation of such product is not conducive for competitive conditions, the levensloopregeling is too recent to offer any clear conclusions. What is generally discussed though is its complexity.

When it comes to second pillar pensions, the picture is more complicated. The Netherlands has an advanced system of second pillar pensions with an important role for fully capitalized pension funds that have a protected status. These pension funds have a central role in providing second pillar pensions. Employees and employers are essentially obligated to participate in industry-wide pension funds. This system has a considerable level of efficiency, yet it is "closed" and not open for competition. The efficiency of the system is rather high, competitive distortions are mostly relevant at the periphery. Meaning, some of these privileged pension funds seek to expand their activities to third pillar pensions. Current government action is precisely on these issues. How to safe guard the virtually complete coverage (among the population) and low cost, yet possibly

[43] The Depla/De Vries amendment – recently adopted in the Dutch parliament – allows banks to play a role in third pillar pensions as well. The responsibilities refer to particular duty of care requirements, i.e. in Dutch, "de zorgplicht".
[44] See also CPB(2005).

improve the efficiency (where possible) of second pillar pensions and resolve the competitive issues (see Boot, 2007b).

*VAT Implementation*

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

The VAT regime should seek to promote VAT-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 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.

### *1.3.5 Exit barriers*

The temptation in an analysis of the competitiveness of a market is to focus on entry barriers rather than exit barriers, yet extensive research shows that exit barriers can be very destructive as well for a healthy competitive environment. Having said this, in the case of the banking sector, it is logical that exit barriers have received less attention since stability concerns related to the failure of institutions have been primarily on the mind of policy makers. However, in the emerging more competitive market of financial services the potential distortions of having exit barriers may become more apparent. Institutions that are in technical default, and face a rather competitive market, have very little to lose, and only "gambling" may offer any hope for resurrection. In a less competitive environment, semi-monopoly profits would possibly allow the institution to slowly overcome its difficulties. This is where the competitive environment comes in. That environment has changed and, as a result, the importance of addressing exit barriers.

Exit barriers are in part regulatory induced. In particular, the presence of deposit insurance allows financial institutions to continue to obtain funding. Market discipline is limited and hence an natural mechanism for exit (no funding available anymore) may not be present. Having said this, the presence of deposit insurance does definitely not reduce exit barriers to zero. To the contrary, lack of trust with counter parties (other banks for example) may dramatically reduce interbank lines of credit and as a result a bank may no longer be able to function. But also in this case, regulators and supervisors might be tempted to help, e.g. provide liquidity support, in order to prevent systemic problems. This tendency to accommodate financial institutions essentially creates exit barriers, and effectively creates a system of implicit cross subsidies in the direction of weaker institutions.[45] The elaborate literature on too-big-too-fail essentially is also about this exit barrier. This creates real competitive distortions. In particular, institutions that know to be rescued when failure occurs behave differently, and may not optimally account for risk. In a sense risk taking is then subsidized. After financial difficulties emerge, allowing such institution to continue may cause the more serious damage. It has nothing to lose, and thus imposes an enormous externality on existing healthy institutions. Particularly,

[45] See for this mechanism the analysis of Boot and Marinc (2007).

see the earlier remarks, when the banking market is rather competitive, such institution will have very distorted objectives and compete on different terms with existing healthy institutions, and in the process damage those institutions.[46]

These mechanisms are not special to the Dutch situation. However, the Dutch legislative and regulatory apparatus may not be optimally designed for reducing such exit barriers, while the US has adapted its structure following the S&L crisis and now has substantially reduced exit barriers. The issue is that a mechanism that allows for *timely* intervention in weak institutions could limit the damage that such institution may inflict on healthy institutions (also called 'prompt corrective action'). That is, timely action, meaning at a clearly positive level of capital, contains the moral hazard type behavior that would follow at even lower levels of capital. This is precisely what the new timely intervention policy in the US seeks to accomplish. Moreover, with timely intervention, searching for potential resolutions becomes a lot easier than in situations of acute financial distress when systemic concerns may induce regulators to be rather accommodating.

There are other types of exit barriers in the financial sector as well. For example, a national flagship attitude towards domestic financial institutions typically also leads to lenient behavior upon failure. Such regulatory capture (too-big-too-fail) and coziness in general between regulator and financial institutions may create enormous exit barriers. This is an important issue yet it is virtually impossible to make an (quantitative?) assessment about the severity of this problem in the Netherlands. Nevertheless, it is crucially important to highlight these issues, and create sufficient awareness with the prudential supervisor.

### *1.3.6 Intermediaries ("tussenpersonen")*

In the Dutch market the functioning of intermediaries ("tussenpersonen") has probably received most attention (e.g. NMa, 2004, 2005). The miss-selling scandals in the market for third pillar pensions (life insurance: "beleggingsverzekeringen", "koopsommen",

[46] For example in the US S&L crisis, the insolvent institutions were willing to offer the highest deposit rates (given presence of deposit insurance, customers were only interested at the interest rate) and were willing to make the most lenient loans. Healthy institutions that had no interest at gambling could not match these terms.

"lijfrentes", etc.) are probably one of the main causes. Also, see section 1.3.4, the role of intermediaries in the market for mortgages has been questioned. There seems to be a close correlation between the activities of these intermediaries and the fiscal/tax incentives that are provided by the government. Transparency is a key issue. As reported in section 1.3.4 several measures have been taken to improve on 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.

A more complicated question is what he impact is of this very developed market of intermediaries on the competitiveness of the market of financial services in general. Implicitly it was already argued that intermediaries may not make the market more competitive from the consumers' point of view. It was indicated that on the mortgage market intermediaries manage to offer highly dispersed mortgage rates which do not readily point at a well functioning competitive market (see subsection 1.3.4). However, it can definitely not unequivocally be stated that intermediaries do not contribute to the competitiveness of the market for financial services. In particular, intermediaries offer an alternative type of distribution network that potentially could help entrants get access to the market. In the market of mortgages this is to some extent observed. But what impact do intermediaries have on banks? Clearly, the growing market share of agents (in mortgages, as reported, banks sell now considerably more via agents than via their own distribution network) has an impact on the functioning of banks. 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 relationship banking to consumers may suffer. The implications of this for the consumer are not clear-cut. Less dependence on banks may have mixed effects. Further clarity on the exact added value of the intermediary distribution network and its interaction with the banking network is desirable.

# SECTION 2: FURTHER ANALYSIS OF THE DUTCH CONSUMER AND SME BANKING MARKET

## 2.1 Further analysis of the consumer banking market

### *2.1.1 Overview*

This section focuses on the Dutch consumer banking market. The key analysis of this market was already contained in section 1, particularly the subsections 1.1 on the measurement of competitiveness (in relation to concentration measures) and 1.3 that listed the key concerns pertaining to the Dutch banking market, and the consumer market in particular. In this section some further evidence is provided.

Some conclusions when it comes to the Dutch banking market for consumers were already provided in the Introduction. There it was stated that The Netherlands is generally considered a low cost banking market for consumers. While payment services are considered in detail in section 3, for assessing the competitiveness of the consumer market, it is relevant to report that the Dutch retail banking market has been documented to have rather low tariffs for payment services. As reported in the Introduction, in a European comparison the European Commission reports in its Interim Report II (EC, 17 July 2006, Figure 33, p. 89) that The Netherlands has low account management fees and low fees per payment transaction. An overall assessment of the Dutch consumer market has been executed by the consultancy Oxera prepared on behalf of the British Banking Association (Oxera, 2006). It documents that The Netherlands along with the UK have the lowest overall cost for consumer banking services in comparison to a large set of primarily European countries. As stated in the Introduction, one should not draw definitive conclusions from this, cross-subsidizing practices may take place and the favorable appearance of the Netherlands may point at a dreadful situation in other European countries.

Thus, assessing the contestability of the Dutch consumer market is very 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 *relative* to the

SME market might be more limited because the branch network might be less important. However, for certain client segments, e.g. the elderly, bank branches are likely to be important. This has more weight in the ageing society we are in. 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 these characteristics which would reduce contestability.

