



Competition in the SME loan market

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About the Monitor Financial Sector

This study has been conducted by the Monitor Financial Sector (MFS). MFS is part of the Netherlands Authority for Consumers and Markets (ACM). MFS conducts studies in the Dutch financial sector into the degree and development of competition and can be reached by email at MFS@acm.nl.



Executive summary

SMEs depend on banks for financing

Small and medium size enterprises (SMEs) are important for the Dutch economy. SMEs often need external financing to grow, invest, and innovate. This financing comes mostly from the three major Dutch banks, ABN AMRO, ING, and Rabobank, which have been providing more than 85% of the total financing by banks to SMEs for years. No other banks operating in the Netherlands provide financing to SMEs on a large scale.

As SMEs depend on these three major banks, it is essential that there is adequate competition among them. A lack of competition could lead to higher financing costs for SMEs, poorer banking services, and less innovation. It is not only SMEs that experience these adverse effects: SMEs pass on higher financing costs to the customers of their products or services. It is thus also important for consumers that there is adequate competition among banks in this market.

Competition among banks in the market for SME loans is not optimal

ACM has investigated competition among banks active in the Dutch market for SME loans for the period January 2007 to September 2014. ACM concludes that there is insufficient competition among banks in this market. There are a number of reasons as to why banks experience relatively little competitive pressure in this market.

Entry barriers

Since the onset of the credit crisis, a considerable number of banks have either downscaled or ceased their activities in this market. No new banks have entered this market for years. In its 2014 study on barriers to entering the Dutch retail banking sector (*Barriers to entry into the Dutch retail banking sector*), ACM already concluded that this was partly due to the existence of entry barriers. Examples of significant barriers are disproportionately burdensome regulations for smaller banks and the limited shopping around and switching behavior of SMEs. As this makes it more difficult for potential entrants to win over customers from the major banks, they take longer to achieve an efficient scale.

Increased capital requirements reduce the opportunities for the major banks to exert competitive pressure on each other

International capital requirements prescribe the minimum amount of equity capital that a bank must use to finance a loan. The available equity capital therefore places a cap on the bank's lending capacity. Due to unexpected credit losses and a tightening of capital requirements, banks must improve their capital ratios. As long as banks do not comply with existing or expected future capital requirements, they will be faced with capacity constraints at group level. Capacity constraints at group level extend to the SME loan market. It is namely not an appealing option for a bank to attract a significant portion of another bank's SME customers. This restricts the opportunities for competitors to discipline each other and leads to less competition.



Limited shopping around and switching behavior by SMEs

Three-quarters of SMEs that require financing apply only to their main bank for a loan. SMEs also rarely switch banks. This inertia is partly explained by the existence of significant search and switching costs. Banking websites, for example, provide little information about acceptance criteria and the actual interest rate that SMEs pay. An SME receives this information only after an extensive application process at a bank. The inability to take an account number to the new bank (account number portability) for overdrafts and the high early repayment penalty if an SME switches during the fixed-rate period leads to substantial switching costs.

Risk of tacit coordination among banks

Since there are only three major banks in the Netherlands, there is a risk that these banks tacitly coordinate their market conduct. The structural monitoring of each other's market share, the absence of external pressure because of entry barriers, the limited number of providers, and increased capacity constraints all increase this risk.

The publication of the "base rate" for overdrafts on the three major banks' websites also increases this risk. The base rate is only part of the interest rate that SMEs pay for their overdrafts. Banks charge an individual premium on top of the base rate. The publication of the base rate therefore does not provide enough information for SMEs to compare providers with each other. ACM finds that banks explicitly take the base rate of their competitors into consideration when determining their own base rate.

Competitive pressure from alternative forms of financing is currently still limited

Lastly, there is currently little competitive pressure from financing alternatives to bank financing, such as crowdfunding and credit unions. Although these alternative forms of financing account for only a fraction of the total financing provided to SMEs, they are experiencing relatively significant growth.

Competition among banks seems to have decreased further in recent years

The increase of the profit that banks expect to make if they provide new SME loans may explain the trend in the degree of competition. In general, profit margins increase when there is less competition in a market. ACM has investigated how the expected profit margin developed in the period from January 2007 to September 2014. The margin calculation reveals that the expected profit margin has increased since 2011, and was structurally higher in 2013 and 2014 than before the onset of the credit crisis. This possibly points to a decrease in competition in the SME loan market. According to ACM, this could mostly be explained by an increase in capacity constraints and the existence of entry barriers.



ACM makes four recommendations for structurally improving competition in the SME loan market

Lower the entry barriers

The capacity constraints of individual banks cannot easily be removed. However, competition can be increased by the entry of new providers. This also causes an increase in the total financing capacity. Lowering entry barriers can contribute to this. ACM conducted a study into entry barriers in 2014 and made recommendations for lowering them. These barriers still exist and it therefore remains important that action is taken on the basis of ACM's recommendations.

Increase shopping around and switching behavior of SMEs

SMEs can increase competition among banks by comparing them with each other and switching if they are not satisfied with their current bank. Reducing search and switching costs can also contribute to this. Search costs can be reduced by providing information on banking products and the acceptance criteria, and by improving the information on financing rates. Solutions to reduce switching costs can be found through (i) evaluating the effectiveness of the Switching Support Service for business bank accounts, (ii) closely examining the method of calculating early repayment penalties on business loans, and (iii) informing SMEs earlier about the end of their fixed-rate period. Lastly, ACM is going to investigate the social costs and benefits of account number portability. Account number portability may make it easier to switch to another bank.

Reduce the risk of tacit coordination

The risk of tacit coordination can be reduced in various ways. One way is through the entry of new providers because the more banks there are, the harder it is to reach a tacit understanding. Lowering entry barriers is crucial in this respect. Another way to reduce the risk of tacit coordination is for banks to use a rate structure that gives a clearer cost breakdown of the "base rate." This makes it clearer to SMEs and third parties whether an increase in the base rate includes any passing on of costs or is in fact an increase of the profit margin. This reduces the risk of coordination and provides more information to SMEs.

Do not impede the growth of alternative forms of financing

In order to reduce capacity constraints and offer alternatives to SMEs, it is vital that the growth of alternative forms of financing is not impeded. A clear regulatory framework must thus be developed for the different alternative forms of financing, as is already the case for credit unions. The regulation of alternative forms of financing and their oversight must also not be more burdensome than is strictly necessary. The government must also prevent banks from being favored over alternative forms of financing. Current guarantee schemes, for example, are mainly aimed at financing by banks.



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1 Introduction

SMEs are important for the Dutch economy. The joint contribution of SMEs to the gross domestic product in 2014 was 64.2%. This is high not only in absolute terms, but also in comparison to other European countries where the average SME contribution is 57.8%.¹

Due to a lack of internal resources, many SMEs depend on external financing. The total amount of SME financing by banks amounted to around EUR 135 billion at the end of 2014.²

Some 92% of SMEs regard one of the three major banks - ABN AMRO, ING, or Rabobank - as the main bank for SME financing.³ Besides the major banks, there are very few others operating in the market⁴ for SME financing.⁵ Although smaller banks are active, they seem to target a specific segment within the market. These banks, which are also referred to as niche players, include Svenska Handelsbanken, Deutsche Bank, and Triodos Bank.

Although alternative forms of financing are on the rise, they currently meet only a marginal part of the demand for financing. Rabobank (2015) estimates alternative forms of financing at a factor of a thousand times smaller than bank financing. Alternative forms of financing are not expected to significantly reduce the dependence of SMEs on banks in the foreseeable future.

Due to the dependence of SMEs on the major banks, it is vital that the SME financing market functions properly. A lack of competition in the SME financing market can be harmful in a number of ways. It can lead to higher financing costs for SMEs, poorer service, and less innovation. It is not only SMEs that experience these adverse effects: SMEs can be forced to pass on the higher financing costs to the customers of their products or services. It is thus also important for consumers and other customers of SMEs that this market functions properly.

There have been many changes in the SME financing market over the last few years. SMEs have been hit hard by the recent credit crisis in that banks have been providing less financing, particularly to smaller enterprises. The liquidity and capital requirements set for banks by regulatory authorities have increased significantly. A number of banks have merged or have been taken over since 2008, such as the takeover of Friesland Bank by Rabobank, while others have downscaled their SME activities (e.g. Deutsche Bank) or discontinued them (e.g. SNS Bank). Lastly, although the growth rate of new players, such as Svenska Handelsbanken, and alternative forms of financing has

¹ MKB in beeld (2014), p.17.

² DNB, table 5.14. For the purpose of these statistics, the Dutch central bank (DNB) defines an SME as an enterprise with an annual turnover that does not exceed EUR 50 million.

³ GfK (2014).

⁴ In this document, the concept of "market" does not refer to the concept of "relevant market" within the meaning of the Dutch Competition Act (*Mededingingswet*).

⁵ Unless indicated otherwise, "financing" in the rest of this document means both overdrafts and long-term loans.



increased in recent years, these are still limited in size. All these developments may have consequences for the degree of competition in the market.

The availability of SME financing is the topic of a lot of research. In 2014, for example, the Social and Economic Council analyzed the obstacles to SME financing. However, very little is known about the degree of competition among banks in the SME loan market. The purpose of this study is to provide insight into the degree of competition in the SME financing market and how this has developed in recent years. This can help to identify possible impediments to competition in this market. Recommendations will be made, where possible, to remove these impediments.

1.1 Research method

In this study, ACM investigates the degree of competition in two ways. First, the trend in the *expected* profit margin⁶ of a SME loan is analyzed. The fiercer the competition in a market, the less profit firms can make. If a bank then charges a higher interest rate to its business customers, it loses some of its customers to its competitors. In contrast, if there is less competition, banks can opt to charge higher interest rates that will result – at the moment the loan is provided – in more profit. The trend in the expected profit margin can thus provide insight into the development of the level of competition.⁷

However, measuring the expected profit margin does not explain the causes of any lack of competition. A lack of competition arises from sources of market power.⁸ ACM has therefore investigated the presence of, and any changes in, the sources of market power. Possible explanations for a lack of competition or the existence of market power include the existence of capacity constraints, search and switching costs, entry barriers, and tacit coordination among banks.

1.2 Scope of the study

The investigated period runs from January 2007 to September 2014.⁹ Data on business financing up to EUR 1 million was used to measure the expected profit margin. For the purpose of analyzing the sources of market power, ACM follows the definition of an SME as closely as possible that the banks use in their internal operations (also see section 2.1). This means that microenterprises with self-employed persons fall largely outside the scope of this study.

The focus of this study at the product level is financing by banks in the form of overdrafts and (secured or unsecured) loans. Alternative forms of financing, such as factoring, credit unions, and

⁶ The concept "expected profit margin" is explained in Chapter 3.

⁷ Profits can fall temporarily due to market "shocks," such as a sudden increase in costs. This cannot be directly explained by a change in competitive circumstances but by the adaptive behavior of firms. The competitive analysis in this study focuses on protracted higher or lower profit.

⁸ Market power is the degree to which a firm can profitably maintain a price that is permanently above its marginal costs.

⁹ ACM does not have enough data for the period prior to January 2007 to be able to make reliable judgements on the degree of competition in that period.



crowdfunding are still limited in size. The question of whether alternative forms of financing exert competitive pressure is discussed in Chapter 5.

1.3 Investigative acts

ACM gathered information via various sources and methods during this study. These sources are outlined below.

Interviews

ACM has held interviews with all the current providers of SME bank loans, companies that have recently left the Dutch market, SME advisors, the Royal Association of Small and Medium-sized Businesses Netherlands (*MKB-Nederland*), and crowdfunding platforms. It has also spoken to the Dutch central bank (DNB, *De Nederlandsche Bank*), the Netherlands Authority for the Financial Markets (AFM, *Autoriteit Financiële Markten*), the Ministry of Economic Affairs, and the Ministry of Finance.

Requests for information

ACM has put written questions to the major Dutch banks.¹⁰ Based on the interviews and answers to the questionnaires, ACM has formed a picture of competitive circumstances in the SME bank loan market and the role of alternative forms of financing.

Data

ACM has also analyzed quantitative information for its study. Sources that have been used for this purpose include DNB's public data, DNB's non-public data on the expected risks of SME financing, and quantitative information from the requests for information that were sent to the banks. The results of a survey into the shopping around and switching behavior of SMEs, conducted on ACM's instructions, have also been used for this study.¹¹

Consultation procedure

The main market participants, including the three major banks, were consulted in respect of the results of this study. Insofar as relevant, the reactions to this consultation have been incorporated in this report.

