Report

Current Account Credit Loans to SMEs

Date March 2009 *(The original document is in Dutch. This is a translation.)*

NMa

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Contents

1 Summary for the Management

Background and aim

The importance of Small and Medium Enterprises (hereafter: SMEs) for Dutch economy is large in terms of production and employment. In order to enable them to start an enterprise, SMEs require short term financing, for example, for paying their suppliers. Overdraft facility plays an essential role, hence a well-functioning market for overdraft facility is extremely important for SMEs.

In 2007 the Netherlands Competition Authority (hereafter: NMa) started an investigation into a possible violation of the Dutch Competition Act (hereafter: Mw) on the market for giving overdraft facility to SMEs. There is evidence that the banks had an agreement regarding the level of interest asked for overdraft facility. No violation of Mw has been detected. The NMa did reach the conclusion that the market is not functioning optimally. The aim of this NMa-report is to increase the insight SMEs and other market parties have into the extending of overdraft facility to SMEs. They can then possibly use that perception in their negotiations about the level of interest rates for overdraft facility. Lowering the switchover thresholds and increasing the purchasing power of SMEs, combined with the SME's more critical attitude, could lead to more frequent switching over to another bank. Furthermore it would be easier for SMEs with their clearer perception to make the most profitable choice in furthering (the base interest rate) interest rates of overdraft facility. Both these aspects will be invaluable to the market.

Overdraft facility for SMEs and large enterprises

There is a link between the overdraft facility and the current account of an SME, and the overdraft facility provides an arrangement for debit on the current account. This situation arises when for example, suppliers must be paid, and the account balance is not sufficient. The interest rate that the SME pays for this facility is the so-called debit interest charge. For SMEs this usually consists of the base interest of the customer surcharge, which is dependant on the individual features of the SME, such as creditworthiness. The base rate comprises the Refinancing Interest Rate (implemented by the European Central Bank) and a general, non-customer specific surcharge. Account managers at the local banking offices have no say about the level of the base interest. This is established for them. Large companies generally use a different construction for their debit interest. They pay the Euribor tariff (an interest charge specified between banks), and an individual customer surcharge. Therefore there is no general non-customer specific surcharge for these large companies.

Results of the NMa-investigation

The high level of parallelism in the base interest charge implemented by banks between 1990 and 2007 also triggered off the aforementioned NMa-investigation. The parallelism in the development of the base interest between banks turns out to be explained by the link with the Refi-interest. When the ECB alters the Refi-interest, the banks follow suit. The parallelism in the level of base interest has in all probability grown over the years. At first the surcharge on the base interest had a temporary character, and later this surcharge became permanent. Banks give varied and contradictory explanations and cannot give a good reason why this surcharge on the base interest averages 75 base points (0.75%).

The NMa-investigation goes into two possible explanations for maintaining parallelism in the level of base interest. In the first place the banks possibly have individual market power. Due to this, banks may maintain the level of surcharge on base interest because SMEs are unable to negotiate with their bank for a lower debit interest due to their limited purchasing power. Secondly, the banks' mirroring behaviour may be the reason for their preservation of this parallelism. This explanation means that transparency of base interest is an important factor. The limited number of providers makes it easier for banks to monitor each other's behaviour. In this case there is no explicit consultation about the surcharge on the base interest necessary, as mirroring will suffice.

Improvement of free-market systems

Depending on the explanation for parallelism in the base interest, the NMa has seen four different possibilities for improving a free-market system. In the case of individual market power, SMEs could discipline banks by switching over to another bank more often. Spreading their various products over different banks instead of taking a package deal at one bank, could make switching over for SMEs easier. Given that there are considerable thresholds at present for switching over, the NMa emphasizes in this context the importance of taking measures which are aimed at facilitating switching over, such as number portability (retaining an account number when switching to another bank). Furthermore, the banks could provide more insight into the credit products and the process of extending credit, which would constitute an improvement of the SME's knowledge of bank products. Measures geared to switching over and to increasing SME's insight could increase SME's purchasing power, which could then contribute to lowering debit interest. In the case of banks mirroring each other (second explanation), the switching over of SMEs to a current account with a different base interest (Euribor) would have a disciplining effect on the banks. The transparency regarding the debit interest would be lessened and the focal point of the base interest would disappear due to this decrease, which would make it less easy for the banks to mirror each other. Furthermore, it would then be possible for SMEs to negotiate over a larger part of the debit interest with their account holders.

2 Introduction

Given the importance of SMEs in Dutch economy[1] and the crucial role the banks play in offering overdraft facility in financing SME activities, it is essential that there is a well-functioning market for giving overdraft facility to SMEs. This report has been drawn up in order to increase insight into how the market functions for SMEs and other stakeholders, and to give advice on how to make these markets work more efficiently. In this way, this document will contribute to improving the functioning of the market by enabling the players on the market to negotiate from an improved and a more evenly matched position of having information about the base and final charges (debit interest rates) of overdraft facilities.

Background

Various indications, such as general economic research, publications and newspaper articles, provided grounds for suspecting that banks are violating the Dutch Competition Act (hereafter: Mw) on the market for overdraft facility to SMEs.[2, 3] Often a long period with a high level of parallelism of the so-called base rates[4] of the various banks from the early 1990s on, was noted. Based on a suspicion of an agreement concerning the height of the base interest, the NMa launched a competition law-investigation into banks in 2007. The three largest players, ABN AMRO, ING and Rabobank had an 85%[5] collective market share in the Netherlands for extending overdraft facility to SMEs, during the investigation period. Consequently, these banks are featured prominently in this report. During the investigation, the NMa has, among other things, paid company inspections, made competition-economic analyses and consulted with those involved. The conclusion of this competition-act investigation is that there is no evidence of any violation of the Mw.[6]

Document structure

Chapter 3 gives a description of the overdraft facility grants to SMEs, in which its product features in particular will be dealt with. Subsequently, chapter 4 deals with the structural features of this market. Chapter 5 provides an overview of the market results from 1990 until mid-2007, whereby the development of the debit interest rates is examined. This chapter also gives possible explanations of the market results of the product features and the structural characteristics. Chapter 6 brings the report to a close with several conclusions.

A note before reading

As mentioned above, this report describes the development of market results within the period from 1990 up until mid-2007. Since then, an extraordinary situation has emerged on the financial market due to the financial crisis. Therefore, the findings concerning the market results (high degree of parallelism of the base rate) are only related to the aforementioned period. However, the conclusions and recommendations in this report remain applicable.

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1 Of all Dutch enterprises, 99% belong to the SMEs, and there are 4.2 million employees working for SMEs. The turnover booked by SMEs in 2006 was EUR 765 billion, which is 58% of the total turnover of all businesses (website MKB Nederland (2008)).

2 Banks do not apply a univocal definition of SMEs. The European Commission states in the case of Fortis/ABN AMRO that the segment of SMEs in this specific situation is made up of companies with a turnover of between EUR 2.5 million and EUR 250 million (European Commission, 2007, margin number 16). This boundary is possibly lower, as shown by data earlier provided by banks. The European Commission applies the following categorization: small enterprises have a turnover < EUR 10 million; medium enterprises have a turnover of < EUR 50 million (European Commission, 2006).

3 The concept "Market" in this report is not used in the sense of the Dutch Competition Act. Therefore there is no relevant market within the scope of the Mw.

4 Chapter 3 provides a description of the Prime rates used by banks, as well as of other product features of current-account credit to SMEs.

5 Monitor Financial Sector (2004), page 122. Chapter 4 gives a description of the main characteristics of this market, where the degree of concentration will also be looked into more closely.