### *2.1.2 Some more data on the Dutch consumer market*

In Table 2.1 the market shares of the relevant players on the Dutch consumer market that were earlier presented are stated once again. Note the earlier caveat relating to the potential inaccuracies in reported market shares. A key insight from Table 2.1 is that concentration is high, yet substantial market share is in the "Other" category. Experiences and interviews in the Dutch market point at the presence of some elements of a competitive fringe when it comes to many of the consumer banking services (section 1.1). The clear exception is the current account. The actual degree of truly having a competitive fringe needs further investigation; as indicated in section 1.1 it is not obvious whether potential entrants and smaller players are truly imposing pricing discipline on the large incumbent Dutch banks.

***Table 2.1: Market shares in consumer banking***

| Consumer banking | 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/* | *25* | *20* | *15* | *15* | *-* | *25* |

| | | | | | | |
|---|---|---|---|---|---|---|
| *mutual funds* | | | | | | |

Source: Estimates ECORYS-NEI, NMa (2004)

Several banks have been on a roller coaster when it comes to the 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 have realized that the branch-network could (still) offer a competitive advantage. While no data are available, it is claimed that the bank that cut branches most drastically suffered market share. Indeed, this seems to be in line with one of the strategic shifts in banking over the last eight years: banks increasingly started (re)emphasizing the importance of their local markets. *The Economist* rightfully concluded that "Banks have rediscovered the virtue of knowing their customers"[47]. Excessive branch closures were typical for Europe (Italy is an exception to this) and not just a Dutch event. The Dutch market might have been affected more. The relative low profitability of domestic consumer banking (in part because of the low cost) may have induced more heavy cost cutting via branch closure (Boonstra and Groeneveld, 2006). Also the individual decisions of some banks to not put consumer banking at the core of their strategy (e.g. ABN AMRO at the end of the 90s) may have done some damage. But branches are on the rise again.[48]

An important question in the context of section 1.1 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 2.1 can be obtained at a distance without a visiting a branch. As already indicated, for the elderly this might be different and also issues of trust and reputation may complicate

[47] *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.

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

the picture. This suggests a somewhat mixed picture about the contestability of the Dutch market. For the current account itself, contestability seems really questionable. The three big players dominate this market more than any other. As stated in section 1.1.3 the cross subsidization of the consumer payment services (and thus the inherent losses that banks face on these services) might well negatively affect entry in these services. Hence, it could induce distortions in the consumer banking market.

A question is also whether banks could take advantage of this, for example via tying arrangements. So far however this is not observed. Bank accounts are accessible without being forced in tying arrangements. Many Dutch consumers also have multiple accounts, in part because of the low cost. The recently announced integration of Postbank in ING may possibly have some impact on this. Until now, the alternative payment infrastructure provided by the Postbank offers for many Dutch consumers an extra payment account. Also the independent positioning of Postbank relative to its owner ING reinforced this. The question is what impact the integration may have for the consumer.

Another issue is whether switching could be encouraged by introducing number portability. This would allow a potential entrant to offer a superior payment package and possibly to obtain an instantaneous substantial market presence. A switching service exists, and is to some extent successful, yet number portability could possibly really make a difference (see also section 2.1.3).

On bundling in the Dutch market the following can be said. The model to make consumer banking profitable is one of cross selling (see Table 2.3). Given the low cost payment services in The Netherlands, this might even be 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 that exclusive tying arrangements. Table 2.2 and 2.3 give some perspective on this. SME loans are discussed in section 2.2. From Table 2.2 it appears that consumer loans/current account and mortgage/life insurance are the two most common types of bundling. This may need some further discussion.

The mortgage/life insurance combination is a direct artifact of the fiscal arrangements that were discussed in subsection 1.3.4, and essentially may have to be looked at as an integrated product. Many players are active in this market, and a branch network does not appear to be essential for success in this market. The bundling arrangement consumer loan/current account does not appear problematic either. As already noted, current accounts are available without being forced to accept other products. So there does not appear to be any "leveraging of a dominant position" stemming from the banks potential strong(er) hold on current accounts. Those banks typically force consumers upon accepting a consumer loan to open a current account as is typically true. However, a separate market for consumer loans exist as well that does not run via the main banks. Thus consumers appear to have a choice whether to accept the consumer loan as part of a bundle or obtain a consumer loan only from more specialized finance corporations.

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. For example, while Royal Bank of Scotland has entered the Dutch market for mortgages in serious way, it focuses exclusively on standard arrangements. For more complex arrangements the local banks seem indispensable.

As a final observation, one could ask the question whether Dutch banks operate supply driven or demand driven. Is there enough consideration for the demand side of the market? One could argue that products are highly standardized and consumers have little to choose from. In a sense, the low tariffs for payment services to consumers may reinforce this. If the quality, cq. heterogeneity of the supply side is lacking, the revealed demand is not very informative. There is then very little effort to discover what consumers really want, let alone effort to cater to these latent demands. The analysis on understanding competition in the Dutch banking market (subsection 1.1.2) would then suggest that contestability is limited and the large incumbent banks are essentially primarily focused on each other.

***Table 2.2: Bundling (tying) in the retail market***

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

***Table 2.3: Bundling, cq 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)

### 2.1.3 Switching costs

In the last 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 calls to introduce account number portability following a general policy discussion on reducing switching costs across a number of different sectors.[49]

The switching arrangement in the Netherlands is called "overstapservice". The Netherlands Banking Association has introduced this service in January 2004 to facilitate current account switching. A website has been 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;
- provide information about all payments that took place through the "overstapservice";
- sends the account switcher a reminder one month before the automatic forwarding period of 13 months comes to an end.

[49] The discussion resulted in a 2002 report (*Kosten noch moeite. Drempels slechten voor de switchende consument*).

Account switchers still have to inform some parties themselves (e.g. their employer). The "overstapservice" has been 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.

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.[50] Another issue is brought forward in a recent tri-partite document (NVB, 2007). That document points at difficulties of maintaining the switching service in the future because of its dependence on using a central processor with one database of all bank account numbers in The Netherlands that is also in charge of processing all interbank transactions.

## 2.2 Evaluation of the Dutch SME banking market

### *2.2.1 Overview*

Banking services directed at small and medium enterprises (SMEs) warrant special attention. SME success is often viewed as a key to generating growth. But if SME access to finance is unduly constrained, there might be follow through effects on productivity and SME-generated growth.

The Eurobarometer 2005 SME Financing survey suggests that SME customers in the Netherlands have a number of concerns about financing, even if, overall, SMEs in the Netherlands are among the better performing SMEs in the EU-15. Netherlands SME managers 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 harder (European Commission, Eurobarometer: SME Access to Finance, October 2005, p. 23) .[51] The EU-15 average was that 33% found it

[50] 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.
[51] 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?"

easier, versus 42% finding it harder. 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)[52] 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.[53] 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 are not suited to their needs. With 43% disagreeing with statements that offers are suited to their own needs compared to an EU-15 average of 50%.[54] 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.

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.

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

[52] 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."
[53] 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."
[54] 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."

obtains potentially valuable proprietary information about its customers. In consumer lending, lending standards can be more based more readily on verifiable information (employment conditions), and possibly linked to mortgages. Also, as noted in ECA (2006), concentration ratio's 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 (even) more important for SMEs.

Potential frictions might be substantial. This does not necessarily mean that the frictions are caused by the structure of the financial sector, cq that financial institutions are "to blame". 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.[55] One would interpret this as evidence that these firms experience 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 however does not necessarily point at a competition problem in the financial sector since legitimate high costs of serving SMEs could also explain lead to such financial constraints.

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 institutions is depressed this could lead to finance constraints that are competition related. But why would large(r) 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. They, instead, may depend more on hard (credit scoring type) 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. US evidence seems to point at entry of new

[55] Kaplan and Zingales (1997, 2000) provide some nuances to this conclusion.

institutions when banks merge and become less receptive, cq. able, to serve 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 US.