1.4 Structure of this report

This report is structured as follows. Chapter 2 deals with the definition of an SME and the different financing options available to enterprises. In Chapter 3, ACM presents the margin calculation of SME financing. Chapter 4 then covers the different sources of market power that can explain the degree of competition or its development, such as capacity constraints and entry barriers. Chapter 5 sets out

¹⁰ Pursuant to Article 6b of the Establishment Act of the Netherlands Authority for Consumers and Markets (*Instellingswet ACM*), ACM has the authority to request information for market studies, such as this one.

¹¹ GfK (2014).



the main developments in relation to alternative forms of financing. Lastly, Chapter 6 contains the main findings of this study and recommendations are made to promote competition in this market.



2 Financing of SMEs

2.1 Definition of an SME

The term SME cannot be encapsulated in one definition. It includes a wide variety of businesses in terms of activity, turnover, number of employees, age, and risk profile. Various definitions are therefore possible. The European Commission applies three criteria to determine whether a business can be classified as an SME. These criteria are (i) the number of employees, (ii) the amount of the annual turnover, and (iii) the size of the balance sheet.¹² A distinction is made within this European definition among micro enterprises (including self-employed persons), small enterprises, and medium-sized enterprises (see Table 1). Figure 1 provides an overview of the number of enterprises in the Netherlands broken down by size on the basis of the number of employees.

Type of enterprise	Employees	Annual turnover	Balance sheet total
Medium-sized enterprise	50-250	€10-€50 million	€10-€43 million
Small enterprise	10-49	€2-€10 million	€2-€10 million
Micro enterprise (including self-employed persons)	< 10	≤ €2 million	≤ €2 million

Table 1: European definition of an SME

Banks use their own definitions of an SME in their daily business operations. From the request for information that was made as part of this study, it has emerged that banks distinguish between

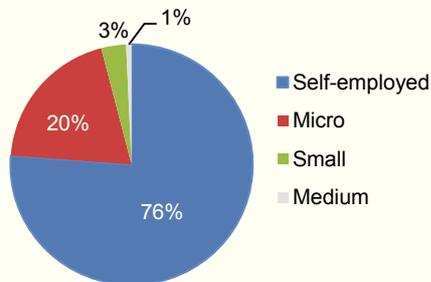


Figure 1: Relative share of the number of enterprises by size, based on the number of employees. Source: Statistics Netherlands.

smaller and larger enterprises on the basis of their annual turnover and/or total financing. If an enterprise remains under the threshold value of these two characteristics, banks regard it as an SME.¹³

This study includes an estimate of the development of the expected profit margin in business financing. ACM has data on business loans up to EUR 1 million to be able to make this estimate. Loans of this size is mainly taken out by enterprises that other organizations view as SMEs. The definitions

that banks use for SMEs in their internal operations are followed in Chapter 4. This means that

¹² http://ec.europa.eu/enterprise/policies/sme/files/sme_definition/sme_user_guide_nl.pdf.

¹³ One bank regards its business customers with an annual turnover from EUR 1 million - EUR 30 million as SME customers. Another bank looks only at the business customer's total financing. If this does not exceed EUR 1 million, the enterprise falls within the SME segment. Yet another bank categorizes an SME as an enterprise for which (i) annual turnover does not exceed EUR 10 million, (ii) credit exposure does not exceed EUR 5 million, (iii) total financing does not exceed EUR 2.5 million, and (iv) annual revenue gained for the bank does not exceed EUR 35,000. The threshold values of the latter bank are cumulative.



microenterprises with self-employed persons largely fall outside the scope of this study.¹⁴

2.2 Financial position of SMEs

SMEs have been hard hit by the recent credit crisis. The Netherlands Bureau for Economic Policy Analysis (CPB, 2014) reported on the trend of a number of key figures in 2014. The solvency of SMEs has decreased at the macro level since the credit crisis. Profitability has also worsened over the same period, and 2009 was a particularly negative year. The turnover of half of SMEs decreased by 6% or more in that year, and it became difficult for enterprises to turn the tide. CPB also notes that it is not possible to state "generally" whether prospects for SMEs are good or bad. There are too many differences among them to do this, yet it is clear that micro enterprises, in particular, are struggling.

Another conclusion of the CPB is that a portion of SMEs are structurally not well-placed, and that this was the case even before the credit crisis. In many cases, these enterprises are referred within banks to their special asset management department.¹⁵

2.3 Description of the available forms of financing for SMEs

SMEs need financing for their business activities. This need arises from investment objectives (e.g. operating assets, accommodation, and vehicles) and the desire to increase liquid assets that are not used directly for investment (e.g. working capital and stock).

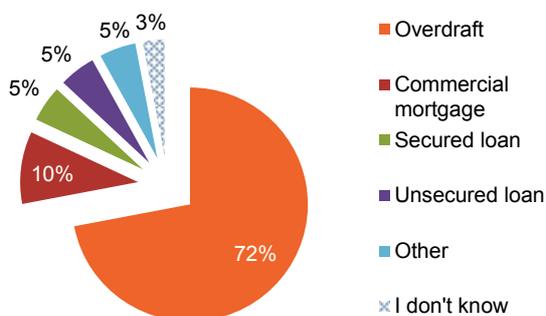


Figure 2: What do you regard as your main form of bank financing? Source: GfK (2014), n = 509.

Depending on the objective, SMEs make use of different types of financing. The main distinction is made between short-term and long-term financing. For short-term financing, SMEs often resort to overdrafts.¹⁶ For long-term financing, SMEs normally make use of long-term secured loans, such as a commercial mortgage.

Another distinction is made between internal and external financing. Internal financing is financing with assets that the enterprise has accrued through its own activities. Internal

financing occurs if an enterprise does not distribute all its profit to shareholders, but retains a part of this instead. External financing makes use of financial resources raised outside the enterprise. These

¹⁴ Self-employed persons are often served via the private banking department of banks.

¹⁵ From the response given by the Minister of Finance to questions from MP Van Hijum on May 9, 2014, it appears that ABN AMRO, ING, and Rabobank have placed 10-20% of their SME customers under special asset management.

¹⁶ <http://www.ingcomfin.nl/media/433949/2013-03-op-zoek-naar-optimale-mix-van-financieringsvormen.pdf>.



include corporate bonds, bank financing, and shareholders' equity.

Many SMEs depend on external financing because they lack internal resources. This is particularly the case with start-ups. The Financing Monitor of the EIM Small Business Research and Consultancy (2014) shows that two-thirds of SMEs which require financing exclusively use borrowed capital as a source of funding for new investments. In approximately 75% of these situations, this involves financing via a bank.¹⁷ Other studies also show that banks are the main source of external financing.¹⁸

Banks offer different forms of financing, and many enterprises consider an overdraft (72%) and a business mortgage as the main forms of bank finance (see Figure 2). An overdraft allows an enterprise to maintain a negative balance on its business current account. A commercial mortgage is a long-term loan that is secured by a mortgage over an asset such as business premises.

Financing through a bank is by far the main source of financing for SMEs. In the next chapter, ACM presents the development of the expected profit margin in bank financing.

¹⁷ EIM (2014), p. 23.

¹⁸ Bureau Bartels (2004), Hoek Commission (2013) and Hebbink et al. (2014).



3 Expected profit margin in the SME loan market

If there is less competition in a market, firms gain market power. They are then able to increase their prices without losing too many customers, and thus make a greater expected profit. Developments in the expected profit margin can thus provide insight into trends in the degree of competition.¹⁹ In this chapter, ACM analyzes how the profit margin on loans and overdrafts to SMEs developed between January 2007 and September 2014.

ACM notes that the estimate of the *absolute* level of the profit margin has a degree of uncertainty, because it is difficult, for instance, to measure the height of the interest rate and operational expenses precisely. Statements on the profit margin in this study therefore relate to the *relative trend* of the profit margin.

Section 3.1 explains the method used to calculate the margin. Section 3.2 then presents the development of the margin. Section 3.3 concludes.

3.1 Description of the method

The expected profit margin of banks on newly-granted financing – overdraft or loan - is calculated by comparing the costs of providing financing with the interest rate that the customer pays. Figure 3 provides a schematic representation of how the interest rate of the financing is structured. If the interest rate that the customer pays is higher than the funding costs and the other cost components, an expected positive economic profit is achieved.²⁰

The term "expected profit margin" or "profit margin" in the remainder of this study means the "expected economic profit" from Figure 3. The box below explains what the expected economic profit is, and how this concept relates to the actual profit achieved. This distinction is important for the correct interpretation of the results from this chapter.

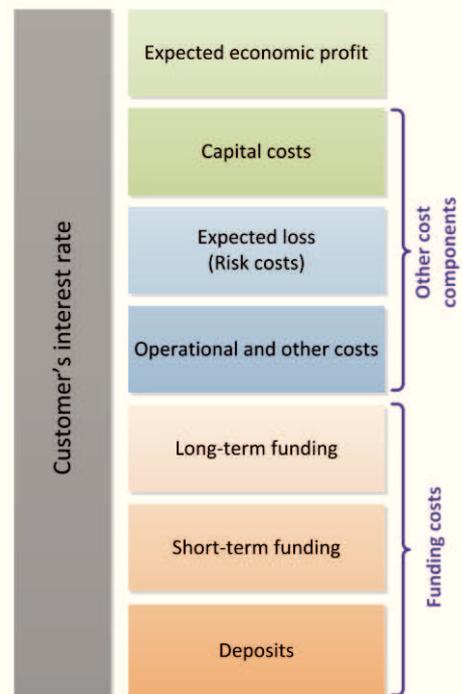


Figure 3: Schematic representation of how the interest rate on SME financing is structured.

¹⁹ A rise or decline in market power can also be explained by factors other than an increase or decrease in the level of competition. According to ACM, since other possible factors do not play a major role in this market, market power is a good yardstick of competition. For more information about the connection between market power and competition, see, for example, Léon (2014).

²⁰ The expected economic profit can be either positive or negative. An expected negative economic profit occurs if the interest rate is too low to cover all the anticipated costs (including capital costs).



Box: Expected economic profit

Measuring market power is about determining the level of independence a bank has in relation to its competitors when setting a price.²¹ When a bank provides financing, it estimates the costs that it expects to incur and calculates a premium (profit margin), which depends on the competitive pressure it is experiencing at the time the loan is provided. As the bank takes the expected costs into account when choosing the optimal price, it are also the expected costs that are used for calculating the profit margin in this study. The difference between the expected costs and the interest rate is the expected economic profit.

The subsequently *achieved* profitability of financing may differ from the *expected* profitability. This happens because certain costs, viewed in hindsight, can turn out to be higher or lower than previously estimated. In the SME financing market, this occurs particularly in the area of risk costs, which are hard to estimate in advance. After the onset of the credit crisis, for instance, it became clear that banks had underestimated the credit risk of SMEs, resulting in lower returns being achieved on SME portfolios.

The model that ACM used in this study to calculate the expected profit margin is comparable to the margin calculations that were made in previous ACM studies in the private mortgages market.²² However, the margin calculation in this study differs in two aspects. First, the risk costs in the SME loan market are far higher than in the case of private mortgages. Second, the capital costs for financing SMEs are also higher than in the case of mortgages because capital requirements are risk-based.

All components of the margin calculation are described in the following sections. The starting point of the margin calculation is the interest rate that the customer pays (section 3.1.1). An estimate is then made of all costs that a bank incurs to provide financing. These are the funding costs (section 3.1.2), the expected risk costs (section 3.1.3), the operational and other costs (section 3.1.4), and the capital costs (section 3.1.5).

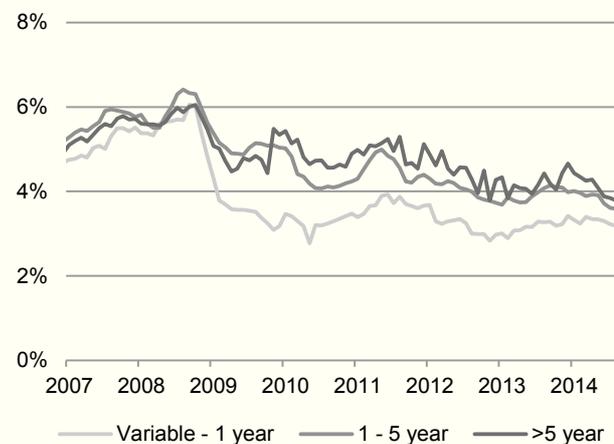


Figure 4: Bank interest on newly-granted financing up to EUR 1 million (January 2007 - September 2014). Breakdown into fixed-rate periods Source: DNB

²¹ Benefits of competition can also manifest themselves, for example, in better quality, a wider product range, or greater innovation.