6 The Dutch Competition Act forbids agreements between enterprises, decisions of company amalgamations and concerted practices which lead to or result in competition on the Dutch market being hindered, limited or falsified (see website NMa).

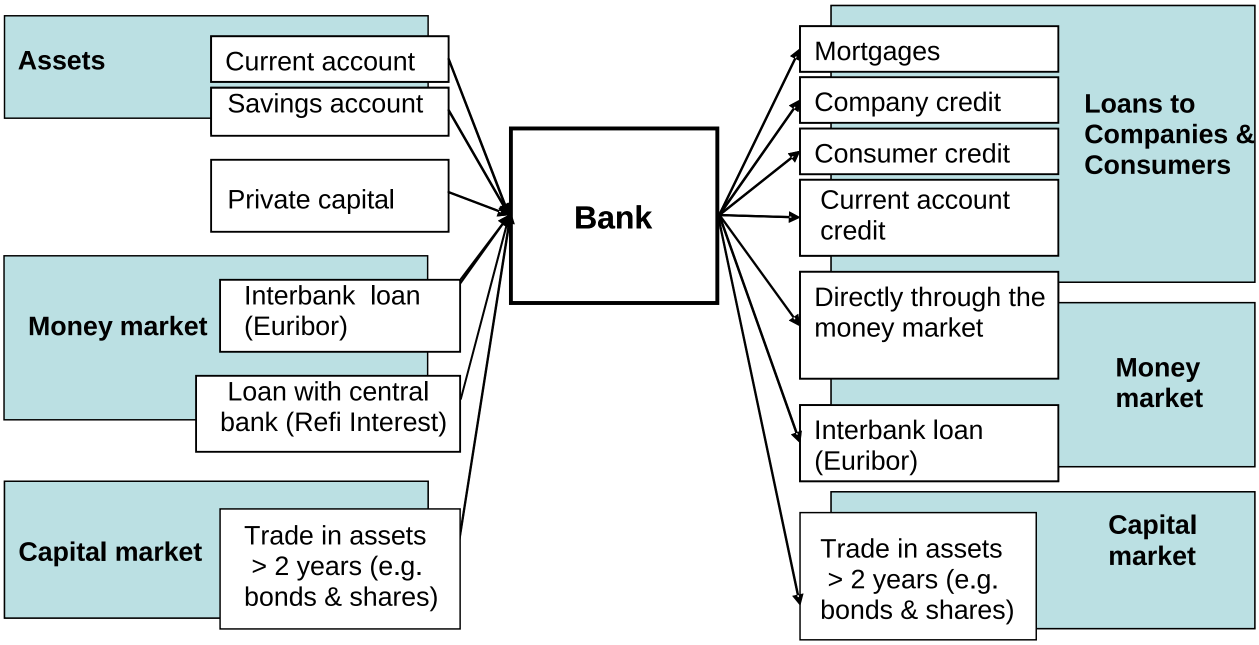
3 Market Description: Product Features

In this chapter the product features of overdraft facility to SMEs will be described. Firstly, as an introduction, this product will be put into perspective in relation to banking activities. Next, the structure of the debit interest rates will be given full consideration. Both the product features and the structural characteristics are important for analysing possible explanations for the observed parallelism into how the debit interest rates are determined. These possible explanations will be examined in chapter 5, while chapter 4 covers the structural characteristics.

3.1 Role of the Banks in Monetary Transactions

The figure below shows a diagrammatic overview of the role the banks play in monetary transactions.

Figure 1: the role of banks in monetary transactions (diagram)



Basically, banks attract money from parties who (temporarily) have a surplus of funds and place it with parties who (temporarily) have a deficit of funds (debit interest). The total cost of the attracted funds is termed purchasing cost or funding cost.

Banks attracting money

On the left side of figure 1 are the so-called financing sources of a bank. Banks draw in funds from trust assets (savings and credit balance on current account), the Money Market and other sources. Trading is done on the Money Market in short money bearing interest.[7] Players on this market are the (central) banks, listed companies and institutional investors. Banks which need extra funds to supply credit can purchase the funds at those companies. A benchmark for the Money Market-prices between banks that lend each other money (the so-called Interbank Market) for the Euro zone, is the Euribor-rate (Euro

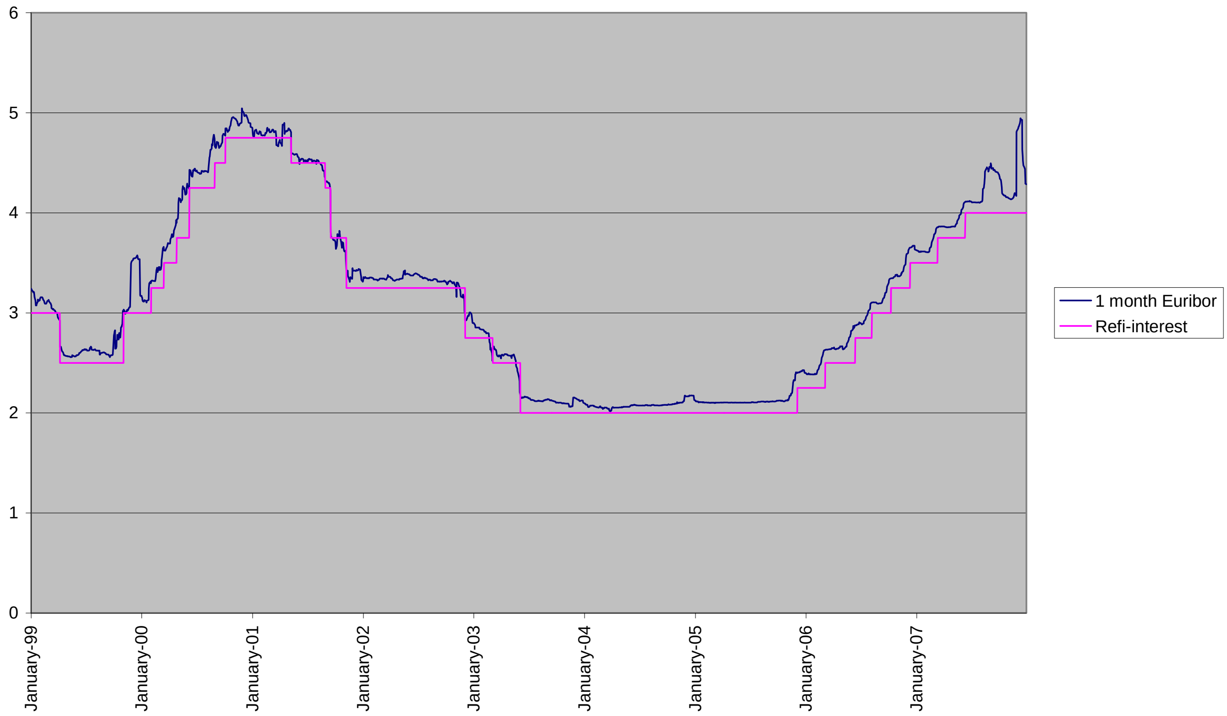
7 The term 'short money' is used meaning financing with a loan term of 1 day to 1 year.