Theoretical developments have been dominating the field. Relationship banking has been shown to potentially facilitate the financing of corporations. Simultaneously, such potentially strong relationship between bank and borrower might make it difficult for the borrower to leave this lender. Hold-up problems, i.e. the incumbent bank may take advantage of the privileged information that it obtains about the borrower, are extensively discussed in the literature (see Rajan, 1992, and Boot, 2000). Typically, this leads to the insight that ex ante borrowers may face a favorable interest rate, but once they are hooked to the bank, the bank can exploit its information monopoly and raise prices. This effect leads to the insight that information sharing might be very important to limit the ex post semi-monopoly of the incumbent bank. This points at the importance of credit bureaus, or other information sharing mechanisms to prevent severe hold up problems (subjected of course to privacy and competition concerns).

The effects of competition in general on bank lending are favorable, 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 up front costs, and could make banks stricter in their initial credit assessment. The typical result is however that competition benefits borrowers because more competitive pricing is available and hold up problems might be easier to contain.

### *2.2.2 Market structure of banking services for SMEs*

The Dutch SME lending market is primarily served by four banks, ABNAMRO, ING, Rabobank and, to a lesser extend, Fortis. The total market share of these four banks in

SME lending is roughly 95% (see Table 2.4, and also NMa (2004), p. 122). Foreign banks are largely absent, and, if present, only observed in serving larger corporations.[56]

Actually, 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 choice between two or three providers. The analysis in section 1.1 would then clearly point at a potential lack of contestability of this market both in terms of limited competitive fringe and absence of potential entry (considering the importance of branches).

As is apparent from Tables 2.5 and 2.6 SME customers do not switch much.[57] The profitability of SME banking is difficult to assess given the lack of data. Table 2.7 does provide some information, but this I difficult to interpret. Much what was said in section 2.1 also applies here. The SME market like the consumer market is highly concentrated. If, as we will argue in section 3, the costs of payment services in the Netherlands are relatively low, then that in conjunction with Table 2.7 point at pricing practices that are linked to loans. Table 2.7 (but note the data limitations) suggests that banks center their fees around loans. SME branch organizations seem to confirm this. Having a loan from a bank appears to truly lock-in the borrower (see also subsection 2.2.3).

There is somewhat more mixed evidence on other type 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 bank finance, suggesting 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

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

[57] 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.

very 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.

Again data availability is a serious problem. Much more data needs to be available to assess these issues.[58]

***Table 2.4: Market shares in the Dutch SME market***

| SME | 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 2.5: Growth rates and switching***

Number of current accounts growth, Churn and Longevity. Weighted average. Year 2005. Consumers and SMEs

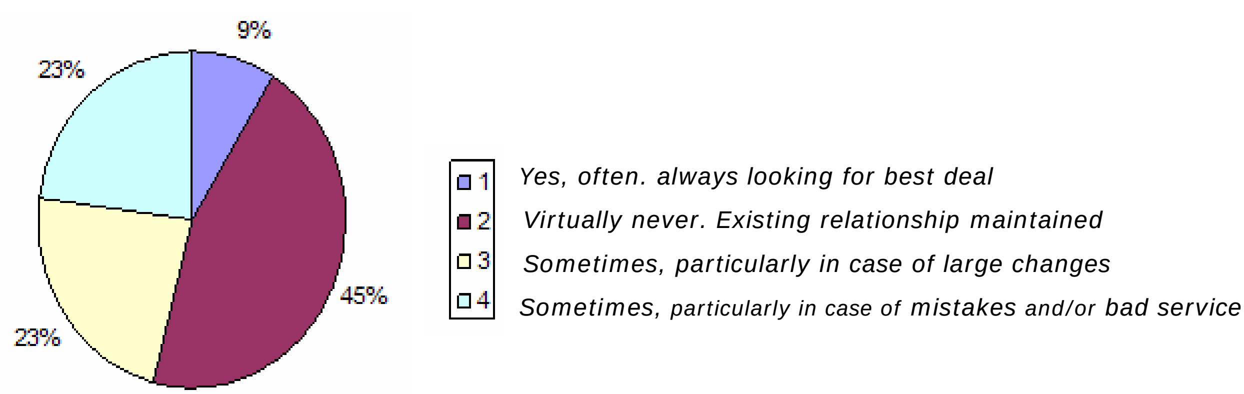
| | **Growth** | | **Churn after control** | | **Longevity** | |
|---|---|---|---|---|---|---|
| | **consumer** | **SME** | **consumer** | **SME** | **consumer** | **SME** |
| **Belgium** | 3.39% | -1.67% | 5.27% | 8.90% | 10.04 | 9.99 |
| **France** | 1.82% | 2.31% | 6.84% | 12.26% | 11.06 | 8.39 |
| **Germany** | 2.55% | 0.01% | 8.46% | 15.15% | 11.55 | 9.85 |

[58] 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 accessible for slightly bigger facilities.

| | | | | | | |
|---|---|---|---|---|---|---|
| **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 2.6: SMEs and bank relationships. Do SMEs shop around?***




Source: NMA, 2004

***Table 2.7: Income from SME services***

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

| Euros | 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)

### *2.2.3 SMEs and bundling*

The NMa has looked at product bundling (tying[59]) in the Dutch market for SMEs (NMa, 2004). As a general conclusion, tying of particular products to having a current account is most commonly 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). Also given the earlier quoted evidence from the SME branch organization one may conclude that Dutch SMEs probably face strong lock-in effects.

While bundling could strengthen lock-in effects, it simultaneously serve a purpose possibly aimed at being able to better serve customers. Nevertheless, a potential concern is the rather weak policy on privacy of data related to client information and intra-conglomerate use of this information. Banks face very few constraints in using this information. The code of conduct of the Netherlands Bankers Association ("Gedragscode verwerking persoonsgegevens financiële instellingen") is possibly to loose, and gives incumbents an advantage that is not warranted inducing competitive distortions in related markets on top of the hold-up problems.

[59] The terminology bundling and tying will be used interchangeably in this report. Strictly speaking, 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.

### *2.2.4 Credit registries and SMEs*

The Netherlands currently has an arrangement for sharing credit information, Stichting Bureau Kredietregistratie (BKR). This credit registry collects information on the paying 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 has granted a loan or a subscription to mobile phone to a consumer, this has to be reported to BKR. A mortgage will only be reported to BKR if the consumer has not paid an instalment over 120 days. BKR provides only 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.

It is important to note that BKR only registers information about loans to consumers, yet some loans to firms without legal structure ("eenmanszaken") are included. Credit information sellers like Dan & Bradstreet do have coverage of the Netherlands. Given the frictions (particularly hold-up problems, see subsection 2.2.1), that characterize the market for SME loans, it seems clearly desirable to expand on the information sharing arrangements in the industry, and have a more thorough coverage of loans to businesses.[60] Observe however that the set-up of such information sharing agency ("credit bureau") warrants careful scrutiny; it should not induce collusive practices.

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

# SECTION 3: PAYMENT SYSTEM ISSUES

## 3.1 Introduction

In this section the payment system is the central focus. Two related sets of questions are asked: i. how to evaluate the Dutch payment system, and what are the possibilities for improvement; and ii. what will the impact be of SEPA, and what opportunities and threats does this imply for the Netherlands?

As will be argued, 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.

The analysis proceeds as follows. Section 3.2 describes the basic characteristics of the Dutch payment system. Section 3.3 focuses on the inefficiencies and frictions in the Dutch payment market. Section 3.4 analyzes the impact of SEPA on the Dutch payment system. Finally, section 3.5 concludes with some further thoughts on interchange fees. Table 3.1 in section 3.4 summarizes the key concerns and provides suggestions for resolutions.