²² See Netherlands Competition Authority - NMa (2010b), NMa (2011) and ACM (2013).



3.1.1 Interest rate

The model makes use of public data of DNB, which reports the interest rates on a monthly basis. This is an average interest rate on newly-granted business financing of up to EUR 1 million by Dutch banks, with a breakdown into different fixed-rate periods. The level and trends in this regard can be seen in Figure 4. Over the period 2007-2014, the interest rate decreased, depending on the fixed-rate period, by approximately 140-170 basis points.²³

The interest rates in Figure 4 also include financing up to EUR 1 million that is provided to large enterprises. Compared to SMEs, large enterprises are usually less risky, have relatively lower operational costs, and a better negotiating position. This is why they pay lower interest rates than SMEs. The actual interest rate paid by SMEs on loans of up to EUR 1 million is thus probably higher than indicated in Figure 4.²⁴

The stated interest rates furthermore do not represent all income that banks receive by providing SME loans. In addition to interest income, there is other income from SME loans, such as handling fees or a commitment fee in case of overdrafts.²⁵

3.1.2 Funding costs

If a bank lends money, it does so mostly with borrowed capital. The bank uses various sources of funding for this purpose. This may include money that has been deposited with the bank (money that consumers and enterprises have placed in current or savings accounts at the bank), but the bank can also borrow money from other banks through the interbank market or from institutional investors. Just as SMEs owe interest to the bank in exchange for their financing, the bank also owes interest to its lenders. The costs that the bank incurs for this purpose are called funding costs.

Funding costs depend on the specific sources of funding that the bank uses. A bank will generally pay more for a long-term loan than a short-term credit facility. ACM distinguishes in the model among three sources of funding: (i) short-term funding, (ii) long-term funding, and (iii) savings. The model establishes the share of each funding source in the financing mix. The costs of each funding source are then determined. The costs of each funding source, weighted according to the share in the financing mix, collectively form an estimate of the funding costs.

²³ One basis point is equal to 0.01 percentage points.

²⁴ ACM assumes that the extent of this underestimation is constant during the investigated period. The underestimation only plays a role in relation to the interest rate: the cost components that are discussed below are based fully on SMEs.

²⁵ ACM assumes for this model that the other income remained constant during the investigated period. No information has been obtained in this study to show that the relative portion of the other income has decreased.



Determining the funding mix

There are different ways of calculating the funding mix.²⁶ One method is to look at banks' balance sheets when the financing is provided. The relationship among the types of borrowed capital that a bank has on its balance sheet (savings, short or long-term funding) can be inferred from this when financing is provided. A drawback of this method is that a bank's balance sheet shows the funding mix for all financing, including loans and overdrafts that were provided in the past.

This study looks at the expected profit margin on *newly-granted* financing in a specific month. This means that in order to determine the relevant funding mix, the focus must be on new financing that is raised in a month, as far as possible. For this reason the model does not look at the outstanding volumes of funding sources for determining the weighting factor, but at *changes* in the volumes, as far as possible.²⁷

Costs of each funding source

The cost of each funding source is determined as follows. The average interest payment on savings for households and enterprises, as reported by DNB, is used in respect of savings. The costs of a loan on the interbank market (six-month Euribor rate) are used for short-term financing. A risk-premium that banks pay for the risk that they may become insolvent is charged on top of the 6-month Euribor rate for long-term financing. This premium is estimated by calculating a market share weighted average Credit Default Swap spread (CDS spread).²⁸

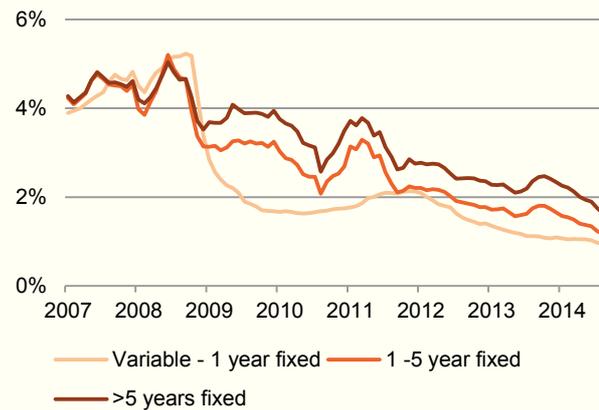


Figure 5: Estimate of funding costs in percentage points, broken down into fixed-rate periods (Jan 2007 - Sept 2014)
Source: ACM calculation

The estimation of the funding costs also takes the fixed-rate period of the loan into account. The interest rate that an SME pays may be variable, but may also be fixed for a specific period, e.g. five

²⁶ For more information on the calculation method, see NMa (2011) and ACM (2013), in which the funding mix is calculated in three different ways.

²⁷ This is what is referred to as the "marginal financing costs method" in the NMa (2011) published study into the mortgage market. The study of 2011 also uses an "average financing costs method" and a "mortgage rate calculation method" to calculate the financing mix. For the sake of completeness, the "average financing costs method" is included in the appendix as a robustness analysis.

²⁸ A Credit Default Swap provides an estimate of the risk premium that a bank pays for raising borrowed capital.



years. The longer the fixed-rate period, the higher the interest rate that the SME usually pays.²⁹ This is because a premium that hedges the risk of future interest rate alterations is factored into the rate. In order to provide a realistic account of the bank's funding costs for different fixed-rate periods, the funding costs for all funding sources are adjusted by means of an Interest Rate Swap.³⁰

Figure 5 provides an overview of the estimate of funding costs broken down into fixed-rate periods. It shows that the longer the fixed-rate period, the higher the funding costs. Over the period 2007-2014, funding costs decreased, depending on the fixed-rate period, by approximately 270-300 basis points.

3.1.3 Expected risk costs

Another important cost component is the premium for expected risk costs. Banks know from experience that for every hundred loans they grant, a number of customers will default. Such business customers can no longer meet their obligations and will possibly fail to repay part of the principal. Since the bank knows in advance that it will incur costs for this purpose (even if it does not know exactly which loans will not be repaid), it factors in these costs for all customers by means of a risk premium. This premium is not the same for all SMEs, because some SMEs are more likely to default than others. The higher the bank estimates the risk of a customer defaulting, the higher the individual risk premium for that SME.

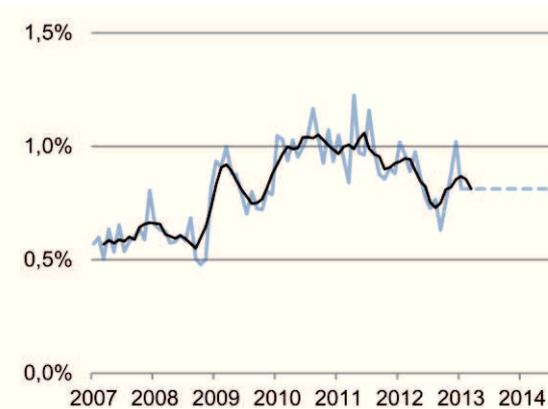


Figure 6: Estimate of the expected risk costs in percentage points on newly-granted financing up to EUR 1 million (Jan 2007-Sept 2014) with moving average and extrapolation. Source: anonymized DNB data, processed by ACM

The precise amount of the risk premium is determined on the basis of the expected loss that a bank anticipates making on a loan or overdraft. This depends on the probability of the default (PD) of the SME, the exposure at default (EaD), and the loss given default, being the portion of the outstanding amount that a bank expects to lose in case of default (LGD). These three variables are multiplied with each other to obtain the expected loss of a loan or credit facility.

The risk costs are estimated in the model on the basis of a dataset that is gathered by DNB as part of its oversight on capital requirements.³¹

²⁹ An exception to this is when a sharp fall in interest rates is predicted: the variable interest at that time may exceed the rate that has been fixed for a number of years.

³⁰ An Interest Rate Swap is a financial derivative that converts variable interest rate into an interest rate with a fixed-rate period.

³¹ More specifically, what is known as the "IRB Health Check SME." Also see: <http://www.toezicht.dnb.nl/binaries/50-227845.pdf>.



ACM has received an anonymized version of this dataset, which contains information about SME financing provided by the major Dutch providers of SME financing.³² This dataset includes information on PDs, LGDs, and EaDs of SME loans and overdrafts, as estimated by the banks themselves. Based on this information, it is possible to calculate a weighted average expected loss. For the purpose of this study, a selection has been made based on the expected risk costs of *newly-granted* loans and overdrafts up to EUR 1 million.³³

Figure 6 shows the trend of expected risk costs on newly-granted financing. Over the period 2007-2014³⁴, the expected risk costs on new financing rose by approximately 30 basis points.

Box: Expected risk costs and the actual credit risk of SMEs

When determining the price of SME financing, banks take into account the expected risk of a customer defaulting. This section shows that these expected risk costs of granted financing increased by approximately 30 basis points in the period 2007-2014.

It is important to emphasize that the expected risk costs of *granted* financing are relevant for the model (and pricing). SMEs that are rejected by a bank or that have not requested financing from banks are thus not part of the dataset used by ACM. It is possible that the credit risk of SMEs as a whole has increased since the onset of the credit crisis by more than thirty basis points, but that cannot be tested on the basis of the available dataset.

3.1.4 Operational and other costs

Operational costs are costs that the bank incurs to grant and manage financing. These include costs of personnel, IT systems, and business premises. The exact operational costs that arise from granting and managing financing granted to enterprises are difficult to estimate because a bank also uses a branch or IT system for other activities, such as current and savings accounts. A bank also incurs a number of other costs in relation to financing, such as the risk of early repayments and what is known as the *pipeline risk*.³⁵

³² The data is anonymized so that it cannot be traced back to individual banks or enterprises.

³³ The loss caused by the past underestimation of risks can lead to adjustments of the risk model that banks use to estimate expected loss. This has been taken into account in ACM's calculations because these are based on the PDs, LGDs, and EaDs as reported by the banks to DNB.

³⁴ An extrapolation of the risk costs has been used for the last period (January 2013-September 2014) due to the limited availability of data. Robustness analyses have been carried out on this with different risk cost levels. In the most extreme scenario, the expected risk costs doubled in relation to the basis scenario between 2007 and 2014. The conclusions from this chapter remain unchanged in this scenario. For more information about this robustness analysis and the effect thereof on increasing margins, see the Appendix: robustness analysis of margin calculation.

³⁵ If the bank makes an offer for a loan, it is valid for a number of weeks. During the period between making the offer and its acceptance by the customer, the underlying funding costs may change. If the funding costs rise in the meantime, the bank is still bound by its offer. The bank runs a risk in this respect and charges a small premium to hedge this risk.



In order to estimate the amount of operational and other costs, ACM requested information from the major banks that finance SMEs. This revealed that the operational costs for large financing transactions are not much higher than for relatively small financing transactions. Expressed in basis points, this means that the premium for operational costs is far higher for small than for large financing transactions.

Based on the requested data, ACM estimates the amount of operational and other costs for all loans and overdrafts up to EUR 1 million at around 100 basis points. Nevertheless, this can exceed 200 basis points for relatively small financing transactions. More significantly, no clear increase or decrease in the amount of the operational and other costs can be observed on the basis of the requested data.³⁶ It has therefore been decided to keep the operational and other costs stable in the model. These costs therefore play no role in the *trend* of the profit margin presented later in the chapter.

3.1.5 Capital costs

The bank finances the largest part of a loan granted to an SME with debt. However, the bank also finances part of the loan with shareholders' equity. In contrast to debt, the amount paid by the bank to equity providers is not laid down contractually. Equity providers are instead entitled to a share of the bank's profits. The exact return on equity is uncertain. There is no guarantee that the bank will make a profit, and if the bank becomes insolvent, equity providers can lose their entire investment.

Depending on the risk that equity providers are exposed to, they receive a compensation on their equity. This is also called the opportunity cost of capital. If this compensation is not offered, investors are not prepared to invest money in the bank.