Interbank Offered Rate).[8] The Money Market is not directly accessible to smaller companies like SMEs; they have only indirect access to the Money Market through an overdraft facility with a bank.[9] To give a complete picture, the capital market is also depicted in figure 1. Here, the assets, such as bonds and obligations with a longer loan term, are traded.[10]

Banks can also borrow money from the European Central Bank (hereafter: ECB). These loans are put out by the ECB through so-called open market transactions. There are various kinds of open market transactions. The most important types are the basic refinancing transactions. In this way banks can bid for a loan by written application. The highest bidders are assigned their loans first until the total loan sum of the ECB is reached. The so-called refinancing interest (hereafter:Refi-interest[11]) serves as the minimum rate for open market operations of the basic refinancing transaction and is determined by the Board of the ECB.[12]

As shown in the figure below, the Refi-interest and the Euribor-rates were strikingly similar until mid-2007. The Euribor-rate was on average 11 base points, or 0.11%-points, higher than the Refi-interest. It can therefore be concluded that the Euribor-rate follows the same trend, but is more volatile than the Refi-interest.

Figure 2: Course of the Refi-interest and the Euribor-rate between 1999 and mid 2007



8 The Euribor-rate is the tariff that banks charge each other for a loan (obligation with a specified term of duration). This charge is determined daily, based on data from very creditworthy banks. Differences in term of duration (e.g. a one month Euribor-Rate versus a six month Euribor-rate) are possible. In this document the one month Euribor-rate is used, unless otherwise stated. Since mid-2007, due to the credit crisis, the Euribor-rate is no longer the benchmark for the tariff by which banks lend each other money.

9 The next chapters deal with the product features of current account credit loans.

10 In the case of the Capital Market in figure 1, the international definition is applied, that is to say: a term of duration of more than 2 years. De Nederlandsche Bank (DNB) applies a term of duration of more than 1 year.

11 Refi-interest stands for Refinance Interest Rate, an interest rate implemented by the European Central Bank.

12 Refi-interest is an important instrument for the ECB in execution of its monetary policy directed towards price stability.

The purchasing costs differ per bank and depend on the composition of the funds that have been raised and the creditworthiness of the bank, which is expressed in a so-called (credit) rating.[13] According to the banks, however, this (credit) rating under 'normal' market circumstances, as was the case prior to the credit crisis, has only a limited effect on the costs of attracting capital on the Money Market, given that the creditworthiness of banks usually varies very little in the short term (up to approximately 1 year).

Banks Lending Money

All money raised by the bank is channelled to the treasury department, which acts as a central cash office. The treasury department examines on a daily basis what is to be done with the funds. The options a bank has are shown to the right of figure 1. The bank can choose between several types of credit loans to be given to companies and buyers, with varying terms of duration (such as mortgages and overdraft facility), as well as lending part of the money to other banks through the Money Market. When considering this, it is not so much the origin of the money (short or long) which is taken into account, but rather the demand of that day and how this demand can be met in the most profitable way.[14] Thus the specific product (e.g. mortgage or overdraft facility) comes into existence at the moment of acquisition. Through this mechanism it is impossible to bind specific buying costs to a specific credit. Nevertheless, that is no problem for the present investigation, because the observed parallelism on base rates is not related to purchasing costs or the level of cross-subsidization between products or customer groups.

3.2 Current account credit

Running a business requires funds. Depending on the necessity of financing (credit product), a fixed source of finances will have to be found. SMEs need, among other things, short-term financing to be able to pay suppliers, for example, prior to securing income from sales.[15] An example of short-term financing is the overdraft facility.[16] For instance, based on the creditworthiness and other characteristics of an SME, the bank stipulates whether that SME will be eligible to receive a business loan.

The credit is linked to the current account of the SME as an overdraft facility. In the assessment of the intended merger between Fortis and ABN AMRO,[17] the European Commission took into consideration that this account may be seen as a "gateway" to establishing a relationship with the customer and the sale of other bank products (cross-selling). The overdraft facility is an arrangement for debit on that account (being in the red), which occurs when, for example, suppliers have to be paid while the balance on the account is insufficient.[18] The fee the company pays for having this facility is the debit-interest. This will be further explained in the following section.

3.3 Debit Interest

In the figure below, a schematic construction of the debit-interest for overdraft facility to SMEs is shown.

13 This has been confirmed by experts in the financial sector, as well as in discussions with banks.

14 Note, though, that banks have separate committees (the Asset & Liability Committees) which look into whether the terms of duration and interest structure of the obligations of the banks combined with the trusted means and the outstanding credit, do not mismatch.

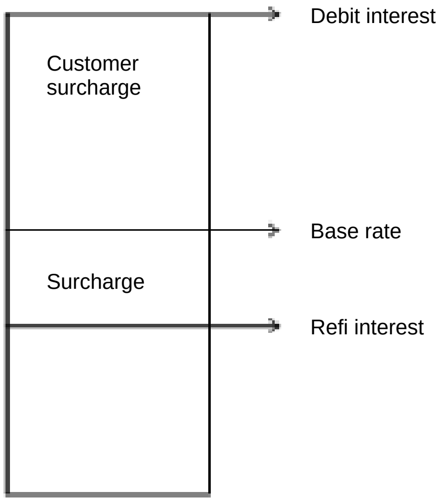
15 SMEs also have a need for long-term financing, for example for a mortgage loan. After all, assets such as company cars are financed by a middle-long-term credit.

16 Of course, an enterprise can take care of its own short-term need for money in other ways, e.g. through a loan with a set duration or through a supplier credit.

17 See European Commission (2007), marginal number 94.

18 As soon as there are enough sales, the balance will again (in theory) be sufficient and will fluctuate over time.

Figure 3. Composition of debit-interest for overdraft facility to SMEs[19]



As shown in figure 3, the debit-interest for SMEs is generally based on the so-called base rate and an individual customer surcharge.[20] This base rate is equal to the Refi-interest with a surcharge. Coupling the base rate to the Refi-interest benefits the banks because this interest rate fluctuates somewhat less than the Euribor-rate. Another advantage for banks is that changes in the Refi-interest give an objective justification for making changes in the base rate. The Dutch Institute for Bank, Insurance and Effect Companies (hereafter: Nibe SVV) states:

> *[The height of debit-interest for overdraft facility is directly related to the refinancing interest (Refi-interest) of the European Central Bank (ECB). When the ECB adjusts the Refi-interest, the interest which the borrower has to pay will automatically also be adjusted. The Refi-interest is raised by a specific percentage. This surcharge is the same for all banks. Refi-interest plus the surcharge comprises the base rate].*[21] (NB: the translation is ours.)

The customer surcharge is a surcharge on top of the base rate, which is dependent on the customer. Costs which are usually passed on to the customer are based on the cost of risk in connection with the creditworthiness of the company,[22] the operational costs of extending credit, capital costs[23] and a margin. Cross-selling options will usually have a decreasing effect on the level of the debit-interest, in the event of the bank making use of cross-subsidies between the overdraft facility and one or more products such as the payment system or other types of credit.

For large companies, in contrast with SMEs, the final debit-interest is usually linked to the Euribor-rate with a customer surcharge or in the case of extremely creditworthy customers, the Euribor-rate will

19 This is a schematic construction. Further explanation about the size of the separate parts follows in paragraph 5.3.1.

20 As mentioned in paragraph 5.4, SMEs make progressive use of the possibilities of relating overdraft facilities directly to the Euribor-rate.

21 Nibe SVV (2007), page B 9.3.

22 Nibe SVV (2007), page D 3.1. This concerns a so-called risk-surcharge. Important in this are, for example, the collateral provided by an SME-company in case of default and the banks' trust in the management of that particular company.