## 3.2 Description and data on the Dutch market for payment services

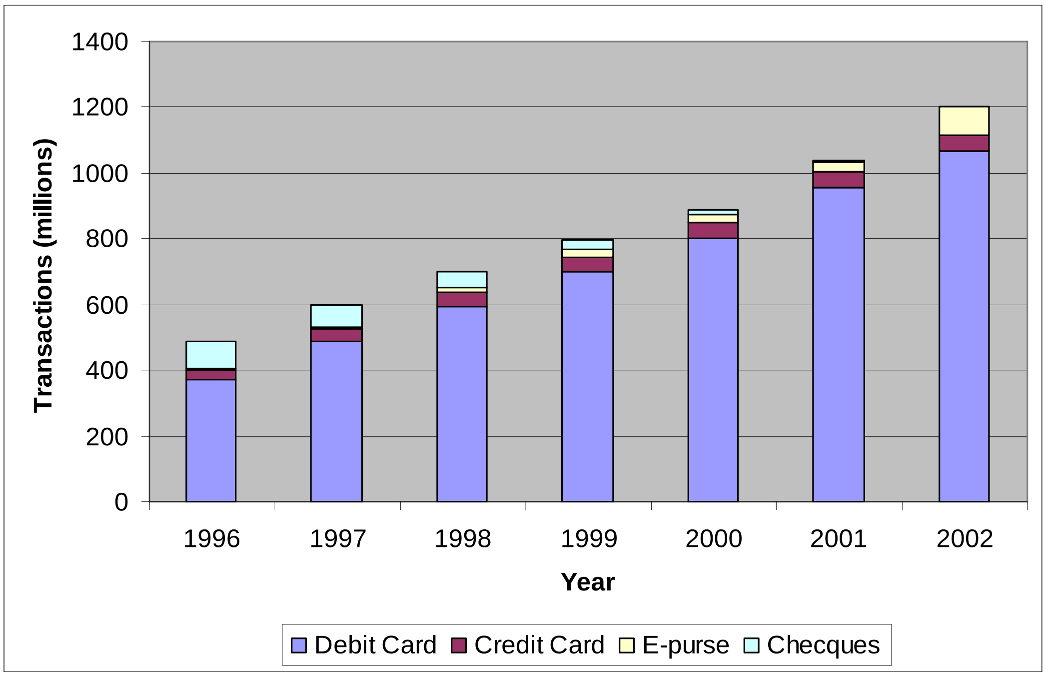
### *3.2.1 Organizational structure*

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

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 paper means of payment. Figure 3.2 shows the migration in payment means over time.

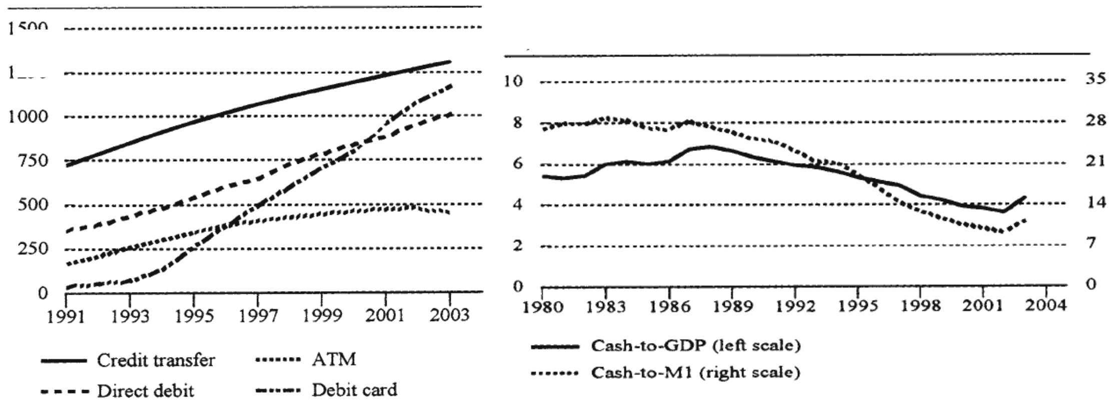
***Figure 3.1: The number of transactions in the Netherlands (in millions[61])***




Source: DNB, 2004.

***Figure 3.2: The use of non-cash payment instruments and cash in the Netherlands.***

[61] 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).




Source: Bolt, 2006.

The Dutch payment system has recently gone through several changes in the governance structure.[62] 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 for 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.

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

### 3.2.2 Further data

[62] 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, 2004).

A characteristic of the Dutch payment practices is the high use of non-cash payments compared to other EU countries, see Figure 3.3. Most noteworthy is the high use of debit cards (note in Figure 3.3 card payments refers to both debit and credit cards). As is apparent from Figure 3.1 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 3.2. The Netherlands is also quite strong on the use of E-purse payment transactions compared to other EU countries (Figure 3.3), yet relative to the use of debit cards it remains very small. The most widely spread form of E-purse payment is Chipknip.

Figure 3.2 shows that cash payments are being replaced by more efficient non-cash payment methods. The Euro introduction slightly affected the conversion, with some temporarily growth in cash instruments during around 2002-2004. In fact, comparing 2003 to 2004 actually monetary coins and notes in circulation increased in other EU countries as well (Figure 3.4). However, this is an anomaly caused by the introduction of the Euro.[63] Figure 3.2 shows that over time – ignoring the 2003-2004 anomaly – cash is clearly becoming less important.

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 3.1 and 3.2 show that there has been a considerable growth in the use of debit cards over time. The use of other payment instruments has increased as well but at a lower pace.

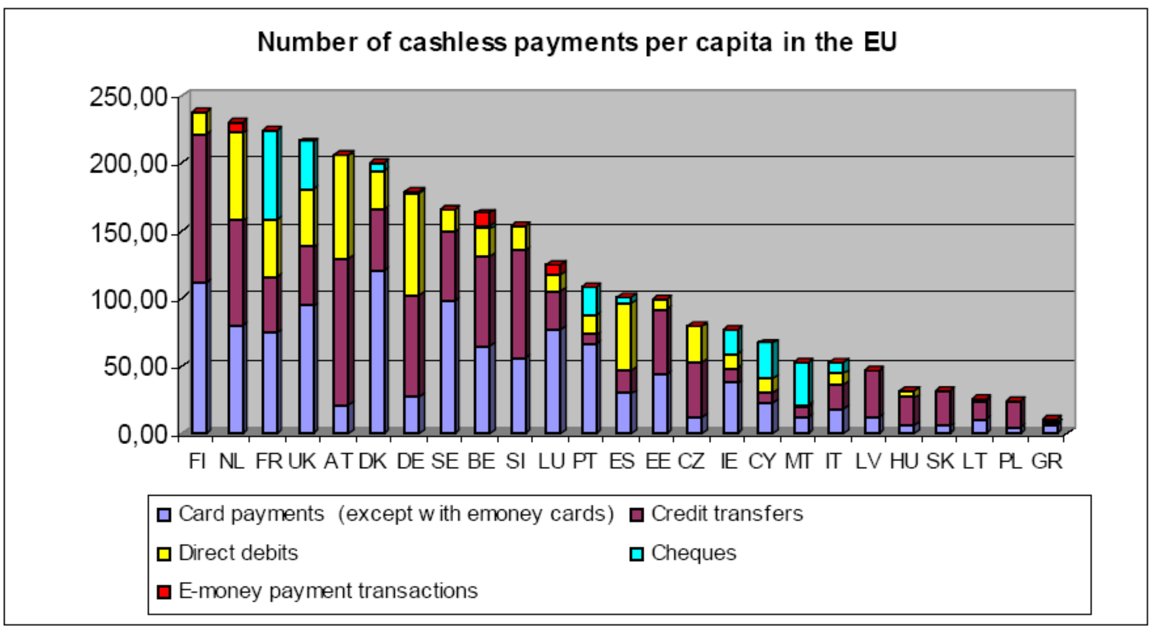
When comparing cash to the debit card, cash turns out to be more cost-efficient for payments below EUR 11.63, while the debit card turns out to be cheaper for higher amounts. Cost savings would be most pronounced if more payments were made by e-purse, irrespective of the specific transaction amount. A scenario where the number of electronic payments would double, replacing 1,500 million cash payments (1,000 million

[63] 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 there 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.

by debit card payments and 500 million by e-purse payments), is claimed to provide a cost saving of over EUR 100 million (DNB, 2004).