Figure 7: Estimate of capital costs in percentage points (Jan 2007-Sept 2014) Source: ACM calculations, DNB data.

There are two parameters for calculating capital costs. First, it is necessary to know what part of SME financing is financed through equity on average. The leverage ratio at bank level is used for this purpose.³⁷ The leverage ratio at bank level probably underestimates the amount of equity that the bank must hold for the SME portfolio, because the SME portfolio usually has a higher-than-average risk weight. An adjustment is made in the model for this purpose.³⁸ The

³⁶ The major market participants have confirmed the view that the operational and other costs have remained almost constant.

³⁷ The leverage ratio shows the relationship between equity and total assets for the bank.

³⁸ This is adjusted in the model by multiplying the monthly leverage ratio by a factor of 1.31. ACM arrived at a factor of 1.31 after studying the ECB's transparency exercise (see <http://www.eba.europa.eu/risk-analysis-and-data/eu-wide->



second required parameter is the required return on equity. The target returns on equity communicated by the banks themselves to their investors are used for this purpose. Based on these targets, ACM arrives at an after-tax return on equity of 12%.³⁹

Figure 7 shows the estimate of the capital costs. Over the period 2007-2014, capital costs rose by around 50 basis points. This was mainly because of an increase in the amount of equity used to finance SMEs.⁴⁰

3.2 Margin developments

The previous section discusses all the components that are needed to perform a margin calculation. Over the period January 2007 to September 2014, funding costs decreased, depending on the fixed-rate period, by approximately 300 basis points. Customer interest rates fell less sharply during this period, by approximately 155 basis points. Consequently, the "interest margin" (the surcharge on funding) increased by approximately 145 basis points.

Developments in other cost components must also be taken into account for the calculation of expected profit margin. In the period from January 2007 to September 2014, the expected risk costs increased by roughly 30 basis points, while capital costs increased by approximately 50 basis points. The operational and other costs remained stable during this period.

Taking all these developments into consideration, an increase in the expected profit margin of around 65 basis points remains for the period from January 2007 to September 2014. The development of the margin can be seen in Figure 8. The first measured period – January 2007 – is used as the starting point in this figure to show the development of the expected profit margin. The exact amount of the increase depends on the chosen assumptions. An overview of the influence of different assumptions on the development of the margin is included in the appendix to this report.

[transparency-exercise](#)). This research shows the exposure of all major banks in the SME sector, with the accompanying risk weight for the capital requirement calculations (the Risk Weighted Assets or RWAs), for two measurement moments (31 December 2012 and 30 June 2013). Based on a fully implemented Basel III, banks are deemed to hold 16% of the RWAs in equity. Based on this data, it is possible to calculate that the leverage ratio at bank level is underestimated by a factor of 1.31 at these measurement moments. The sensitivity for this assumption is tested in the Appendix: robustness analysis of margin calculation.

³⁹ The model takes into account pre-tax compensation on equity of 16%. The after-tax compensation can be calculated as follows: after-tax required return = (1 - corporate tax) x pre-tax required return.

⁴⁰ Theoretically, if a loan or overdraft is financed with more equity, the share of borrowed capital in the financing mix also decreases. However, it appears from the request for information from the banks that finance pricing does not always work in that way. A robustness analysis is included in the analysis, which uses this weighted average cost of capital (WACC) method as the basis for calculating the expected profit margin.

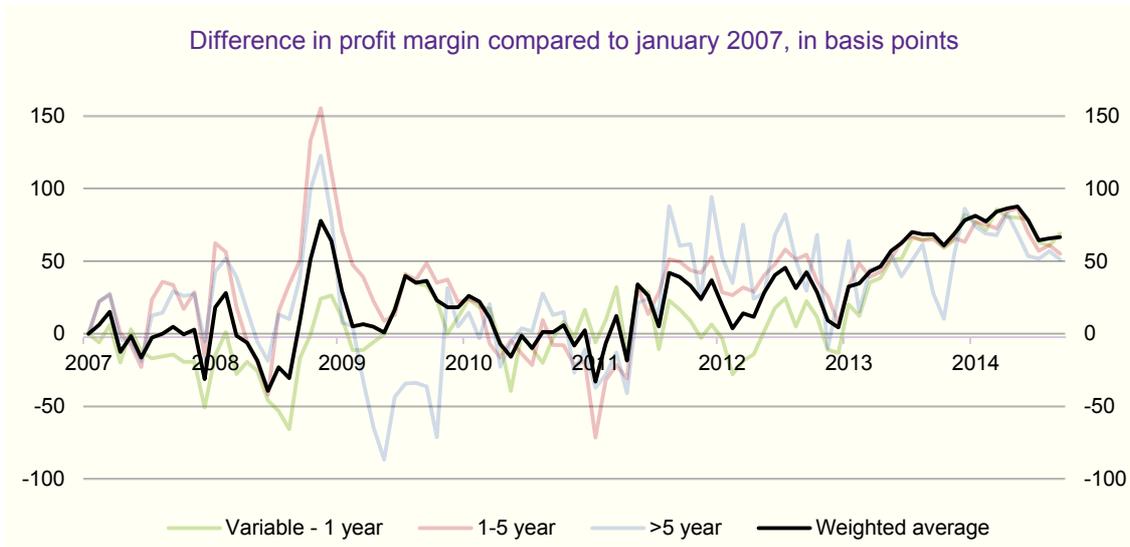


Figure 8: Estimate of the development of the estimated profit margin on bank financing up to EUR 1 million (January 2007-September 2014) broken down to different fixed-rate periods. Represented as a difference in basis points compared to January 2007. Source: ACM calculations

Figure 8 shows that no definite trend in the development of the expected profit margin could be observed in the first half of the investigated period.⁴¹ The profit margin fluctuated around the January 2007 level between 2007 and 2011. From 2011, the weighted average expected profit margin seemed to rise slightly, although it still fluctuated sharply in 2012 and fell twice close to the January 2007 level. In 2013 and 2014, the profit margin rose sharply to a level around 65 basis points higher than the January 2007 level.

As noted at the start of this chapter, the margin estimation relates only to the development of the profit margin and not its absolute level. Two major banks indicated during the consultation on this chapter that while they agreed that the margin had increased, this was an increase from a loss-making situation to a less loss-making situation. ACM cannot make any judgement about this on the basis of the margin calculation, since this relates only to the development of the profit margin. However, ACM thinks that it would not make business sense to structurally provide financing which amount to foreseeable expected losses. When asked, the major banks indicated that they did not structurally provide financing under cost price (an expected loss-making situation) before the credit crisis. According to ACM, it is therefore more likely that the expected profit margin in Figure 8 is positive for most of the investigated period.⁴²

⁴¹ Not every small increase or decrease in the profit margin in Figure 8 should be interpreted as a small increase or decrease in the level of competition. The large trends that can be observed in the expected profit margin are more important. These can provide an insight into developments in the level of competition.

⁴² As stated earlier, it is difficult to measure the exact level of a number of components of the margin calculation. For example, ACM believes that the interest rate used underestimates the actual income that banks earn on SME financing up to EUR 1 million. As a result of this, the absolute level of the margin in the calculations is negative.



3.3 Conclusion on the margin calculation

ACM has estimated the development of the profit margin that banks expect to earn – at the time they grant financing - on Dutch SME financing. The margin calculation takes into consideration the relevant marginal costs that a bank incurs when granting new financing.

The margin calculation shows that the expected profit margin rose from 2011, and rose sharply from 2013. This possibly points to a decrease in competition among banks in the Dutch SME loan market.

The development of the expected profit margin gives no insight into the absolute level of competition. In the next chapter, ACM will therefore assess the degree of competition in the market for SME loans based on the different sources of market power.



4 Sources of market power in the SME loan market

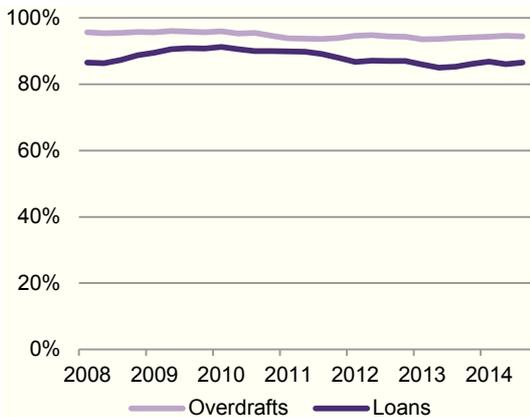


Figure 9: C3 ratio (the joint market share of the three largest players) for overdrafts and loans to enterprises with an annual turnover of EUR 1-10 million. Source: information from banks.

The major Dutch banks, ABN AMRO, ING, and Rabobank have provided more than 85% of all financing to SMEs for years (see Figure 9). Furthermore, since the onset of the credit crisis, a considerable number of banks have downscaled (e.g. Deutsche Bank) or discontinued their activities (e.g. SNS Bank) in the area of SME financing.⁴³ As a result of the credit crisis, Rabobank has also taken over Friesland Bank and Fortis Bank Nederland has been absorbed into ABN AMRO. Besides the three major Dutch banks, there are still a few other banks operating in this market, including Triodos Bank and Svenska Handelsbanken (see Figure 10). There are also a number of alternative forms of

financing, but these only finance SMEs on a relatively small scale.

This market situation raises the question of the extent to which there is adequate competition in the area of SME financing. Any lack of competition is caused by one or more sources of market power. This chapter deals in more depth with the degree of market power in the Dutch SME loan market. ACM analyzes whether each individual source of market power has an important influence on the reduced competition in this market. There are many different sources of market power. It is unlikely that a number of these sources, such as patents or licenses, have an important influence in this market. As a result of this, the analysis has been reduced to five sources of market power. These are capacity constraints (section 4.1), search costs (section 4.2), switching costs (section 4.3), entry barriers (section 4.4), and tacit coordination (section 4.5).

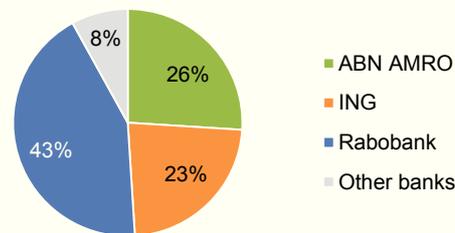


Figure 10: Market share of the major banks. Source: GfK (2014).

4.1 Capacity constraints

If a firm produces at maximum capacity, it may be too expensive or even impossible to increase

⁴³ ACM has spoken with both banks. Deutsche Bank states, for example, that it has discontinued part of its SME financing because it was unable to operate its customized service model profitably for all its SME customers.



capacity any further in the short term. The firm must thus respect its maximum capacity.⁴⁴ A firm has what is known as a capacity constraint.

Capacity constraints can influence how firms compete with each other in a market. In the absence of capacity constraints among providers, each firm has an incentive to set a lower price than its competitors. After all, by setting a lower price than its competitors, a firm can attract a lot of customers. This causes a race to the bottom, in which the final price tends toward a competitive level. This form of competition is called Bertrand competition.⁴⁵

Capacity constraints reduce the incentive for a firm to set a lower price than its competitors. A lower price leads to an influx of new customers, but due to the capacity constraint, the firm cannot handle that influx. This gives the firm an incentive to set higher prices, in order to limit the influx of customers. It follows from the economic literature that the market outcome in a Bertrand model with capacity constraints corresponds with that of a Cournot model.⁴⁶ This means that prices will be higher in a situation with capacity constraints and the firms will make higher profits than in a situation without capacity constraints.

Capacity constraints at Dutch banks

On the basis of prudential legislation, every loan must be financed with a minimum amount of equity capital (referred to below as capital requirements). This means that banks are limited in their capacity to grant loans by their available equity capital.

Due to unexpected credit losses⁴⁷ and the tightening of capital requirements⁴⁸, all major Dutch banks have to improve their capital ratios in order to comply with the new capital requirements. A bank can improve its capital ratios through: (i) retained earnings, (ii) attracting new equity capital, or (iii)

⁴⁴ Belleflamme & Peitz (2010), p.60.

⁴⁵ The extent to which the market price lies above the level of marginal costs depends on the degree of product differentiation.

⁴⁶ Moreno & Ubeda (2006) and Kreps & Scheinkman (1983).

⁴⁷ As a result of the credit crisis, banks have suffered greater-than-expected losses on their lending portfolios. In 2007, for example, the major Dutch banks wrote off EUR 10 billion as a result of credit losses (DNB, 2008, p.16). These unexpected credit losses have had a negative effect on the amount of banks' equity capital.