23 Capital costs are the result of solvability demands of De Nederlandsche Bank (DNB). This concerns the minimum amount of capital necessary that a bank must hold on to in relation to the risks run. This makes sure that the banks have enough capital at their disposal to serve as a buffer for unexpected setbacks, even under less favourable conditions. This capital (money) that the banks keep cannot be put out for a product (such as overdraft facility or mortgages), so that the bank is unable to make a profit (Wielen (2007), page 288).

possibly be reduced by a customer reduction.[24] The level of this customer surcharge is dependent on, among other things, the creditworthiness of the SME, the confidence the bank has in the customer and the position of the customer as regards negotiation. There is no general, non-customer-specific surcharge applied for large enterprises such as there is in the case of base rate surcharge for SMEs. The NMa has neither carried out an investigation into the differences in end-rates (debit-interest rates) between the bank's various customer groups divided into large companies and SMEs, nor into the differences in end-rates between the various banks. In section 5.4, we will go into more detail of possible advantages and disadvantages for SMEs on overdraft facilities based on the base rate or the Euribor-rate.

In general, local account managers have no influence on how high the base rate is. In other words: the debit interest for SMEs is usually at least at the level of the base rate. An adjustment in the base rate automatically causes an adjustment in the debit interest rates of SMEs. Only adjustments in the customer surcharge lead to a change in the contract of a SME, of which the bank ought to inform the SME separately.[25] One bank stated that in this way, the base rate offers the head office the possibility of securing that part of the margin through screening this from the relationship between the account manager and the customer. An additional advantage, according to this bank, is that it gives the head office the opportunity to adjust the base rate, even when the Refi-interest provides no grounds for doing so.[26] The conclusion of the NMa is that because of this, SMEs are less aware of the different causes of changes in the base rate, namely an adjustment in the Refi-interest or the bank's adjustment of costs.

Finally, within range, the account managers usually have authority over the individual customer surcharge. The head office normally determines this range, which differs per bank. It is possible for the holder of the account in specific cases, to deviate from these ranges (e.g. by cross-selling). As a rule, permission from the head office is necessary for such deviations. The NMa-investigation into banks shows that it does occur that SMEs request several offers from different banks and use them in the process of negotiation to obtain a better rate or conditions.

4 Market Description: Structural Features

In this chapter a description is given of the structural features of the market for granting overdraft facilities to SMEs. These features, along with the product features described in chapter 3, are used in chapter 5 to formulate possible explanations for parallelism in the method of specifying the base rate for this credit.

4.1 Introduction

To gain insight into the structure of the market for granting business loans to SMEs, the NMa uses various market-structure indicators.[27] This is because the market structure (e.g. degree of concentration and entry barriers) and the market behaviour (e.g. pricing policy and strategic behaviour) influence the market results (e.g. price level).[28] The market-structure indicators give information from the perspective of

24 As stated earlier, the Euribor-rate is more volatile than the Refi-interest. One bank states that overdraft facilities based on Euribor therefore carry more risk, because companies have to deal with relatively large fluctuations of the interest rate than in the case of Refi-interest.

25 See also Jongkind (2004).

26 See also Jongkind (2004).

27 See for a generic frame MFA 2005 pages 8 + 9 and NFS 2006, page 15. Besides market structure indicators, the analysis of behaviour of market parties and market results offers additional insight into possible risks in market functioning.

28 The first conceptual details of the structure-behaviour-result paradigm were presented by E.S. Mason in 1939 and have been often revised in various reference books about industrial organization.

the market structure about the expected degree of competition in terms of market behaviour and market results on this market. The following indicators will be covered: the number of players and the level of concentration, entry barriers, switching barriers, the measure of transparency and purchasing power of SMEs.

4.2 Number of Players and Level of Concentration

In the Netherlands, the number of players is limited on the market for granting overdraft facilities to SMEs. In the past few years, there has been no entry of significant new players.[29] During the period researched, three large banks, ABN AMRO, ING and Rabobank dominated the market. In addition, there were a number of smaller players active, such as Fortis, Friesland Bank and SNS Bank. The market for granting overdraft facilities may therefore be designated “concentrated”, with a joint market share of the three largest providers (the C3-ratio) of approximately 85%.[30]

4.3 Entry Barriers

Up until now, entry barriers could explain the lack of significant new players and the consequent limited threat of new providers of overdraft facilities to SMEs.[31] Knowing the ins and outs of a company is essential for assessing its creditworthiness. The banks’ long-term relationship with the company plays an important role here.[32] Besides, SMEs operate predominantly locally, regionally or at most on the national market. New entrants therefore must have - chiefly specific - sector knowledge and must gain knowledge of local or regional market conditions as well, in order to become successful entrants.

Furthermore, competition for SMEs that are first-time buyers of the product on this market seems to be stronger, compared to the competition for SMEs that already have a steady relationship with providers of overdraft facilities.[33] It is important to SMEs to have the security of a good relationship with their bank.[34] An entrant bank must set up a network of branches, which could lead to limited opportunities for a successful entry for new entrants.

Finally, to be permitted to offer financial products, it is necessary to have a banking-license from De Nederlandsche Bank (hereafter: DNB). This legal arrangement creates an entrance barrier. For that matter, it should be noted that this is applicable to all types of financial services offered and not only for granting overdraft facilities to SMEs.

4.4 Switching Barriers

Various national and foreign investigations show that SMEs “cannot easily or cheaply” switch to another provider.[35] From an international perspective, the Netherlands scores low with an annual switching

29 Research on actual entry is based on the following sources: the WFT (Dutch Financial Supervision Act), the DNB-register in combination with websites of important bank organizations such as Currence and Equens. See also MONITOR FINANCIAL SECTOR (2005).

30 MONITOR FINANCIAL SECTOR (2004), page 122.

31 It may occur for example, that banks which would normally not give credit loans to the target group of SMEs, would grant this product on request to an individual customer. However, the NMa does not view this as a significant new entrant.

32 MONITOR FINANCIAL SECTOR (2004), pages 81 and 82 and OECD (2007), page 27.

33 MONITOR FINANCIAL SECTOR (2004), page 79.

34 MONITOR FINANCIAL SECTOR (2004), page 90.

35 MONITOR FINANCIAL SECTOR (2004), page 78.

percentage of 8.88% among SMEs.[36] A possible barrier to switching could be due, among other things, to the importance of the relationship with the account manager. NMa studies in the past reveal that Dutch SMEs are chiefly organized by the Relationship Banking Model. The strong relationship between bank and customer is of first importance here. Banks strengthen this by making use of the product links and package offers.[37] Given the importance of the relationship between SMEs and the account manager, and the cost of switching, the SMEs will not readily switch over for a scant price difference.

Moreover, the connection between the overdraft facility and the current account of SMEs forms a complicating factor. Once SMEs switch to another provider, this means indirectly that they also prefer to switch to another bank and payment system. The absence of number portability, i.e. retaining the bank account number when switching to an alternative provider, complicates the switchover.[38]

The NMa earlier indicated its preference for number portability for current accounts. This can ensure an easier switchover for SMEs to another bank for money transfers.[39] It should be noted that discussions about the cost of introducing this system and the risk of losing the possibility of identification of banks in this framework, have not yet been settled.[40] Number portability can simplify the switchover with products linked to a current account, such as an overdraft facility. This could lead to more competitive pressure from SMEs.