Other important data pertain to the profitability of payment services to banks in the Netherlands. In Figure 3.5 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. Figure 3.6 shows that there was a considerable cross-subsidization going on. In particular, banks made profits on payment services to companies, yet made losses to consumers.

***Figure 3.3: Comparison of cashless means of payments in the Netherlands with other EU countries***

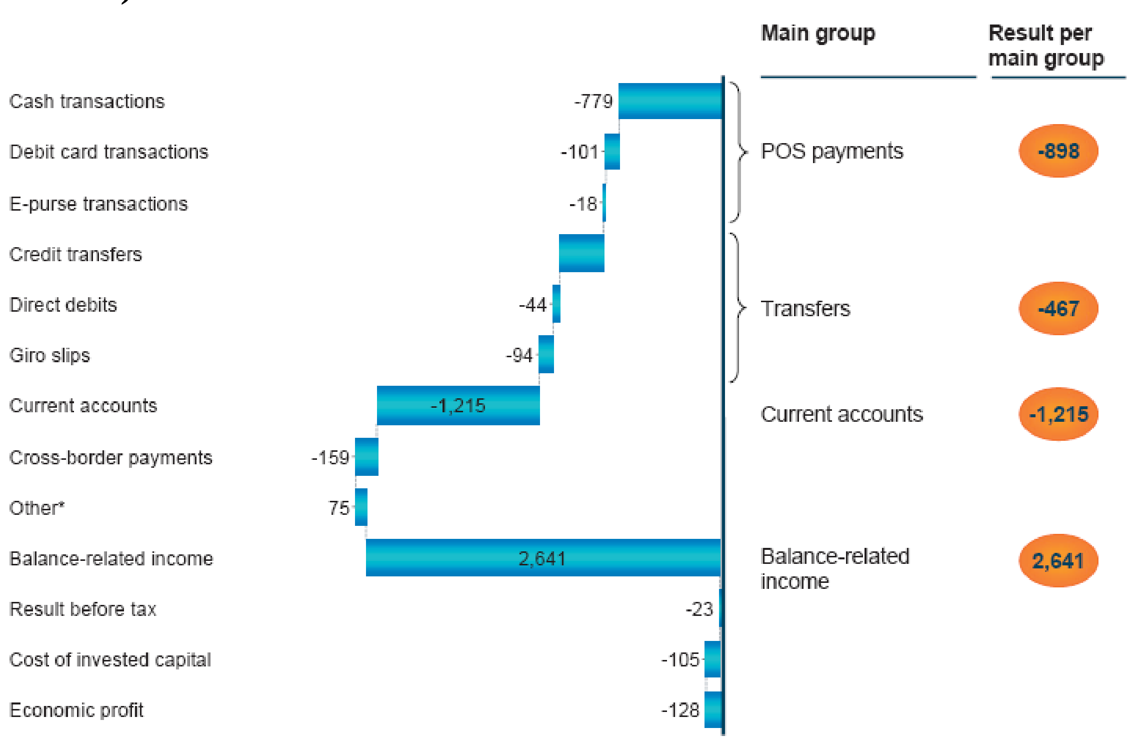



Source: Commission services retail banking sector inquiry, 2005-2006

***Figure 3.4: Annual number of non-cash transactions per inhabitant vs. coins and notes in circulation (2003 vs. 2004)***

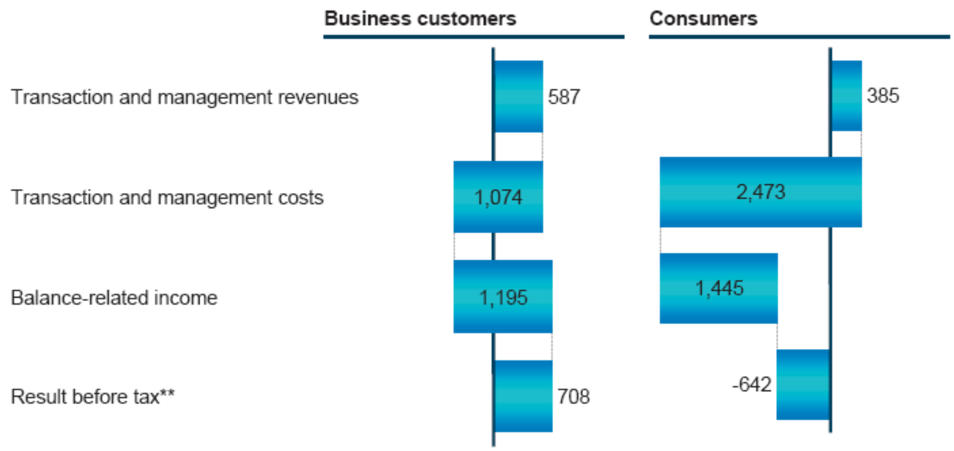

Source: ABN AMRO, 2006.

***Figure 3.5: Overview of revenues and costs for banks from payment services (in million €)***




Source: McKinsey, 2006.

***Figure 3.6: Comparison on total profits on business customers and consumers***




Source: McKinsey, 2006.

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

### *3.3.1 Overview*

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 3.4.

The section starts out with some observations about entry barriers in the Dutch payment market (subsection 3.3.2). Subsection 3.3.3 focuses on other potential inefficiencies, in particular, the consequences of the lack of transaction pricing in the Dutch payment market. In subsection 3.3.4 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.

### *3.3.2 Evidence on entry*

The special status of Currence has been suggested to complicate entry to the Dutch market. 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 which can give market parties (banks, payment product providers…) access to the market of collective payment products".

However, key in the assessment of the impact of Currence on competition is the actual conduct of Currence. It is instructive to note that Currence has been 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). Key for such role are its establishment as an independent organization with transparent, objective and non-discriminatory criteria. Much debate centers around the actual structure where the incumbent Dutch banks are the actual of shareholders of Currence. Key to the 'neutral' role of Currence is that these shareholders cannot impact Currence policies and actions directly and/or indirectly.

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.[64] 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.

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.

[64] 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.

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.

In several Member States, acquiring of Visa and/or MasterCard transactions is done by a monopoly player. Such acquirers act as *joint ventures* of incumbent banks that at the same time issue cards on that market. This situation may enable issuers to exercise significant market power. In the Netherlands, this is in essence also the case. PaySquare BV – a joint venture of Dutch banks for acquiring merchants for MasterCard and Visa credit card and a 100% subsidiary of Interpay – has basically the complete market.[65]

The investigation by European Commision identified several other barriers to entry in the payments markets (EC, 2006a, 2007). These barriers are of a structural, technical or behavioral 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 this also holds for other Euro-area member states, and that these barriers are in part the rationale for the SEPA initiative (see section 3.4).

Even though the fees for entering the PIN scheme are relatively low in the Netherlands (approximately €50000, among the lower 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. Consequently, a foreign bank without access to the PIN scheme

[65] 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).

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, e.g. act as payment transaction processor.

Interestingly, 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 (always without PIN) cannot be used in the national Dutch payment system unless Dutch merchants would choose to accept Maestro together with the necessary investment. This again forces foreigners to open a bank account at a Dutch bank.[66]

In sum, to enter the Dutch payments market as issuer or acquirer, banks must at least have a banking license from the Dutch Central Bank and they must have access to the Equens (Interpay) circuit in order to facilitate payments (OECD, 2006a). This is – as stated before – part of the rationale of SEPA, yet note SEPA will continue to allow for national specifications.[67]

### *3.3.3 Other inefficiencies in the Dutch payment market*

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).

---

[66] 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.
[67] Interview with Equens chairman Michael Steinbach, as reported in the Dutch language *Banking Review*, May 2007.

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. The earlier reported study ordered by the Dutch Central Bank and the Netherlands Bankers Association (McKinsey, 2006) showed that the Dutch banks together made a loss of approximately €23 million in 2005 on payment services. While consumer payment services are essentially free (and this imposed 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 3.6).