⁴⁸ The credit crisis clearly showed that the capital requirements in force at the time (Basel II) were inadequate to absorb the unexpected credit losses of banks. International capital requirements for banks have thus been tightened qualitatively and quantitatively. The capital requirements of Basel III have been in force in the Netherlands, via European and national legislation, since January 2014. Banks must comply fully with the new requirements by 2019. The minimum Tier 1 Capital Ratio under Basel III is being gradually raised, for instance, from 4.5% to 6%. Certain capital instruments under Basel III are also not taken into account as equity capital. As a result of this, the total amount of equity capital for Dutch banks (tier 1 and tier 2) is around 20% lower. See DNB (2014a), p.4.



reducing its balance sheet.⁴⁹

In practice, Dutch banks have improved their capital ratios through retaining earnings and balance sheet reduction.⁵⁰ This manner of increasing a bank's equity capital generally takes longer than attracting new equity capital. Table 2 shows that the major banks did not distribute a large portion of the net profit as dividends after the onset of the credit crisis. They did not issue any new shares to comply with the higher capital requirements.⁵¹ As long as banks do not comply with existing or expected future capital requirements, they will be faced with capacity constraints.

	Net profit in the previous year	Dividend	Dividend as a % of net profit
2005	11,933	4,912	41%
2006	14,041	5,457	39%
2007	15,158	4,835	32%
2008*	22,052	23,085	105%
2009	5,568	813	15%
2010	1,377	926	67%
2011	7,224	1,341	19%
2012	9,169	1,477	16%
2013	7,214	1,433	20%
2014	6,606	2,092	32%

* Due to the takeover of ABN AMRO, the 2008 data gives a distorted picture.

Table 2: Distributed dividends versus net profit of the major banks, in millions of euros. Source: annual reports of banks.

A possible reason why banks have not issued any new shares is the associated costs.⁵²

These costs can be caused by factors such as information asymmetry.⁵³ If banks wish to increase their equity capital, investors may take this as a sign that the bank is not solvent enough. In order to avoid such a negative sign, banks prefer other options for supplementing their equity capital. Banks with high debt overhang are moreover reticent to attract new equity capital because the benefits mainly accrue to the debt providers and not to the equity providers.⁵⁴

Capacity constraints in the SME loan market

Having capacity constraints at the bankgroup level does not *automatically* mean that a bank also has capacity constraints in the provision of SME financing. It simply means that a bank must be more selective in the loans that it does and does not provide. Every euro of equity capital that the bank uses for SME financing can no longer be used to provide other loans, such as a private mortgage.

Capacity constraints that banks experience at group level extend to the SME financing market. A

⁴⁹ IMF (2014), p.24. When reducing its balance sheet, a bank sells profitable assets, causing the ratio between equity capital and assets to increase.

⁵⁰ ACM (2013), p.24.

⁵¹ DNB (2014b), p.11.

⁵² Not issuing new shares can also be strategically important, namely to maintain capacity constraints. See Schliephake & Kirstein (2013).

⁵³ Myers & Majluf (1984).

⁵⁴ See Netherlands Bureau for Economic Policy Analysis - CPB (2010), p. 36.



bank wishes to use its limited equity capital for loans that give the best return on each euro of invested equity. This means it is not in the bank's interest to use its available equity capital to compete fiercely in the SME financing market only to earn low margins. A bank can rather use its equity capital to invest in a more profitable activity.⁵⁵

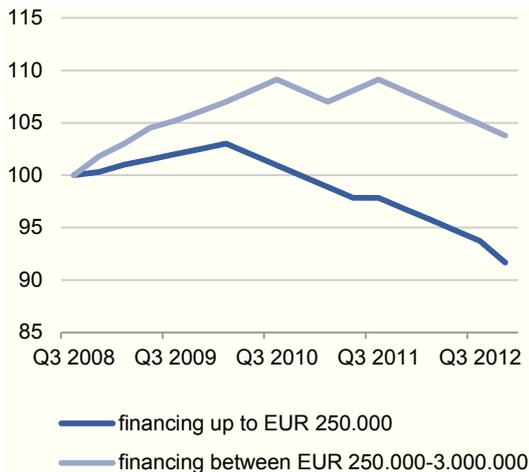


Figure 11: Outstanding amount of financing to enterprises by the three major banks (Q3 2008-Q4 2012) Basis index = Q3 2008.

Sources: *Taskforce Kredietverlening (Lending Task Force) (2010)* and *Stuurgroep Kredietverlening (Lending Steering Committee) (2013)*, edited by ACM.

Furthermore, with the introduction of Basel II and III, the capital requirements have become increasingly risk-based. Consequently, banks must hold more equity capital for the relatively risky SME portfolio in comparison to other activities. This makes it less attractive to provide SME financing. An SME loan takes up a great deal of the available equity capital.

Figure 11 shows the development of the amount of financing given to enterprises by the three major banks in the period Q3 2008-Q4 2012. This figure shows how the amount of small loans, in particular, dropped sharply. This decline is consistent with a changed form of competition as a result of capacity constraints.

Conclusion on capacity constraints

Capital requirements prescribe that a bank must have a minimum amount of equity capital in order to finance a loan. The available equity capital places a cap on the banks' lending capacity. Due to unexpected losses and a tightening of capital requirements, banks must improve their capital ratios. As long as banks do not comply with existing or expected future capital requirements, they will be faced with capacity constraints. Capacity constraints at bankgroup level extend to the SME financing market. This limits the opportunities for competitors to discipline each other and is thus a source of market power.

4.2 Search costs

SMEs who need financing are not always aware of the full offerings in the market. It takes time, effort, and sometimes money to obtain relevant information about the range of products. They also need to make the mental effort to understand and compare the relevant information. This is referred to as "search costs."

⁵⁵ In other words, because of capacity constraints at bank level, a bank must also take the implicit costs into account when reducing its prices (and increasing demand) in the sense that additional loans that are granted to SMEs are to the detriment of the ability to grant other loans (opportunity costs).



SMEs take these search costs into account. They include an additional provider in their choice and orientation process only if the expected benefits of doing so - the possibility of a product with a better price/quality ratio - compensate for the additional search costs. The existence of significant search costs may mean that SMEs do not include the entire range of products in their choice and orientation process. Providers take this into account in a market with significant search costs. Due to the high search costs, it becomes less attractive for a provider to make a competitive offer as it will not be noticed by all customers. Search costs therefore cause less competition among providers and may be a source of market power.⁵⁶

Search costs in the SME loan market

One way to investigate the level of search costs in the market for SME loans is to look at which information SMEs are able to gather in advance from public sources about the product range of the various banks. Based on this information, SMEs may decide which providers to apply to for a loan.

ACM has investigated which characteristics SMEs find important when taking out finance.⁵⁷ These are: (i) the acceptance criteria of the bank, (ii) the speed of the application process and the granting of the loan, (iii) financing costs, (iv) securities to be provided, and (v) the relationship with the bank advisor. The information that SMEs have been able to find online about these characteristics is described below.⁵⁸

(i) Acceptance criteria of the bank

Banks provide limited information about their acceptance criteria on their websites. Two banks do indicate which criteria they use, without indicating which criteria are decisive. One of these two banks also indicates how the chances of acceptance can be increased. The other banks give practically no information about their acceptance criteria.

(ii) Speed of the application process and payment

Most banks provide a short description of the different steps in their application process on their websites. Based on this, SMEs can make a rough estimate of how long an application will take. The descriptions given by the banks of their application process are largely similar. It is understandable that a bank can only provide a certain level of insight in this regard as the processing time of an application depends on how quickly the customer can supply all the relevant information. On the other hand, none of the banks provide any indication of how long the application process normally takes.

(iii) Financing costs

All the major banks describe the cost components of a loan, although one bank does so in more depth than the others. This information provides insight into the constituent components of the

⁵⁶ Stiglitz (1989), p.772.

⁵⁷ GfK (2014).

⁵⁸ The websites of ABN AMRO, ING, Rabobank, Triodos Bank, and Svenska Handelsbanken were consulted for this purpose.



interest rate and which components SMEs can influence themselves to arrive at a lower rate. There is no information about the actual interest rate on most banks' websites. Only ING differs from this positively by publishing its overdraft price levels based on the size of the credit facility and by publishing an average rate for loans. The other banks do not do this.

(iv) Securities to be provided

Most banks indicate that securities are required. None of the banks explain how many securities this involves, or whether there is any room for negotiation.

(v) Relationship with bank advisor

Little information about contact with a bank advisor is available on the banks' websites. Only ABN AMRO refers to a "customer relationship manager as a personal point of contact." The other banks do not discuss the service concept being offered to the customer.

ACM establishes that SMEs can only obtain limited *ex ante* information on the product range of banks. Limited information is available on their websites about the five product characteristics that SMEs find important. If information is available, it is often insufficiently detailed to be able to compare banks. Banks do not seem to compete with respect to offering much information about one or more of these characteristics, in order to set themselves apart from their competitors. This means that SMEs wishing to obtain all the relevant information to compare banks to each other, must obtain this information in a different way. This may include hiring an advisor or going through the application process at different banks.

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Box: specialized SME advisors

Various advisors specializing in SME financing operate in the Netherlands. These financial service providers function as intermediaries between the customer and the bank. Most SMEs do not use these service providers, choosing to rather organize this on their own, sometimes with the help of their own accountant or auditor. Research by Melse & Weltevreden (2013) shows that around 50% of the interviewed enterprises with 1-50 employees completed the full financing application process themselves. A further 25% of these enterprises requested assistance from an "intermediary," often their auditor or administration office. None of the undertakings with more than fifty employees hired a specialized advisor.

ACM has spoken with three national organizations of SME advisors. During these interviews, the organizations were asked various questions, including the extent to which the advisor makes a financing application at several banks. Two of the interviewed market participants indicated that an application is firstly submitted to the customer's main bank. The chance of acceptance at the main bank is considered to be greatest.

Finance application process

A financing application at one of the major banks works as follows. The first step for an SME is the preparation prior to the finance application. Banks require all types of information from applicants before they can process the finance application. This includes annual figures of previous years and a forecast for the current year, a business plan, and substantiation of the investment and finance application. The information that the banks request in this regard is mostly the same. The second

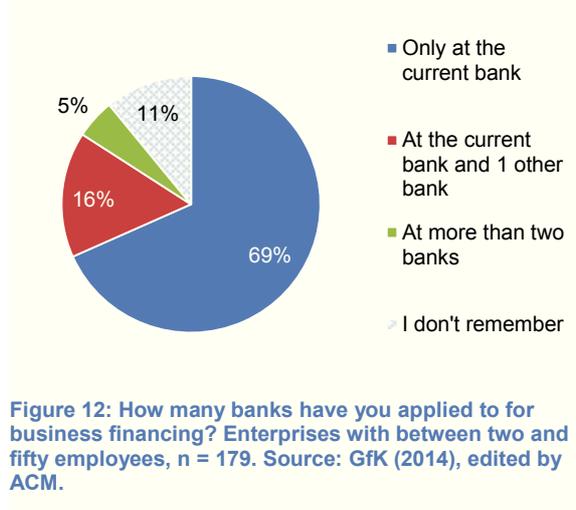


step is the finance application. This includes one or more meetings with the bank and the submission of any additional information. The bank carries out a credit assessment and gives approval in this step. If the first two steps are successful, the offer is made in the third step. The offer is usually valid for two weeks. Acceptance from the customer is obtained in the last step. Securities are established and the financing is also made available in this step.

SMEs normally receive the relevant information that could be used to compare different providers only during the third step. This includes the term of the loan, the interest rate, and the necessary securities. Based on the information that was obtained from its requests for information, ACM understands that the first two steps can easily take a month. One of the major banks has indicated that it takes 35 days on average before the customer receives the first offer.

Customers know only at the end of the finance application whether they have been accepted and then find out the conditions for their financing. Since the application process lasts a few weeks and requires significant time investment from SMEs, there are significant search costs in the SME loan market.

Actual shopping around behavior in the SME loan market



In practice, many SMEs do not include all banks in their search and orientation process. It is evident from GfK (2014) that around 70% of the interviewed enterprises with 2-50 employees made a finance application only to their "main bank."⁵⁹ There is no clear explanation for this high percentage. Spontaneous reasons provided by enterprises include "I have a good relationship with my main bank," "I have no need for this," and "I'm satisfied with my current bank." This percentage is significantly higher for small enterprises (70%) than medium-sized enterprises (55%).