4.5 Degree of Transparency

On the one hand, transparency of charges makes it easier for SMEs to choose a provider. On the other hand, transparency makes it easier for banks to adapt their behaviour accordingly. SMEs are aware of the base rate among the five largest providers. Up until 1 October 2007, the base rate of these providers was published daily in the Dutch financial newspaper Het Financieele Dagblad (hereafter: FD). Nowadays, banks only publish changes in the base rate in national papers, among which the FD. The websites of banks and consultancy firms give a summary of their current base rates. However, compared to the base rate, debit interest rates are less transparent, since these can differ per customer and are therefore not made public. SMEs can however obtain a more complete picture of debit interest rates of various providers by requesting several offers.

4.6 Purchasing Power

For selecting a bank, the location of that bank is essential for SMEs (e.g. for making cash deposits).[41] Consequently, SMEs can often only choose between a limited number of providers of overdraft facility.[42] The individual purchasing power of SMEs is less than that of larger enterprises. The financial transactions

36 SEO, Economic Investigation (2008), page 8 and EC (2006b), page 102. This refers to the Committee's investigation into the switchover behaviour with overdraft facilities for SMEs.

37 MONITOR FINANCIAL SECTOR (2004), page 82. When it comes to relationship banking, it seems that enterprises prefer the security of a possibly more expensive loan to the insecurity of a cheaper loan. An alternative for relationship banking is transaction banking, whereby a one-time transaction is made central. This image is corroborated by the banks, whereby one bank stated that for SMEs it involves the total package offered, with a matching total price bracket.

38 In 2004 the Dutch banks introduced the Switchover Service. With this service, account holders may switch banks, whereby transactions will be diverted to the new account number for a period of 13 months. The potential mobility of account holders is increased by this switchover service, but the actual switchover behaviour remains limited. Business account holders indicate that the most important barriers to actually switching-over are "having to inform agencies and relations", "transferring automatic transactions" and "new account numbers".

39 NMa (2008), vision document SEPA, "One payment market, more competition?", page 11.

40 These discussions are taking place at this moment in European perspective in view of the development of European integration of the national payment markets.

41 OECD (2007) pages 27 – 29.

42 OECD (2007) page 29.

are smaller. SMEs are less up to date about credit products and the process of extending credit.[43] Moreover, SMEs do not have direct access to the Money Market. Finally, there is only a limited number of alternative products available to meet liquidity needs.[44] Hence, one could state that SMEs have limited purchasing power.[45]

4.7 Conclusion

The NMa concludes that the market for overdraft facilities for SMEs is characterized by an oligopolistic market structure. This is proven by the fact that only a limited number of players, with a large combined market share, is active on this market. In recent years, no significant new players have entered the market, which is possibly due to the relatively high entry barriers. Besides this, the NMa concludes that, because of the limited number of providers as well as the limited knowledge of credit products and the process of extending credit, there is scarcely any purchasing power among SMEs, which results in a low switchover rate.

Moreover, the switchover is complicated due to the importance of the relationship with the account holder, the fact that SMEs usually purchase a complete deal with one bank only, and coupling overdraft facility with the current account. Consequently, the NMa considers that important conditions for stronger competition on the banking market are the measures taken, which are geared to switchovers[46] and to increasing SMEs' insight into credit products and the procedure of extending credit.

In an oligopolistic market structure, players can monitor each other relatively easily due to the limited number of competitors. When determining their market behaviour, players take the anticipated reactions of other players into account. This is especially the case regarding prime rates, which is familiar to all players on the market.

The next chapter describes the analysis of market results (notably the parallelism in the base rate) and looks into how much these market results can be explained, based on the product features and the structural features, as well as the NMa investigation into the banks.

5 Market Results

This chapter deals with the market results in the period from 1990 until mid-2007.[47] The following subjects are examined: parallelism in the development of the base rate (when adjustments in interest took place), parallelism in the level of the base rate and a comparison of overdraft facility based on a base rate, versus overdraft facility based on the Euribor-rate. Particular attention is given to possible explanations for the observed parallelism. Therefore, this chapter refers to the NMa-investigation into banks, as well as an NMa-analysis regarding the product features and structural characteristics mentioned in chapters 3 and 4. First and foremost, the development of the base rate will be examined, because the investigation is limited to the period from 1990 until mid-2007. The period from mid-2007 onwards is excluded, due to exceptional Money Market conditions created by the economic crisis.

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43 This refers to various aspects of application for credit, such as for example, formal requirements, how long it takes before a decision can reasonably be expected, as well as explaining why an application may be rejected. European Commission (2007), margin no. 14 and discussions with representatives of SMEs.

44 These are supplier-credit and factoring (contracting out of management of the debtors ledger).

45 See NMa (2004), vision document purchasing power, page 35, for a generic framework.

46 Such as, for example, releasing the link between business loans and the current account of SMEs and introducing current account number portability.

47 The period after mid-2007 is not taken into account, since from that period forward one can speak of extraordinary circumstances on the money market.

5.1 Base rate Background

During the Guilder era the base rate was linked to the so-called Promesse Disconto (Discounted Promissory notes, hereafter: PD)[48] and added to the Extra Temporary Surcharge (hereafter: ETS).[49] Changes in the PD occurred seldom. The DNB solely adjusted the PD when financial and economic circumstances called for adjustments. Therefore the development of PD interest rates and Aibor, the interbank interest rate at that time, do not mirror each other during certain periods. To compensate the differences between the Aibor and the PD, the banks introduced the ETS.[50] In the period between 1991 and 1994-1995 and from 1995 onwards the ETS became permanent and lost all connection with developments on the Money Market. The surcharge is asymmetric (not negative with a Money Market surplus) and increases to the extent that it supersedes the difference it ought to compensate (overcompensation).[51,52] The NMa requested the banks to explain this permanent surcharge. The explanations offered were contradictory and were related to a different time period.

The DNB decided to rescind the Money Market surcharge PD in January 1994. Banks were informed of this decision. When this charge was discontinued, the PD was only once brought into line with the Advance Interest[53], plus 75 base points. Regarding this policy change, banks introduced the base rate system in 1994.

NMa-investigations indicate that DNB and the banks subsequently negotiated about the base rate. In addition, one bank stated to the NMa that until the end of the `90s, there were consultations with the DNB prior to changes in the surcharge, so as not to obstruct the monetary policy. However, this particular bank could not submit any written proof of these consultations having taken place. In this context the DNB stated that from the perspective of monetary politics there is no reason to apply such a surcharge on the base interest.

Two banks have stated to the NMa that the level of the base interest surcharge has developed simultaneously over time. It remains unclear how the surcharge precisely came into being. The banks have indicated that they are not aware of how the base rate system emerged, as the process occurred in the early `90s. Individuals questioned by the NMa were not working for the banks (or at least not in their current position) at that time.

According to the NMa, the above findings support the hypothesis that the surcharge of the base rate has developed in this manner over time.[54,55]

48 The PD was one of the official money market charges of DNB. It refers to promissory notes from companies which a bank could lodge with (discounted) DNB to obtain liquidity.

49 The ETS was added in the periods that the PD lay far below the money market interest rate and caused the risk that parties would borrow from a bank for the purpose of putting it in a savings account with a higher rate (“merry-go-round”) (see Dunnen (1991), page 38).

50 Bergeijk and others (1995): the banks endorsed this by means of statements.

51 Bergeijk and others (1995) outline that this surcharge was altered as from 1991 into a permanent surcharge which had hardly any relationship to developments on the money market. When the base rate was introduced in 1994/1995, the surcharge temporarily disappeared.

52 After 1995 the surcharge has at times disappeared but this applied only for a short period of one week at most.

53 The Overdraft Interest was the charge that a bank paid for the liquidities which they received from DNB against a collateral of Treasury bonds or similar securities.