More explicit and transparent pricing may help further optimize 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. A further increased competition in the market for acquiring might lead banks to stop cross subsidizing more costly means of payments.

Surcharging may also help, and is allowed in the Netherlands. Yet, surcharging might also distort incentives to use the most efficient payment method, i.e. surcharging debit card payments without at the same time surcharging the less efficient payment method, cash transactions, will stimulate consumers to use expensive cash rather than their more efficient debit payment cards

Dutch banks also point at another distortion. Suboptimal fees due to the cost of data communication (telco's 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 (sur)charging customers if they want to use their payment card for low payment amounts (below € 10-€15), again favoring more costly 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. [68]

### *3.3.4 Is the transfer of merchant contracts effective?*

The migration of merchant contracts from Interpay to the individual banks institutions 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).

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).

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. Smaller retailers have not benefited. As also the discussion on SMEs in Section 2 suggests, SMEs do not appear to have had an opportunity to "shop around".

[68] "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.

## 3.4 SEPA

### *3.4.1 Definition and objectives of SEPA*

The ECB states the definition and objectives of SEPA 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 market, 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.

SEPA defines 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.

The envisioned advantages of SEPA include i. benefits of economies of scale, ii. enhanced competition in (retail) banking markets, iii. more efficient use of payment instruments, and more controversially, iv. 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.

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 and speed of transactions (NMa, 2006). Also measures to smooth access to licenses for non-bank suppliers of payment services are intended. But note SEPA is a market-led initiative, thus banks, not governments and/or policymakers, are in the driver's seat. This clearly limits the role of governments and policy makers.[69]

### *3.4.2 Standardization for cards*

An essential element of SEPA is that it seeks to harmonize cards and standards. 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).

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.

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

[69] Coordination might be important though. Recently, the Dutch Central Bank, the Netherlands Bankers Association and Currence produced a joint document on the "transition to SEPA" (NVB, 2007).

decide on the actual choice of interoperable solutions and the pace of transformation (EPC, 2006b).

### *3.4.3 Cooperation, competition and self regulation*

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 allows for competition and cooperation at the same time. First, there will be the competitive bank layer in which banks provide SEPA products and services for customer use. The second layer relates to the scheme cooperation. This defines the basis on which banks cooperate to provide standards, rules and interoperability. The third layer relates to the processing infrastructure. This layer is primarily competitive, although communities of banks can and do cooperate to meet common needs.

The implementation of SEPA is basically left to market forces (i.e. 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 merchants have identified several dangers that the implementation of SEPA can 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. This development would then backfire on merchants and consumers.

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.[70] Customers are able to pay electronically using iDeal through the website of their own bank, a variant of internet banking. Fortis, SNS Reaal and Friesland Bank have joined this initiative as well (NMa, 2005). The question is, however, whether this system will not present a natural barrier for foreign banks to enter in the Netherlands simply because foreign banks may have internet payments products that have different standards (OECD, 2006a).

## 3.5 Analysis of implications of SEPA for debit cards in the Netherlands

### *3.5.1 SEPA compliant?*

Given the popularity of debit cards in the Netherlands, the implications of the introduction of SEPA for the existing Dutch system of debit cards (PIN) are of considerable importance. An important issue is what it takes to make the Dutch debit card system SEPA compliant. More specifically, the SEPA Card Framework (SCF) has adopted the EMV chip as the supporting card technology going forward. An assessment of EMV compliance for cards (POS and ATM) shows that the Netherlands as well as much of Europe have a substantial compliance gap to close. It is not clear though whether really sizeable investments are needed in the Dutch PIN based debit cards to make them SEPA compliant.

The international card schemes have been using a “carrot-and-stick” approach to push EMV standards. The standards deliver benefits in terms of security in processing card transactions, but cards that are not EMV-compliant will be refused the same fraud guarantees as EMV-compliant cards. This “liability shift” means the liability for

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

fraudulent card transactions will pass to the party that is not EMV-compliant in cases where a card has been lost, stolen, or counterfeited. However, POS equipment must be upgraded to attain EMV compliance – an investment that some owners are reluctant to make. In the Netherlands, for example, retailers own the POS equipment, and they may not be keen to make further investments. However, Dutch retailers have been given until 2013 to replace their POS terminal. This may substantially reduce the burden since it better matches with the common economic duration of the terminals.

In general, ATM compliance is more widespread, as there is a positive business case for migrating an ATM to EMV standards, mainly because ATM owners receive a higher service charge from the issuing bank when an ATM is EMV-compliant (ABN AMRO, 2006).

### *3.5.2 Replacement of PIN by an international scheme*

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 with exclusive market power for Visa and MasterCard (Maestro).[71]

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 ever 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, this is a somewhat mood point, international scheme companies have

[71] 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 at that corporates subsidize the payment services for consumers in the Netherlands. This cross-subsidizing could induce distortions. Also low tariffs my go at the expense of introducing innovations.

already made their schemes SEPA compliant and PIN scheme is close to be SEPA compliant as well.

However, the expected proliferation of international card schemes with their typically higher interchange fees could induce banks to choose such schemes over their national schemes. 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).

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. For reasons external to Europe, MasterCard has abandoned the user-driven model in favor of a shareholder-driven solution, and Visa has recently announced similar intentions. In a market with insufficient competition, such a decision could lead to upward pressure on fees. 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).

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 to emerge. 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 to survive if banks decide to abolish the PIN scheme. Also note that SEPA does not require a separation of that like Currence and Interpay. It might be desirable to amend SEPA if otherwise a duopoly of Visa/MasterCard is unavoidable.[72]

### *3.5.3 Co-branding domestic card with an international card scheme*

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.

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 are 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.

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).

### *3.5.4 Alliances and/or introducing a new EU scheme*

An alternative solution for containing the Visa/MasterCard dominance 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

[72] NMa (2006, pg. 173) points also at the potential positive effects of vertical disintegration for innovation.

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).

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). Three more members – Interpay (Netherlands), Laser (an Irish POS system) and Activa (another POS system in Slovenia) – are also expected to join. Implementation projects have already been set up by processors in Germany, Italy and the Netherlands (EAPC, 2006).

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, simply enabling interconnectivity. EAPS may therefore offer a way to maintain the efficiency of existing national card payment systems within SEPA.[73] It will be up to the banks to decide whether this EAPS scheme (or schemes) has international reach. A key competition issue is that such EAPS scheme(s) should be able to co-brand with Visa and MasterCard for coverage outside the Euro area.

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 skeptical about the viability of such third international payment scheme. Establishing a new European card scheme would need an extremely high level of initial investment and its implementation could put banks under considerable risk. Starting with an alliance might be a more feasible approach. One could argue that forming alliances might only be a starting point and a European card scheme might gradually evolve from such cross-country alliances between national payments systems. From a public policy objective, one may need to evaluate how such process might be facilitated without invoking competition concerns.

---

[73] 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).

*Table 3.1: Key concerns and resolutions for SEPA implementation*

| **Key concerns** |
|---|
| • SEPA may increase the cost of the Dutch payment system leading to higher fees.[74]<br>• Vertical integration may undermine the specialized market for processing services, and further complicate the emergence of other pan-European schemes.<br>• A duopoly Visa/MasterCard may emerge |

| **Resolutions** |
|---|
| • Consider (force?) unbundling in SEPA along the lines of the Equens/Currence model. This could reduce anti-competitive effects of vertical integration in Visa/MasterCard.<br>• Facilitate co-branding and prevent international schemes (Visa, MasterCard) from abusing their position vis-à-vis co-branding.<br>• Encourage initiatives (e.g. EAPS) for establishing alternative international card schemes. |

### 3.6 Some further thoughts on interchange fees

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.[75]

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

[74] See the earlier qualifications that put some warning on interpreting the current low tariffs in the Dutch payment arena as only a benefit.