A possible explanation for why medium-sized enterprises often apply for financing at several providers is that it is more worthwhile for them to shop around than it is for a small enterprise. Discussions with advisors have revealed that the differences in interest rates among the three major banks are limited, especially for small enterprises. Since small enterprises need less financing than

⁵⁹ There is no unambiguous definition of the term "main bank." ACM defines the main bank as the bank through which the SME channels most of its business payment transactions. Most enterprises already have a business current account before they take out an overdraft or long-term loan.



medium-sized enterprises, the additional search costs for the small enterprise are possibly not compensated by the chance of another bank making an improved offer. In contrast, since medium-sized enterprises have a greater need for financing, a lower price at another provider may compensate the search costs. It is therefore worthwhile for a medium-sized enterprise to submit financing applications to several providers.

Conclusion on search costs

SMEs must incur significant search costs in their choice and orientation process. SMEs can only find limited information in public sources about important product characteristics, such as acceptance criteria and interest rates. In order to obtain all relevant information, SMEs must therefore make a finance application at a bank that often takes several weeks to process. The above is reflected in the actual orientation behavior of SMEs. Research shows that three-quarters of SMEs contact only one bank for a finance application.

Significant search costs ensure that banks compete less with each other. It is likely that this is a source of market power in the SME loan market.

4.3 Switching costs

Switching costs are all costs that a consumer or enterprise must incur to change provider. These include both financial switching costs and costs in the form of "hassle," such as administrative acts. As a result, consumers or enterprises are to some extent bound to their current provider. This is called the lock-in effect.⁶⁰

The lock-in effect gives a provider market power over its current customers. A customer will switch to another provider only if the difference in price or quality compensates for the switching costs. The current provider can therefore raise its prices to a point where it is not yet attractive for the customer to switch. The higher the switching costs, the higher the provider can set its price, and thus the greater the market power.⁶¹

Switching costs in the SME loan market

SMEs are confronted with various switching costs if they change banks. The extent of the total switching costs depends on the individual circumstances of the enterprise.

SMEs that wish to switch banks must again gather information about the product range of other

⁶⁰ Farrell & Klemperer (2007).

⁶¹ On the other hand, there may be fiercer competition for new customers if there are switching costs than in a situation without switching costs. A provider knows that it will have subsequent market power over customers who purchase a product from it now. Part of the market power that a provider has over existing customers is thus returned *ex ante* to new customers. See OFT (2003), p. 39.



banks. This implies search costs, as already described in section 4.2.⁶² When switching, the new bank also charges a one-off handling fee for the financing. According to one major bank, these handling fees often amount to 1% of the financing amount.⁶³

When financing SMEs, banks also ask for collateral securities, such as a home or stock. Many of these types of security are difficult to divide and distribute among several banks. Stock, for example, is normally pledged in its entirety to one bank. According to SME advisors, it is therefore more difficult for SMEs looking for additional financing at another bank to provide security to that other bank.

Changing banks also implies that SMEs have to deal with a new relationship advisor, after sometimes dealing for years with a specific advisor at their current bank. Giving up this business relationship can be a mental barrier for SMEs to switch banks. The study does however show that SMEs are finding the relationship with their advisor increasingly less important. This is partly because the client load for each advisor has increased in recent years and SMEs often have to deal with a different advisor at their current bank.

Specific switching costs for overdrafts

Most banks grant an overdraft on the condition that most payment transactions go through a business current account at the same bank.⁶⁴ Switching to a new bank with an overdraft thus means that a business payment transactions will go through a new account number. The enterprise must inform its business relations of its new account number and make administrative changes, including to its stationery and website.⁶⁵ Although this is not an insurmountable challenge, research shows that SMEs are under the impression that this involves a lot of work and hassle.

In order to reduce switching costs for enterprises, the "Interbank Switching Support Service for Payments" (*Interbancaire Overstapservice Betalingsverkeer*), referred to below as the Switching Support Service, was introduced in 2004. The service guarantees the redirection of payments paid into the old account to a new account for thirteen months.⁶⁶ No more than 10,000 enterprises use the Switching Support Service each year.⁶⁷ A survey conducted by GfK on ACM's instructions has shown

⁶² Search costs differ from switching costs in the sense that search costs also influence the competition for new customers.

⁶³ <https://www.abnamro.nl/nl/zakelijk/lenen/ecb-korting.html>.

⁶⁴ For example, see the ABN AMRO's General Provisions for Corporate Credit (*Algemene bepalingen voor het Ondernemerskrediet*), December 2009: Article 12; and ING's General Lending Provisions (*Algemene bepalingen van Kredietverlening*), March 2015: Article 12.

⁶⁵ Enterprises can moreover cancel the overdraft at the old bank at any time, free of charge, subject to the immediate repayment of any outstanding balance.

⁶⁶ <http://www.overstapservice.nl/ondernemers/>.

⁶⁷ Consumentenbond & Trigenum (2011), p.8.



that many enterprises are not aware that this service exists.⁶⁸

Specific switching costs for long-term loans

Switching a loan means the remaining debt is completely repaid at the old bank and a new loan is taken out at another bank. Many SMEs with long-term loans fix the interest rate for a specific period, often five years.⁶⁹ If an SME wishes to switch during the fixed-rate period, it must pay a penalty to the old bank. The amount of this early repayment penalty is the net present value of the difference between the customer's interest rate and the interbank interest rate (Euribor) for the remainder of the fixed-rate period. This penalty can quickly amount to tens of thousands of euros and thus implies switching costs.

In addition, the calculation of the early repayment penalty for business loans differs from the calculation of the penalty for private mortgages. The early repayment penalty for business loans includes the funding costs (excluding Euribor), the operational costs, the risk costs, and the capital costs for the remaining fixed-rate period. The bank thus assumes that it will still incur these costs during the remaining term. However, if an enterprise pays off its loan early, the bank no longer needs to incur all the costs of the remaining term. Only the funding costs of the remaining term are included in the early repayment penalty for private mortgages.⁷⁰

33/56

Box: Difference in early repayment penalty between private mortgages and business loans

The manner in which early repayment penalty is calculated for early repayment of a private mortgage differs from that of a business loan. The early repayment penalty for a private mortgage is the difference between the interest rate that the customer pays and the interest rate that a bank can ask a new customer for a comparable mortgage at that time, with a term equal to the remaining fixed-rate period. This difference is taken as the net present value of the current customer rate of a comparable loan with a comparable remaining fixed-rate period.

However, the rate that the bank can obtain on a comparable loan for a new customer is not taken into account for a business loan. Instead, the difference is taken between the customer rate and the interest rate that the bank must pay on the interbank market for a comparable loan with a term equal to the remaining fixed-rate period. This interest rate is currently far lower than the customer rate. In May 2015, for example, the interbank interest for a five-year term was 0.34%. This difference is taken as the net present value of the interbank rate.

The difference between these two calculation methods can clearly be shown in an example. Suppose an SME took out an interest-only loan of EUR 300,000 five years ago, at a fixed rate of 6%, and with a term of ten years. Imagine that the SME now wishes to repay that loan in full because it wishes to switch banks. The early repayment penalty will amount to around EUR 84,000, based on a five-year interbank rate of 0.34%. However, for a private mortgage with the same

⁶⁸ GfK (2014), p.31 and 32.

⁶⁹ EIM (2008), p.11.

⁷⁰ One major bank indicated during the consultation that it also only includes the funding costs of the remaining term for business loans. However, this is not stated in that bank's current general terms and conditions.



product characteristics (EUR 300,000, interest-only, ten years, 6% fixed rate), the early repayment penalty will be around EUR 38,000. This assumes a current interest rate of 3% being fixed for five years and the ability to repay 10% of the loan on a penalty-free basis. The early repayment penalty on the business loan in this example is more than double that for a comparable private mortgage.

An enterprise does not have to pay any early repayment penalty if it switches banks after the end of the fixed-rate period. SMEs receive a new interest rate proposal from their bank at least two weeks before the end of the fixed-rate period.⁷¹ In most banks, SMEs must respond to this in writing no later than one week before the end of the fixed-rate period. This gives an SME little opportunity to shop around since it would take 35 days on average for another bank to make a detailed offer (also see section 4.2).

Actual switching behavior in the SME loan market

There are no public figures available on the extent to which enterprises with an overdraft or long-term loan switch banks. Earlier investigations of the NMa (2010a, p. 11) and GfK (2014) have asked how likely it would be for enterprises to switch banks in the coming year, by their own estimates. Most of the interviewed enterprises did not consider that likely (Figure 13).⁷² These outcomes suggest that relatively few SMEs switch banks in practice.

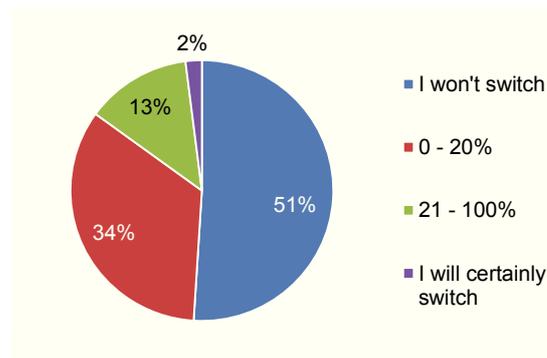


Figure 13: How likely is it that your enterprise will switch banks in the coming year? Enterprises with two to fifty employees, n = 179. Source: GfK (2014), edited by ACM.

Conclusion on switching costs

SMEs with overdrafts or long-term loans must incur significant costs, in terms of expense and effort, to switch banks. These switching costs give banks a certain degree of market power over their existing customers. Lowering these costs will thus lead to less market power and more competition.

4.4 Entry barriers

The entry of new players – or the threat thereof – can increase competition in a market. A firm will enter a market only if it can expect to achieve a positive business case. Entry barriers are factors that impede or prevent entry to a market. There are different definitions of the concept of an "entry

⁷¹ Rabobank's General Terms and Conditions of Corporate Finance 2010 (*Algemene voorwaarden bedrijfsfinancieringen van de Rabobank 2010*): Article 28(g) and (h); ABN AMRO's General Provisions for Corporate Credit (for business customers), November 2011: Article III.2.1; ING's General Lending Provisions, March 2015: Article 24.

⁷² These figures probably overestimate the actual switching behavior. Answers to the questions in surveys often differ from actual behaviour. Those surveyed say they intend to switch but do not follow through in practice.



barrier" in the economic literature. ACM defines an entry barrier as something that ensures a smaller difference between expected profit and sunk costs.⁷³ The advantage of this definition is that it also takes barriers to expansion and exit into account.

The higher entry barriers become, the less competitive pressure firms in a market experience. The market is then less contestable.⁷⁴ This does not mean that high entry barriers automatically lead to market power. Besides the height of entry barriers, this also depends on the competition among the existing firms. Low entry barriers automatically affect the degree to which firms can exercise market power. In case of low entry barriers, positive profits trigger direct entry. Entry barriers are therefore a necessary, but insufficient, condition for market power.

Entry barriers in the SME loan market

ACM conducted a study into entry barriers in the banking sector in 2014. A number of barriers that apply to different retail banking markets - including the SME loan market - were identified during the study. The main barriers identified by ACM are (i) the existence of restrictions on the cross-border use of capital, (ii) imperfections in the application process of a banking license, (iii) the extent and complexity of regulations, and (iv) disproportionately burdensome regulations for and oversight of small banks. These entry barriers have increased even further, particularly after the onset of the credit crisis.

ACM has formulated several recommendations to lower these entry barriers. In response to the ACM study, the Ministry of Finance has instructed the Advisory Board on Regulatory Burden (Acta, *Adviescollege Toetsing Regeldruk*) to investigate whether regulations can be decreased or simplified.⁷⁵ The Dutch Parliament has also recently adopted a regulatory framework for credit unions that will enter into force on a date yet to be determined.⁷⁶

ACM welcomes these developments and continues to push for the acceptance of its recommendations. These recommendations are also very relevant for the SME loan market.

In addition to the entry barriers that apply to the entire retail banking sector, there is a specific entry barrier in the SME loan market. There are economies of scale because of the relatively high fixed costs (e.g. ICT and compliance) and the fact that banks are better able to spread the credit risk, the

⁷³ For more motivation on this definition, see ACM (2014), p.15.