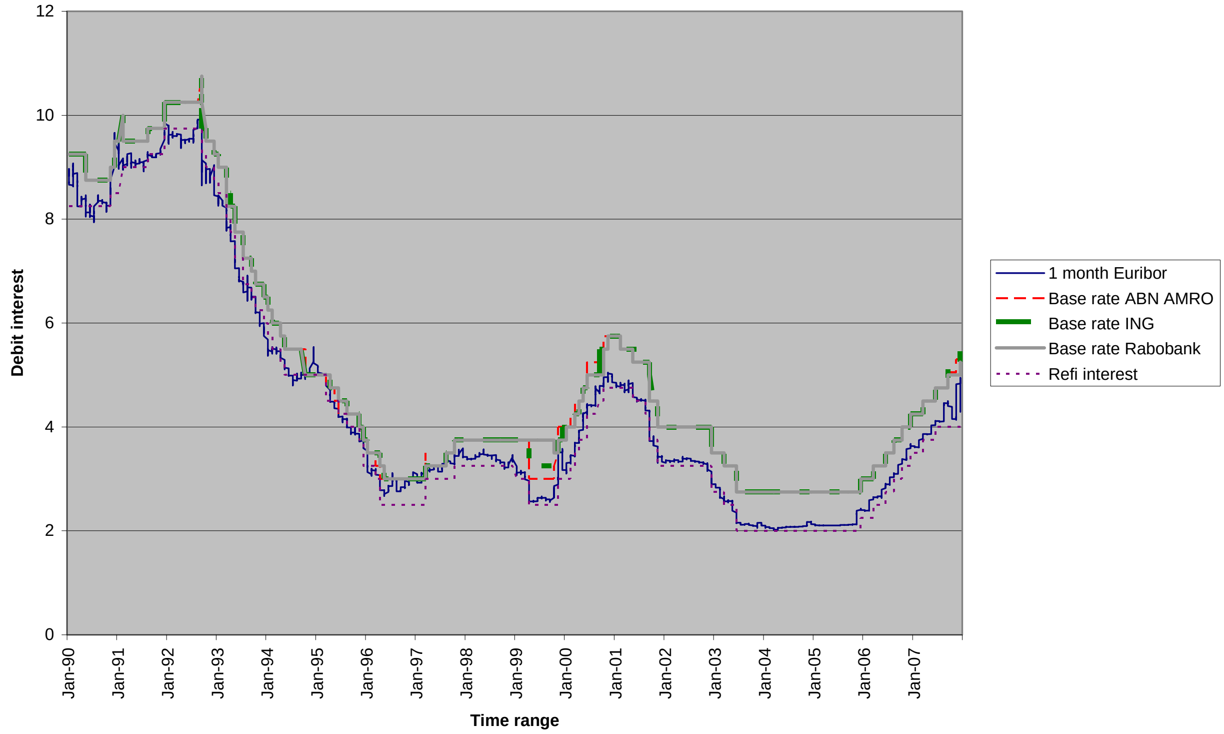
54 The above applies to SMEs, as already stated. As far as the NMa is aware, under the system of the base rate, there is no generic, non customer-specific surcharge on the Refi-interest for larger businesses.

55 As already mentioned in chapter 1, there proved to be no infringement of the Dutch Competition Act.

5.2 Parallelism in Development of Base Interest

Figure 4 shows the development of base rates for business loans of three banks and the development of the interest rates Refi-interest (and its predecessor, Promessedisconto or PD) and the Euribor-rates.[56] This figure shows that the base interest of the three banks illustrates the development of the PD or Refi-rate during the period from 1990 until August 2007. This means that in general the banks adjust their base rates at the same time or shortly after a change in the Refi-interest (or PD). This parallel behaviour at the moment of adjustment is explained by the previously mentioned link between the base interest and the Refi-interest (prior to 1999, PD or Advance Interest).[57]

Figure 4: Growth of base rate, Refi-interest (and predecessor Discounted Promissory Notes) and one month Euribor-rate between 1990 and mid-2007



5.3 Parallelism in Level of Base Interest

5.3.1. Market Results

Figure 5 shows the surcharge in base interest over the period from 1990 until 2007. In particular, the difference between the base rate and the Refi-interest. The figure demonstrates that the surcharge in the base interest in relation to Refi-interest (PD) fluctuates between 0 and 150 base points (0 and 1.5%).[58] Since the introduction of the Euro, this surcharge has usually been 75 base points. Temporary deviations are caused by changes in the Refi-interest. The base rate is usually adjusted within a few days after

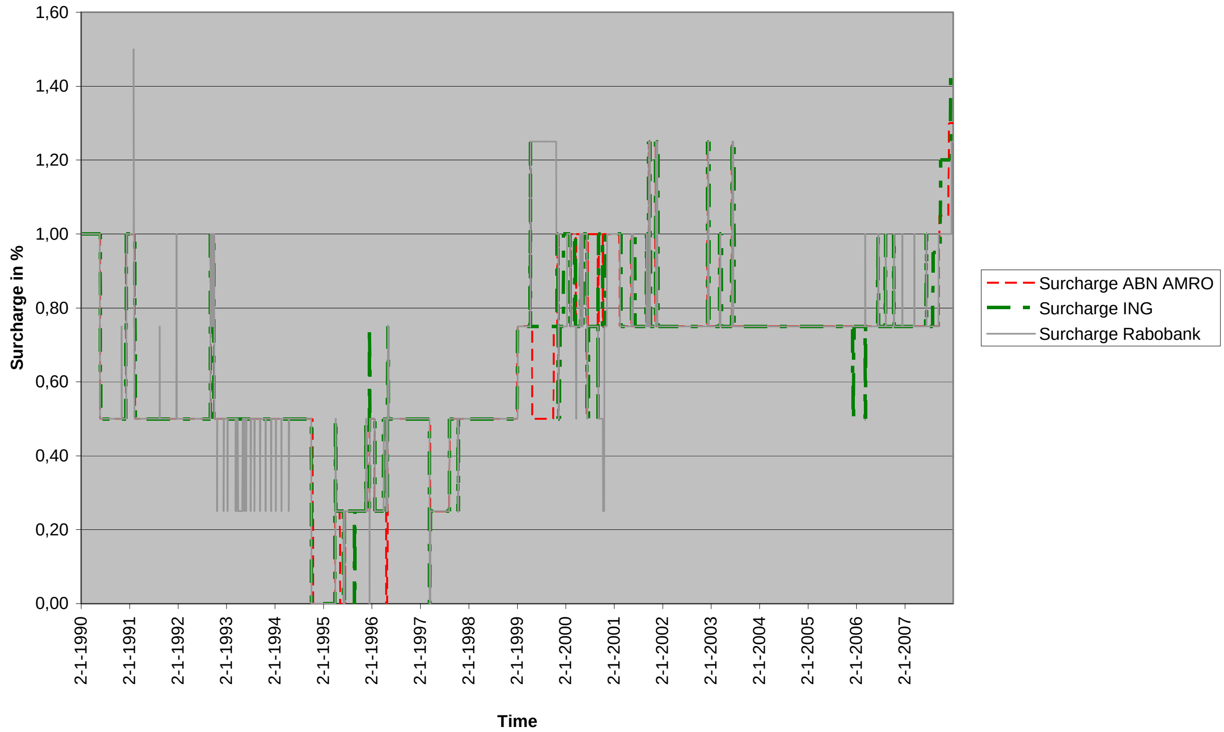
56 As already indicated in section 3.1, the one month Euribor-rate was on average 11 base-points (0.11%) higher than the Refi-interest in the period from 1990 until mid-2007.