[75] 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).

shows that interchange fees are likely to be retained by banks and are not (fully) transferred to card owners.[76]

In the Netherlands, the interchange fees are fairly low. The NMa has been looking closely at 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[77] 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. In is not even clear whether interchange fees are at all needed in the Dutch market.

The discussion on interchange fees is also important for the viability of domestic payment schemes. A potential danger is that possibly high(er) levels of interchange fees in certain schemes might 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.[78]

---

[76] 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).

[77] The equivalent of Article 81(1)EC.

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

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).[79]

Given the lack of evidence, both theoretical and empirical, it is difficult to take a stance on the level of interchange fees, and the desirability of MIFs in particular. The competition authorities will only allow MIFs if an exemption can be made from Art.81.1 EU based on Art.81.3 EU. Bilateral IFs are a different story, pairs of banks can choose to divide costs if they so desire. Given this state of affairs, a further investigation into the status, level and optimal structure of interchange fees is needed.

[79] 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).

### *References*

ABN AMRO, 2006, World Payment Report, http://www.efma.com/wpr06/about.htm

Allen, F., E. Carletti, and R. Marquez, 2006, Credit Market Competition and Capital Regulation, mimeo, University of Pennsylvania.

APCA, 2007, Payments Monitor, Australian Payments Clearing Association, 2007, First Quarter 2007.

Barth, J. R., G. Caprio and R. Levine, 2003, Bank Regulation and Supervision: What Works Best? *Journal of Financial Intermediation 13*, 205-248.

Baumann, U., and E. Nier, 2003, Market Discipline and Financial Stability: Some Empirical Evidence, *Financial Stability Review*, Bank of England, June, 134-141.

Baxter, W.F., 1983, Bank Interchange of Transactional Paper: Legal and Economic Perspectives, *Journal of Law and Economics 26*, 541-588.

Beck, T., A. Demirguc-Kunt, and R. Levine, 2005, Bank Concentration and Fragility: Impact and Mechanics, NBER Working Paper 11500.

Berger, A., N. Miller, M. Petersen, R. Rajan and J. Stein, 2005, Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks, *Journal of Financial Economics* 76, 237-269.

Berger, A., A. Saunders, J. Scalise and G. Udell, 1998, The Effects of Bank Mergers and Acquisitions on Small Business Lending, *Journal of Financial Economics* 50, 187-230.

Bhattacharya, S., A.W.A. Boot and A. Thakor, 1998, The Economics of Bank Regulation, *Journal of Money, Credit and Banking 30*, 745-770.

Bikker, J., L. Spierdijk, and P. Finnie, 2006, The Impact of Bank Size on Market Power, DNB Working Paper, December.

Bikker, J.A., and A.A.T. Wesseling, 2003, Intermediation, Integration and Industrialization: A Survey on Banking in Europe, Working paper, DNB (Dutch Central Bank).

BIS II, 2003, *The New Basel Capital Accord*, Basel Committee on Banking Supervision Consultative Document, Banks for International Settlements, April.

Bishop, S., and M. Walker, 2002, The Economics of EC Competition Law: Concepts, Application and Measurement, London, Sweet & Maxwell.

Bolt, W., 2006, Retail Payments in the Netherlands: Facts and Theory, De Economist 154, 345-372.

Boonstra, W., and H. Groeneveld, 2006, Concentratie en concurrentie in het Nederlandse bankwezen, *Financiële en Monetaire Studies,* 63p.

Boot, A.W.A., 2007a, The Competitive Challenge in Banking, report prepared for Unicredit Foundation, April.

Boot, A.W.A., 2007b, Advies inzake modernisering van het uitvoeringsmodel voor pensioenregelingen, report voor het Ministerie van SZW, 19 maart.

Boot, A.W.A., and M. Marinč, 2007, Competition and Entry in Banking: Implications for Capital Regulation, working paper, University of Amsterdam.

Boot, A.W.A., T. Milbourn and S. Deželan, 2001, Regulation and the Evolution of the Financial Services Industry, in: *Challenges for Central Banking*, eds. A.M. Santomero, S. Viotti, A. Vredin, Kluwer: Massachussetts, 39-58.

Boot, A.W.A., S. Deželan and T. Milbourn, 2000, Regulatory Distortions in a Competitive Financial Services Industry, *Journal of Financial Services Research*, 17(1), 249-259.

Boot, A.W.A., and A.V. Thakor, 2000, Can Relationship Banking Survive Competition?, *Journal of Finance 55*, 679-713.

Boot, A.W.A., and A. Schmeits, 2004, Imperfecties in de vermogensmarkt en overheidsbeleid, In: B. Jacobs and J. Theeuwes, Eds, Innovatie in Nederland, Preadviezen voor de Koninklijke Vereniging voor de Staathuishoudkunde, 95-131.

Boyd, J.H., and G. De Nicoló, 2005, Bank Risk and Competition Revisited, *Journal of Finance 60*, 1329-1343.

Boyd, J.H., G. De Nicoló and B.D. Smith, 2003, Crises in Competitive Versus Monopolistic Banking Systems, IMF Working Paper, September.

Brits H., and C. Winder, 2005, Payments Are no Free Lunch, DNB Occasional Study 3.

Calomiris, C., and C. Kahn, 1991, The Role of Demandable Debt in Structuring Optimal Banking Arrangements, *American Economic Review*, 497-513.

Caminal, R., and C. Matutes, 2002, Market Power and Banking Failures, *International Journal of Industrial Organization*, 20, 1341-1361.

Canoy, M., and S. Onderstal, 2003, Tight Oligopolies, Central Planning Bureau, February 2003, pp. 92-93.

Carletti, E., and P. Hartmann, 2002, Competition and Stability: What is Special about Banking? working paper, European Central Bank.

Cetorelli, N., B. Hirtle, D. Morgan, S. Peristiani and J. Santos, 2007, Trends in Financial Market Concentration and Their Implications for Market Stability, Economic Policy Review of Federal Reserve Bank of New York, 13(1), 33-53.

Claessens, S., A. Demirguc-Kunt and H. Huizinga, 2001, How Does Foreign Entry Affect Domestic Banking Markets? *Journal of Banking and Finance 25*, 891–911.

Claessens, S., and L. Laeven, 2004, What Drives Bank Competition? Some International Evidence, *Journal of Money, Credit and Banking 36*, 563-583.

CPB, 2001, Competition and Stability in Banking, report, CPB Document 15.

CPB, 2003, Price Setting and Price Dispersion in the Dutch Mortgage Market, CPB Discussion Paper No. 21, September.

CPB, 2005, Competition in Markets for Life Insurance, CPB Document 96, The Hague, September 2005, http://www.cpb.nl/eng/pub/cpbreeksen/document/96/doc96.pdf

Cruickshank, D., 2000, *Competition in UK Banking: A Report to the Chancellor of the Exchequer*, (339 pages), March.

Dialogue, 2007, Report SEPA: Banks Get Serious as Corporates Engage, Dialogue Q1, www.swift.com/index.cfm?item_id=61591

Diamond, D., and R. Rajan, 2001, Liquidity Risk, Liquidity Creation and Financial Fragility: A Theory of Banking, *Journal of Political Economy 109*, 287-327.

Demsetz, R.S., M.R. Saidenberg and P.E. Strahan, 1996, Banks with Something to Lose: The Disciplinary Role of Franchise Value, *Federal Reserve Bank of New York Economic Policy Review 2*, 1-14.

Djankov, S., C. McLeish and A. Shleifer, 2007, Private Credit in 129 Countries, *Journal of Financial Economics 84*, 299-330.

DNB, 2002, Aanbevelingen van de Nederlandsche Bank inzake tariefstructuren en infrastructuur in het Nederlandse betalingsverkeer, De Nederlandsche Bank, 28 March 2002.

DNB, 2004, The Cost of Payments. Survey on the Costs Involved in POS Payment Products, the Working Group on cost of POS payment products, March, http://epso.intrasoft.lu/papers/DNB-cost-of-payments.pdf

Duffhues, P., 2003, De financierbaarheid van het MKB: Een analyse van de financiële structuur, Onderzoeksrapport in de opdracht van de Raad voor Zelfstandiging Ondernemerschap.