⁷⁴ Baumol (1982).

⁷⁵ Minister of Finance (2014), p.9.

⁷⁶ Credit Unions Supervision Act (*Wet toezicht kredietunies*), see:
https://www.eerstekamer.nl/wetsvoorstel/33949_initiatiefvoorstel_agnes.



more business customers they have.⁷⁷ This means that the marginal costs decrease as a bank acquires more customers. In order to be able to compete with the major banks, it is essential for an entrant to acquire enough customers.

As is clear from sections 4.2 and 4.3, many SMEs apply for a loan at their main bank and do not often switch banks. This – in combination with economies of scale – can work as an entry barrier. As limited shopping around and switching behavior makes it more difficult for potential entrants to win over existing customers of the major banks, they take longer to achieve an efficient scale.

Different existing studies refer to (i) access to payment systems in order to be able to offer an overdraft, (ii) establishing a branch network, and (iii) obtaining information on the creditworthiness of enterprises as entry barriers.⁷⁸ However, interviews with smaller lenders show that these aspects are not experienced as an impediment.

Conclusion on entry barriers

There are significant entry barriers in the Dutch SME loan market. A lack of competition means that major banks are not disciplined by new entrants or the threat of new entrants.

4.5 Tacit coordination

In an oligopolistic market, a firm knows that the conduct of its competitors depends on its own conduct and vice versa. This mutual dependence may lead to firms tacitly coordinating not to compete or to compete less with each other. This tacit coordination can take on various forms. The most obvious way is not to compete on price. But the coordination can also aim at market-sharing, for instance by not competing for each other's customers. In any event, a market equilibrium is achieved through coordination, as a result of which the profit for the coordinating enterprises is higher than if they were to compete.

Box: Coordination and the Dutch Competition Act (*Mededingingswet*)

Firms can increase their profits through coordination, which can be either explicit or tacit. Explicit coordination means that firms, specifically and by means of direct and indirect communication, jointly determine the market price or market-sharing. This form of coordination - cartel formation - is prohibited under Article 6 of the Dutch Competition Act and Article 101 of the Treaty on the Functioning of the European Union.

Firms can also engage in tacit coordination. This form of coordination is more difficult to establish and maintain because there is no direct or indirect communication as in the case of explicit coordination. This form of coordination – parallel market conduct – is not prohibited under the Dutch Competition Act. However, the harm to prosperity can be just as great as in the case of explicit coordination.

⁷⁷ Stimpert & Laux (2011). However, different empirical studies into economies of scale in the banking sector show that once a bank reaches a certain size, the marginal costs increase again. See, for example, Benston et al. (1982) and Clark (1996).

⁷⁸ See, for example, CMA & FCA (2014), p.107; OFT (2010), p.20 and Boot (2007), p. 29.



A market equilibrium achieved through tacit coordination is inherently unstable. This happens because individual firms have an incentive to deviate from the common understanding. In a non-competitive market, an individual firm can make even more profit by making a competitive offer. All that discourages an firm to deviate from the common understanding is the expectation that it will be punished by the other coordinating firms if it does not keep to the tacit agreement.

Due to this inherent instability, tacit coordination cannot be established in every market. This is only possible if the following four enabling conditions are satisfied (known as the "Airtours criteria"):⁷⁹

- Firms are able to tacitly reach a common understanding.
- Firms can adequately monitor whether each of them is adhering to the common understanding.
- There is a credible deterrent mechanism if a provider deviates from the common understanding.
- The understanding is not jeopardized by the conduct of outsiders.

In the rest of this section, ACM investigates the extent to which the Dutch SME loan market complies with each enabling condition.

Opportunity for banks to reach a common understanding

It is easier for firms to tacitly coordinate, the more parties' interests are aligned.⁸⁰ Firms then have equal views on what conduct corresponds and does not correspond to the common line of conduct. Similar interests are determined, for example, by the extent to which firms are symmetrical in terms of market share, costs structure, and capacity. The firms must also tacitly establish a coordination mechanism.

Tacit coordination is easier to achieve as a market becomes more stable and less complex.⁸¹ There are currently three banks that grant financing to SMEs on a large scale. These banks are relatively similar to each other in terms of market share, costs structure, and capacity. The similar interests that arise from this may contribute to the incentive to tacitly coordinate toward an over-competitive profit level.

There are various possible coordination mechanisms in this market. First, the 'base rates' that ABN AMRO, ING, and Rabobank publish on their websites for some of their products since the onset of the credit crisis can serve as a coordination mechanism (also see the box "Base rate as coordination

⁷⁹ European Commission (2004), para. 41, and case T-342/99 Airtours v. European Commission (2002).

⁸⁰ European Commission (2004), para. 44.

⁸¹ European Commission (2004), para. 45.



mechanism?").⁸² The number of financing products based on the base rate is relatively large. At most banks, more than 90% of overdrafts under EUR 1 million are based on the base rate.

Box: Base rates as coordination mechanism?

Banks use a base rate, which they publish on their websites, for many standardized – and particularly smaller – overdrafts. This base rate forms an important component of the interest rate that an SME pays for financing based on the base interest rate. The other component of the interest rate that an SME ultimately pays is determined by an individual risk-dependent premium, which can quickly change during the term of the contract. Major banks are thus able to influence the rate for an entire product category through the base rate.

According to ACM, the base rate can serve as a coordination mechanism. The final interest rate that an SME pays (base interest rate + premium) is often the result of individual negotiations and is thus not easy to monitor. In contrast, the base rate is the same for an entire product category. As the base rate is published on the bank's website, it can also be easily monitored by competitors. The base rate can serve as a benchmark in the market.

In 2007, the NMa launched an investigation under competition law into the explicit coordination of the major banks in relation to the base interest rate for the period from 1990 to mid-2007. The investigation did not reveal any basis for an infringement of the Dutch Competition Act because there was a strong connection between the base rates and the ECB's refinancing (refi) rate. Figure 14 indeed shows that the base rates of the major banks mirrored the refi rate exactly from 2004 to mid-2007. NMa (2009) still pointed in its report to the risk of tacit coordination.

The base rates and the refi rate stop mirroring each other from Q3-2007. Although the refi rate remained stable at 4% from Q3-2007 to Q3-2008, base rates increased. This may be explained by the fact that funding costs also increased during this period.

From Q4-2008 – when funding costs began to drop sharply – there is also no clear correlation any longer between the base rates and funding costs. Between Q4-2008 and Q3-2009, the refi rate and funding costs decreased by more than 300 basis points. Over the same period, base rates decreased only by 150 basis points. The difference between the base rate and funding costs thus increased by 150 basis points. This difference increased even further in 2013 and 2014. Over the entire period under investigation, the surcharge on funding costs increased from 60 basis points at the start of 2004 to almost 300 basis points at the end of 2014, an increase of 240 basis points.

⁸² See the websites of ABN AMRO (<https://www.abnamro.nl/nl/zakelijk/sparen/basisrentetarieven/index.html>), ING (<https://www.ing.nl/zakelijk/financiering/tarieven/tarieven-financiering/index.html>), and Rabobank (<https://www.rabobank.nl/bedrijven/koers-en-rente/>).

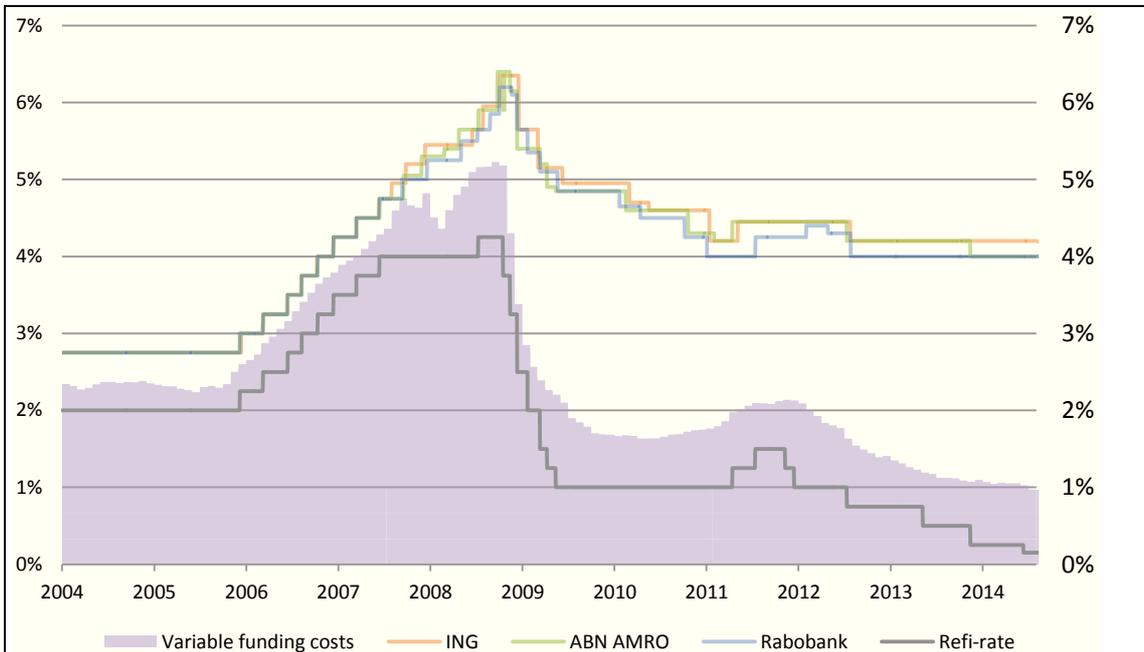


Figure 14: Base rates of the three major banks for the period January 2004-September 2007, compared with the ECB's refi rate and variable funding costs. Sources: Information request banks, DNB, ACM margin calculation.

As part of this study, ACM questioned the major banks on the structure of the base rate. The information request revealed that banks look mainly at the following factors for altering the base interest rate: (i) developments in funding costs, (ii) the base rates of its competitors, and (iii) the return on the portfolio linked to the base rate. The major banks indicated that the base rate serves to cover at least the funding costs, but also part of the other costs, such as operational costs. They could not indicate the precise costs involved or the portion of these costs that are covered by the base rate.

As described in Chapter 3, operational costs remained relatively stable and capital costs rose by around 50 basis points. The increase as estimated in Chapter 3 cannot be used for the expected risk costs in this context because the base rate applies to a specific product category and not to all newly-granted financing up to EUR 1 million. The expected risk costs for new financing up to EUR 1 million increased by roughly 50-100 basis points between 2007 and 2012.⁸³ When added together, the increase in the expected risk costs and capital costs that are relevant to the base interest rate does not exceed 150 basis points. This increase therefore cannot fully explain the difference between the base rate and the funding costs of 240 basis points.

Banks could also engage in tacit coordination on the basis of their market share. The answers to the requests for information show that the major banks gather detailed quarterly figures on the market shares of each provider in different segments of the market through a survey company. This enables them to monitor changes in market shares, for example because a competitor applies a lower price.

⁸³ The risk premium is not determined individually at one bank. However, the risk of an SME defaulting does determine the credit limit and thus the associated premium on the base interest rate.



Degree to which banks can monitor whether each of them is adhering to the common understanding
Coordinating firms have an inherent incentive to deviate from the common understanding in order to increase their profit, on the assumption that the other firms are adhering to the common understanding.⁸⁴ Only the credible threat of quick and sufficient retaliation keeps the coordinating firms from deviating. Such a threat depends on the information that firms can gather about the market conduct of their competitors. Coordinating firms must be able to determine with some certainty whether unexpected conduct is the result of deviating from the common understanding.⁸⁵

Deviating conduct involves a major bank applying a lower profit margin than its competitors with the aim of attracting more financing applications. A bank would be able to reduce the profit margin by setting a lower base interest rate or by gaining market share.⁸⁶ However, as other banks could detect this, it is unlikely that banks will deviate from the common understanding in this way.

Other options are setting lower individual premiums on the base rate or giving "secret" discounts. However, by means of the aforementioned surveys that identify the market share of each provider, the major banks can monitor the extent of any changes to individual market shares. In this way, they can detect "secret" discounts and deviations from the implicit agreement.

Existence of a credible deterrent mechanism

Tacit coordination is not sustainable unless the retaliation after the deviating conduct ("*cheating*") is sufficiently severe to convince all coordinating firms that it is in their own interest to adhere to the common understanding.⁸⁷ However, the threat of future retaliation is credible only if it is sufficiently certain that a deterrent mechanism will actually be used if deviating conduct by one of the firms comes to light.