57 See chapter 3. Another possible hypothesis is that the banks were in collusion at those moments when the interest rates were being adapted, but as already stated in the introduction, no such infringement of the Dutch Competition Act has emerged.

58 Between October 1994 and March 1995 the surcharge on the base rate was nought.

changes in the Refi-interest have been made, and the surcharge again amounts to 75 base points. In comparison, the customer surcharge, depending on the customer risk and the amount of credit, varies from approximately 100 to 550 base points.[59] Therefore, the surcharge in the base interest contributes to a significant portion of the end tariff, particularly in periods with a low Refi-interest. For a Refi-interest of 3% (300 base points) and a customer surcharge of 200 base points, the surcharge in the base rate averages 13% of the total charge.

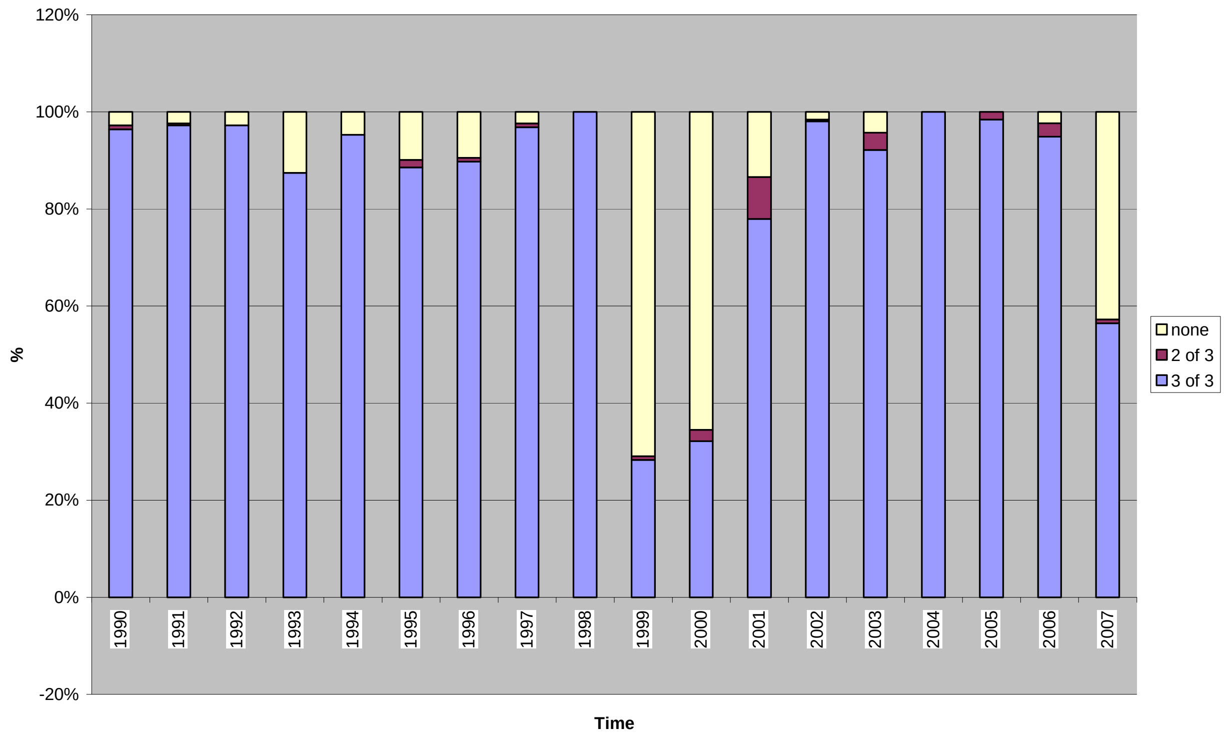
Figure 5: Growth of the surcharge in the base rate between 1990 and mid-2007.[60]



59 Based on the investigation into banks and the NMa analysis.

60 The lines of the separate banks overlap, which means that the surcharge on the base rate of the banks to each other was equal. The peaks and troughs are caused by the fact that the banks sometimes adjust the base rate several days after each other instead of at the same time.

Figure 6: Annual percentage when the base rate for none, two or three of the banks was identical



In figure 6 the percentage of time that the base rate at the three banks exactly coincides is further specified. With the exception of six years (1993, 1995, 1999, 2000, 2001 and 2007), the base rate at the three banks in the period between 1990 and 2007 was exactly the same for 90% of the time. Hence, during almost the entire period there was a high level of parallelism in the standard of the base rate at the three banks.

It follows that this parallelism was maintained also regarding the decrease and increase in the surcharge on the base rate. The next section will deal with possible explanations for this parallelism. As was already stated, both the NMa investigation into banks and the NMa-analysis based on product features and structural features will be covered.

5.3.2. Possible explanations for parallelism in the level of base rates

Banks have been questioned numerous times as to how the surcharge on the base rate emerged, and moreover, why the high level of parallelism in the standard of base rates between the various banks exists. Banks give diverse and contradicting explanations for the level of the surcharge in base rates. Nevertheless, the base rate shows a high level of parallelism during the period between the mid-1990s until mid-2007. Possible explanations are presented below.[61]

61 For the sake of completeness, note that these possible explanations have emerged based on the investigation by the NMa. There are other possible explanations.

Base interest possibly reflects the purchasing costs of a bank

Banks explained that the costs incurred for attracting money (purchasing costs) used for extending overdraft facility, result in the level of the base rate. However, purchasing costs between banks differed, while the base rate was almost constantly equivalent.[62] Moreover, banks explained that effective purchasing costs are almost impossible to determine at product level (in this case, the overdraft facility for SMEs), as the money first comes in at concern level and is not immediately allocated (see section 2.1). Moreover, there is no equivalent product (i.e. a product with the same term of duration and characteristics as an overdraft facility) on the Money Market available. This complicates any comparison with purchasing costs.[63] Based on the above, the NMa concludes that it seems illogical to attempt to explain parallelism in the level of base rates with a possible parallelism in purchasing costs. Subsequently, two other possible explanations based on the product and structural features will be discussed.

Base rate possibly developed over time and remained so, due to individual market power of banks

As was explained in paragraph 5.1, the NMa finds it plausible that (the surcharge on) the base rate has developed naturally over time. Keeping to the line that the system has developed in this way, and considering the features of this market (the oligopolistic market structure with a high level of transparency, which is further distinguished by relatively modest bargaining power and infrequent switchover behaviour of SMEs[64]), it is understandable that the level of parallelism in the level of base rate has been upheld over time. This is because each individual bank in this kind of market structure possesses enough market power to sustain the price level (level of surcharge on base rate).

Base rate has possibly developed in this way due to the banks mirroring each other

Besides individual market power, follow-the-leader type of behaviour is another possible explanation for upholding the parallelism in the level of the base rate. Due to the oligopolistic market structure and transparency of the base rates, banks can monitor and mirror each other easily.[65]

It is possible that they have an understanding between themselves by expediency not to deviate one-sidedly from the level of the (surcharge on the) base rate on the market for granting overdraft facility to SMEs. Banks believe that when they decrease the base rate one-sidedly without inducement from the perspective of the Refi-rate, this could cause a decrease in the base rates of other banks. When other banks react and also decrease (the surcharge on) the base rate, this may result in disappearance of the surcharge on the base rate in the long term. It is thus in their own interest not to deviate one-sidedly. Banks can monitor and mirror each other due to the transparency of the base rate as a point on which to focus. This could cause the emergence of a benchmark in the debit interest charge. A certain market balance will not be easily thwarted, due to the limited number of new entrants and the limited level of purchasing power of SMEs.[66]

Based on the information available, it is impossible to deduce the exact reason for the parallelism in the level of the base rate. The next section will cover a possible development towards business loans to SMEs based on the Euribor-rate, instead of on the base rate, and the consequences of this in the two possible explanations as illustrated.