EAPC, 2006, Wiesbaden Declaration, Euro Alliance of Payment Schemes, September, http://www.eufiserv.com/extranet/common/viewPdf.asp?site=1&docId=647

EC, 2006a, Interim Report I - Payment Cards, Sector Inquiry under Article 17 Regulation 1/2003 on retail banking, European Commission, April, http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/interim_report_1.pdf

EC, 2006b, Commission staff working document accompanying the Communication from the Commission, Sector Inquiry under Art 17 Regulation 1/2003 on Retail Banking, SEC(2007)106, http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/

EC, 2006c, Commission staff working document addressed to the European parliament and to the Council on the impact of Regulation (EC) No 2560/2001 on bank charges for national payments, http://ec.europa.eu/internal_market/payments/docs/reg-2001-2560/report-070111_en.pdf

EC, 2007, Communication from the Commission, Sector Inquiry under Art 17 of Regulation 1/2003 on retail banking (Final Report), http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/com_2007_033_en.pdf

ECB, 2006a, The Single Euro Payments Area: An Integrated Retail Payments Area, 2006, http://www.ecb.int/paym/pol/sepa/html/index.en.html

ECB, 2006b, The Eurosystem's View of a »Sepa for Cards«, November, http://www.ecb.int/pub/pdf/other/eurosystemsviewsepacardsen.pdf

ECB, 2006c, A SEPA for Cards: A Contribution To a Cashless Society?, Speech by Gertrude Tumpel-Gugerell, Member of the Executive Board of the ECB, EFMA Cards and Payments Conference Paris, 20 September 2006.

ECB, 2007, http://www.ecb.int/paym/pol/sepa/html/index.en.html

EPC, 2007a, Making SEPA a Reality, Implementing the Single euro Payments Area, European Payments Council, January, EPC066-06 Version 1.3, http://www.fbf.fr/Web/internet/content_europe.nsf/(WebPageList)/6408B798BCCF16ACC12571A10048A849/$File/Making_SEPA_Reality_janv07.pdf

EPC, 2007b, A Response to the Eurosystem's view of a "SEPA for Cards", April, http://www.europeanpaymentscouncil.eu/documents/EPC071-

07%20Position%20on%20Eurosystem%20report%20on%20SEPA%20for%20Cards.pdf

Flannery, M.J., and K.P. Rangan, 2004, Market Forces at Work in the Banking Industry: Evidence from the Capital Buildup of the 1990s, mimeo, University of Florida.

Focarelli, D., and F. Panetta, 2003, Are Mergers Beneficial to Consumers? Evidence from the Market for Bank Deposits, *American Economic Review 93*, 1152–1172.

Freixas, X., S. Hurkens, A.D. Morrison, and N. Vulkan, 2004, Interbank Competition with Costly Screening, Oxford Financial Research Centre Working Paper.

FSA, 2000, *Response by the Financial Services Authority to the Cruickshank Report on Competition in UK Banking*, July, 32p.

Group of Ten, 2001, Report on Consolidation in the Financial Sector, www.bis.org

Hartsink, 2007, SEPA: We're all in the same boat, An interview with G.Hartsink, the EPC Chair, by Swiss Interbank Clearing as published in ClearIT, the Swiss professional journal for payment traffic, March 15.

Interpay, 2003, Keuzemogelijkheid voor het afsluiten van overeenkomst PIN en/of Chipknip, 22 December.

Keeley, M.C., 1990, Deposit Insurance, Risk and Market Power in Banking, *American Economic Review 80,* 1183-1201.

Kroes, N., 2006, European Commissioner for Competition Policy, Payment Cards Competition Inquiry – Preliminary Results, Introductory remarks at press conference, April, Brussels http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/06/239&format=HTML&aged=1&language=EN&guiLanguage=sl

Kokela, E., and R. Stenbecka, 2000, Is There a Trade-off between Bank Competition and Financial Fragility?, *Journal of Banking and Finance,* 1853-1873.

Kopecky, K.J., and D.VanHoose, 2006, Capital Regulation, Heterogeneous Monitoring Costs, and Aggregate Loan Quality, *Journal of Banking & Finance 30*, 2235–2255.

McKinsey & Co, 2006, *Payment Services in The Netherlands: An Analysis of Revenues and Costs for Banks*, final report, July 10, 25p.

Merton, R.C., and A.F. Perold, 1998, Theory of Risk Capital in Financial Firms, *Journal* *of Applied Corporate Finance,* 1998, 16-30.

Morrison, A.D., and L. White, 2005, Crises and Capital Requirements in Banking, *American Economic Review 95*, 1548–1572.

NBA, 2006, Reply of the Netherlands' Bankers Association to Interim Report on Cards, Netherlands Bankers' Association, June, http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/report_1/47.pdf

NMa, 2005, Financial Sector Monitor 2005, http://www.nmanet.nl/engels/home/News_and_publications/Publications/FSM05.asp

NMa, 2006, Monitor Financiële Sector 2006, http://www.nmanet.nl/Images/MFS%202006_tcm16-96809.pdf

NVB, 2006, Reply of Dutch Banks to the Second Interim Report on Current Accounts and Related Services, October, http://www.nvb.nl/index.php?p=17002

NVB, 2007, Joint document (in Dutch) of the Dutch Central Bank, the Netherlands Bankers Association and Currence on the transition to SEPA ("De overgang op SEPA"), Version 3.3., June 2007.

OECD, 1998, *Enhancing the Role of Competition in the Regulation of Banks,* Committee on Competition Law and Policy, (428 pages), September.

OECD, 2006a, Roundtable on Competition and Efficient Usage of Payment Cards, June 6, DAF/COMP/WP2/WD(2006)33.

OECD, 2006b, Roundtable on Competition and Regulation in Retail Banking, The Netherlands, DAF_COMP_WP2_WD(2006)54.

Oxera, 2006, *The Price of Banking: An International Comparison*, Report Prepared for British Bankers' Association, November, 95p.

PDHN, 2006, SEPA Incentives: Response Platform DetailHandel Nederland, Platform DetailHandel, Nederland, http://www.platformdetailhandel.nl/index.cfm/28,551,c,html/2006%203%2020%20Response%20Platform%20Detailhandel%20Nederland_1.pdf

Riksbank, 2000, The Banking Law Committee's Main and Final Report, *Economic Review 3*, Riksbank (Central Bank of Sweden).

Rochet, J.C., and J. Tirole, 2002, Cooperation among Competitors: Some Economics of Payment Card Associations, *Rand Journal of Economics 33*, pp. 549-570.

Sapienza, P., 2002, The Effects of Banking Mergers on Loan Contracts, *Journal of Finance* 57, 329-367.

Sengupta, R., 2007, Foreign Entry and Bank Competition, *Journal of Financial Economics, 84,* 502-529.

Schmalensee, R., 2002, Payment Systems and Interchange Fees, *Journal of Industrial Economics, 50,* pp. 103-122.

Shaked, A., and J. Sutton, 1982, Relaxing Price Competition through Product Differentiation, *The Review of Economic Studies 49*, 3–13.

Stein, J., 2002, Information Production and Capital Allocation: Decentralized versus Hierarchical Firms, *Journal of Finance* 57, 1891-1921.

Stiroh, K.J., and P.E. Strahan, 2003, Competitive Dynamics of Deregulation: Evidence from U.S. Banking, *Journal of Money, Credit, and Banking 35*, 801–828.

Syverson, C., 2004, Market Structure and Productivity: A Concrete Example, *Journal of Political Economy 112*, 1181–1222.

Vives, X., 2001, Competition in the Changing World of Banking, *Oxford Review of Economic Policy 17*, 535-547.

Wright, J., 2004, The Determinants of Optimal Interchange Fees in Payment Systems, *Journal of Industrial Economics 52*, 1-26.