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62 See section 3.1 for details. However one bank states that it is not impossible that the purchasing costs of the banks run parallel.

63 See for more details section 3.1.

64 See chapter 4 for more details.

65 See chapter 3 for more details.

66 See chapter 3 for more details.

5.4 Base Rate versus Euribor-Rate

As stated previously, the system of base rate (in which a generic, non-customer specified surcharge is applied) is characteristic for the specific SME-customer group. Banks apply diverse pricing systems for different groups of clients. Business loans for large companies are linked directly to the Euribor-rate, while business loans to SMEs are mostly based on the base rate. The NMa-investigation shows that the SMEs are increasingly making use of the possibility of linking business loans directly to the Euribor-rate.[67] If the parallelism in the level of the base rate was a consequence of the individual market power of the bank, it is unlikely that a switch to Euribor-linked business loans would lead to lower debit-interest for SMEs. Due to the limited purchasing power of SMEs, another method of interest calculation will have no consequences on the level of the debit-rate paid. Taking measures aimed at facilitating switching-over[68] and increasing insight into credit products and to the process of extending credit to SMEs, could lead to a greater purchasing power for SMEs.

However, in the case of oligopolistic mirror behaviour, business loans for SMEs based on Euribor could lead to lower debit interest rates. Firstly, the market would become less transparent (part of the base rate would be transferred to the individual customer surcharge and the banks would be unable to monitor each other), by which oligopolistic mirror behaviour between banks would be more difficult. Secondly, local competitive account managers could stipulate a larger part of the debit interest.[69] Hence, the focal point for debit interest charges would no longer exist.[70]

While consulting with the NMa, the banks stated that the basis for their charges (base interest or not) makes no difference regarding the level of the base rate offered. However, as shown in the investigation by the NMa, there have been discussions within the banks about using the Euribor-rate on which to base interest rates for business loans to SMEs and about margin erosion. According to experts, the position of the SMEs would improve when the debit interest rate of the business loans is directly connected to the Euribor-rate.[71] Additionally, the investigation shows that banks are reticent regarding setting the Euribor-rate as the base for SME business loans.[72]

Hence, the NMa concludes that in the case of oligopolistic behaviour, connecting the Euribor-rate directly to SME business loans could result in lower debit interest rates.

67 See also Wichers et al (2007).

68 Such as, for example, the introduction of current account number portability, but also releasing of the linking of business loans to the current accounts of SMEs. It has come up earlier that discussions in the area of practical implementation of current account number portability have not yet been settled. See chapter 4.

69 Even though in this case the SMEs have better insight into the structure of debit interest for business loans, it is not impossible that the account manager would be limited in his actions through specific minimum margins for particular target groups. For SMEs it is crucial that this is visible and negotiable; the bank ought to inform the client about adjustments in costs. Cost adjustments, such as a change in the base rate (when there is no adjustment in the Refi-interest rate) by which it is not necessary to inform the customer, do not occur in this case. See also Jongkind (2004).

70 The reference here is to the point of focus brought about by the base rate. In the case of both Euribor related business loans as well as business loans based on the base rate, the base rate (Euribor or Refi-interest) is made public.

71 See also Wichers et al (2007) and Jongkind (2004).

72 See also Wichers et al (2007).

6 Conclusion

business loans for SMEs and large companies

The NMa investigation concerning SME business loans illustrates the following. First of all, SME business loans are generally based on a base rate system, as defined by the bank and as consisting of the Refi-rate and a customer-independent surcharge. Business loans for large companies are commonly based on the Euribor-rate without a customer-independent surcharge. Thus SMEs pay non-customer specific surcharges, whereas larger companies do not.

Account managers at local banks cannot influence the level of base rates as this is indisputable. At head-office level a bank can adapt debit interest rates for SMEs by changing the base rate, without re-establishing the contract, even when the Refi-rate has not been adapted.

market structural features for granting business loans to SMEs

The features of the market for granting business loans to SMEs are of an oligopolistic structure, allowing a provider, when making commercial decisions, to take into account the expected reactions of other providers due to a limited number of parties on the market. The purchasing power of SMEs is limited because of the number of providers, as well as the SMEs limited insight into credit products and the process of extending credit. Moreover, SMEs very occasionally change from one provider to another. A reason for this is that business loans are connected to the current SME account. A lack of account number portability makes switching over difficult. At the same time, the relationship between SMEs and account managers, often characterised by package deals with one specific bank, causes apprehension towards switching over.

nma investigation findings

During the period 1990-2007 there was a high level of parallelism in both the course and the level of the base rate. The parallelism at the moment of adjustment is explained by the link to the Refi-interest rate. The surcharge in the base rate seems to have emerged over the years. The basis appears to lie in a temporary surcharge which has acquired a permanent character. The explanations provided by the banks are unfortunately inconsistent. The banks do not give a comprehensible, well-substantiated explanation as to why the surcharge in the base rate totals an average of 75 base points.

Two scenarios were discussed which possibly explain the maintaining of parallelism in the level of the base rate. Based on the information available, it is impossible to determine which of the two is the most probable explanation. In the first scenario, the parallelism in the level of the base rate is connected to the individual market power of the bank. Due to an oligopolistic market structure and limited purchasing power of SMEs, banks are able to maintain a certain level of surcharge in the base rate.

The second scenario illustrates how oligopolistic behaviour causes banks to monitor each other. The transparent base rate facilitates a focal point for banks, which forms a basis for debit interest rates. In which case there is no explicit collusion necessary for the maintenance of parallelism in the level of the base rate, but the banks can suffice with mirroring each other’s behaviour.

Recommendation for improving competition

The NMa indicates four possibilities for improvement of competition on the market for SME business loans. A contributing factor is the explanation of the parallelism in the base rate.

In the first scenario of individual market power, establishing the Euribor-rate as the basis for SME business loans, instead of the base rate, will have no consequences for the level of the debit interest rate for SMEs. Nonetheless, measures taken in order to increase switching from one bank to another (e.g. account number portability, disconnecting business loans from the current account), and expanding SME knowledge of the product, could contribute to an increase of the SMEs purchasing power. Once SMEs divide their products between the banks, it would be easier for them to switch over to another bank for individual products. In this scenario, measures to increase the purchasing power of SMEs ought to result in lower debit interest rates.

In the case of oligopolistic mirror behaviour, the NMa investigation verifies developments whereby SMEs use Euribor as the base for business loans, resulting in less transparency with regard to part of the debit interest. This means there would no longer be a focal point. Similarly, a larger part of the debit interest would be specified by account managers who are competing at a local level. An increase in business loans based on the Euribor-rate in this scenario could thus lead to lower debit interest rates for SMEs.

As stated in the introduction, the aim of this report is to increase SMEs' insight into competition of market operations for extending business loans. SMEs can utilize this knowledge when negotiating debit interest rates. Consequently, this could result in a more critical attitude of SMEs, which, combined with lower switching barriers could lead to SMEs switching from one bank to another more frequently. Besides this, the report provides insight into the differences in the base rates (base interest and Euribor). This way, it will be easier for SMEs to choose the debit interest rate which is to their own best advantage. Both aspects can contribute to the level of competition in this specific market.

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