Banks can discipline each other in case of deviating conduct by reverting, for instance, to the interest rate that would prevail under competitive circumstances or by gaining market share from each other. Moreover, since the major banks in the Netherlands operate in practically the same markets, they would be able to punish each other in markets other than SME financing, through fiercer competition in those markets.⁸⁸

⁸⁴ European Commission (2004), para. 49.

⁸⁵ European Commission (2004), para. 50.

⁸⁶ The existence of capacity restrictions influences these incentives. If there are capacity restrictions in the market, there is less of an incentive to deviate from the common understanding because a lower market share can be gained. On the other hand, punishment is also more difficult. These two effects basically neutralize each other. See: Ivaldi, Jullien et al (2003), p. 58.

⁸⁷ European Commission (2004), para. 52.

⁸⁸ Bernheim & Whinston (1990).



Threats from outsiders

Tacit coordination is possible only if the implicit understanding is not undermined by the conduct of market participants that are not involved therein (outsiders).⁸⁹ This may be, for example, small players that could experience strong growth, or potential entrants.

The conclusion was already reached in section 4.4 that there are significant entry barriers. There is also no countervailing buyer power because the financing needed by an enterprise is relatively limited in relation to the total lending by a bank to SMEs. The shopping around and switching behavior is also limited. In view of the above, ACM finds it unlikely that the sustainability of a tacit understanding would be jeopardized by the conduct of outsiders.

Conclusion on tacit coordination

Firms may have the incentive and opportunity in a market to tacitly increase their market power by implicitly reaching a common understanding not to compete or to compete less with each other. Tacit coordination is possible only if the four enabling conditions are satisfied. These conditions seem to be satisfied in the SME loan market.

4.6 Sources of market power as an explanation for the increased profit margin

The previous sections dealt with the different sources of market power that exist in the SME loan market. This revealed that competition in the SME loan market is not optimal. It further follows from the margin calculations that the profit margin on SME financing has increased in recent years, which indicates a decrease in competition. A logical follow-up question is whether changes in the sources of market power can explain the increase in the expected profit margin since 2011 and the sharper increase in 2013 and 2014.⁹⁰ ACM analyzes each source of market power below to determine whether these can explain the rise in the expected profit margin.

Search and switching costs

ACM does not consider it likely that search and switching costs are an explanation for the increased profit margin since 2011. ACM does not see any clear increase in the search and switching costs from 2011 that could explain the margin increase. Search costs in this market seem to have decreased rather than increased, among other things because of improvements in the application process, such as Standard Business Reporting. There has not been any clear-cut development in the different switching costs in the area of financing since the credit crisis. For example, the relationship with the bank's advisor is not as close as before, which is a factor that reduces switching costs. On the other hand, any penalty interest at this stage will be somewhat higher than the relatively low interbank interest rate, which is a factor that raises switching costs.

⁸⁹ European Commission (2004), para. 56.

⁹⁰ It is not possible to explain every small increase or decrease in the profit margin by a change in a source of market power. The margin calculation fluctuates too strongly for this purpose and changes in sources of market power cannot be determined with sufficient accuracy.



Entry barriers

The study into entry barriers (ACM, 2014) shows that these barriers have increased since the onset of the credit crisis. Entry barriers are not in themselves a source of market power and therefore cannot explain the increase in the expected profit margin. Entry barriers are a necessary condition for the existence of market power. The increase in entry barriers since the onset of the credit crisis may thus have facilitated the increase in the expected profit margin since 2011.

Capacity constraints

As described in section 4.1, the manner in which firms compete with each other changes because of capacity constraints, leading to a higher profit margin. A possible explanation for the increased profit margin since 2011 is an increase in capacity constraints. Since the onset of the crisis, capacity constraints have played a role in the SME loan market and increased further after the crisis due to the tightening of capital requirements (Basel III). When granting a loan, a bank does not only take the current capital requirements into account, but also anticipates the expected future capital requirements. Although CRD IV (the European implementation of Basel III) only entered into force in 2014, banks seem to have been preparing for the new capital requirements since 2011.⁹¹ This is in line with an increase in the expected profit margin since the start of 2011.

In a market with capacity constraints, the number of players (and the capacity they represent) influences the degree of competition and thus the profit margin. Theoretically, as the number of providers decrease, the profit margin increases. In 2013, Deutsche Bank announced that it would be disposing of a major part of its SME portfolio.⁹² Although Deutsche Bank had a limited market share, it did represent a potentially large capacity. The exit of this competitor may explain the increase in the expected profit margin in 2013 and 2014.

Tacit coordination

Lastly, it cannot be ruled out that tacit coordination contributed to an increased profit margin from 2011. Due to the structure of the SME loan market, there is a risk of tacit coordination. The risk of tacit coordination may increase when providers exit the market. Theoretically, this reduces the threat from outsiders and the risk of coordination is greater.

4.7 Conclusion on sources of market power

There are fewer banks operating in the Netherlands that provide SME financing on a large scale after the crisis than before. The three major banks have provided more than 85% of all bank financing for years. This market situation raises the question of the extent to which there is adequate competition. ACM has investigated this by analyzing sources of market power.

⁹¹ See: <http://www.dnb.nl/nieuws/nieuwsoverzicht-en-archief/dnbulletin-2013/dnb290489.jsp>.

⁹² See Deutsche Bank's press releases of December 2012

(https://www.deutschebank.nl/nl/content/over_ons_nieuws_en_publicaties_nieuws_2294.html) and April 2013

(https://www.deutschebank.nl/nl/content/over_ons_nieuws_en_publicaties_nieuws_2671.html).



ACM concludes that the competition among banks in the area of SME financing is not optimal. First, there are various entry barriers. The major banks further exert less competitive pressure on each other due to the need to improve capital ratios. These capacity constraints have increased over recent years and may explain the increase of the expected profit margin from 2011. SMEs offer limited competitive pressure because they do not shop around and switch banks that often. Lastly, there is a risk that the major banks may be able to increase their profit margin through tacit coordination.



5 Competitive pressure from alternative forms of financing

Banks are by far the main providers of financing to SMEs (see Chapter 2). However, alternative forms of SME financing have recently emerged. These alternative forms of financing currently meet only a small portion of the total demand for SME financing. Rabobank (2015) estimates alternative forms of financing to be a thousand times smaller than bank financing.

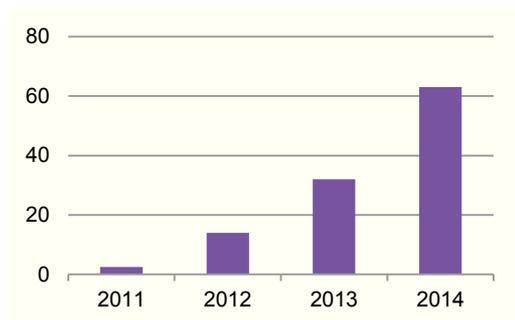


Figure 15: Extent of crowdfunding in the Netherlands. Amounts in millions of euros. Source: Douw & Koren (2014).

This means that the current alternative forms of financing *presently* do not exert any substantial competitive pressure on banks. In other countries, such as the United Kingdom, the market share of alternative financing is significantly larger. There may be a variety of reasons for the relatively limited presence in the Netherlands. Different forms of financing do not equally satisfy the requirements and specific needs of an enterprise. Bank financing is often cheaper than alternative forms of financing.

Lastly, unfamiliarity with these new forms of financing among many SMEs also plays an important role. Alternative financing providers often lack an advisory function, which means that SMEs have to find information on the offerings of these providers themselves online. The specific skills needed to understand all of this information are not always present.

The absolute amount from alternative providers of financing has nonetheless increased strongly in recent years. Crowdfunding, for example, has grown in the Netherlands from EUR 2.5 million in 2011 to EUR 63 million in 2014 (see Figure 15). Competitive pressure from alternative forms of financing could thus also increase in future.

This chapter briefly describes the different alternative forms of financing that are now available to SMEs. It then deals with the question of whether alternative forms of financing will result in greater competitive pressure in future. Lastly, section 5.3 looks at the role the government can play in relation to alternative forms of financing.

5.1 Description of the alternative forms of financing for SMEs

There are many different alternative forms of financing for SMEs. They differ with regard to the amount of the financing, whether they involve venture capital or borrowed capital, and the identity of the lenders, namely private individuals, enterprises, or institutional investors. A summary of the main forms of alternative financing follows below.

- *Credit unions* are a form of financing in which a cooperative of business owners within a sector or region deposit money in a common fund. The credit union uses this to fund members of the union that require financing. A credit union operates on a non-profit basis



and both the borrowers and lenders are co-owners of the cooperative. The members must share a common characteristic to be able to join the credit union, such as belonging to a certain profession or community.

- *Crowdfunding* is a form of financing in which a large group of individuals (the crowd) each invest relatively small amounts in an enterprise via a platform. The Netherlands has a few dozen crowdfunding platforms. These platforms can vary greatly in terms of procedures and target groups. A number of platforms specialize in a certain niche, such as social and sustainable enterprises.
- *Asset-based finance* is a form of financing in which a specific asset or receivable on the balance sheet of the enterprise is used as collateral security. *Leasing* and *factoring* are two well-known and specific forms.
- *SME funds* grant subordinated loans under which investors receive their money back only after all other creditors have been paid. As the investor under a subordinated loan runs more risk, the interest rates are relatively high.
- *Participating interests*: investors contribute towards the equity and so become co-owners of the enterprise. These investors are generally active shareholders and make their knowledge, money, and network available. Participating interests may take on various forms. If wealthy individuals make individual investments in enterprises, they are referred to as informal investors or business angels. Participating interests can also be acquired through a venture capital company.
- *NPEX* is a trading platform that focuses specifically on the listing of small and medium-sized enterprises. enterprises can issue shares or bonds in their business via this platform.

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The important economic role of SMEs is also recognized by the government, which tries to support SMEs through all types of initiatives. In most cases, the support is given in conjunction with private parties. Some of the main examples are listed below:

- *Qredits* is a private, non-profit foundation that provides financing of up to EUR 250,000 to start-ups and existing business owners from all levels of society. This lender also provides coaching and resources to SMEs. Qredits works together with the authorities at national, provincial, and municipal level. It is partly financed by the Ministry of Economic Affairs.
- The Dutch Investment Institution (*Nederlandse Investeringsinstelling*) is a cooperative venture among institutional investors (insurers and pension funds) with the aim of making Dutch investment projects in SMEs, among others, more accessible to institutional investors.
- *Guarantee schemes*: the government acts as guarantor for both loans and equity capital of enterprises via three initiatives. Via the government-guaranteed scheme for loans to small and medium-sized enterprises (*Borgstelling MKB - BMKB*), the guarantee for business financing (*Garantie Ondernemingsfinanciering - GO*), and the Growth Facility (*Groeifaciliteit*), the government tries to make investment in Dutch SMEs more appealing. Most of the guarantees relate to bank financing but venture capital companies and other alternative investors are also eligible.



5.2 Competitive pressure from alternative forms of financing in the future

Further growth from alternative forms of financing may contribute towards reducing the adverse effects on competition that arise from capacity constraints (see section 4.1). If banks grant fewer loans, in order to comply with stricter capital ratios, for example, alternatives can fill this gap. This has a positive effect on the quantity and price (interest rate) of SME financing.

Alternative forms of financing can also result in a broader product offering. By developing new and innovative forms of financing, the specific needs of more SMEs can be met. Examples include the amount of the required loan, the speed at which it can be granted, and other conditions such as the possibility of early repayment. Not every form of financing is moreover suitable for every enterprise. For example, SMEs that cannot obtain a loan from a bank can enter into an agreement with a credit union or business angel. Crowdfunding or a business angel is perhaps a better option for start-ups. The larger and more diverse the range of available financing, the greater the chance that an SME will find financing that suits its specific situation and needs.

Lastly, alternative forms of financing can increasingly develop into full substitutes for bank financing. This may lead to increased competitive pressure on banks and thus lower interest rates and better conditions. To this end, it is moreover necessary that alternative forms of financing reach sufficient scale to be able to match the lower funding costs of banks.

It is uncertain how alternative forms of financing will develop further in future. Current growth is strong, but seems to be partly inspired by the way in which banks have positioned themselves. Banks actively refer SMEs that do not qualify for bank loans to alternative lenders.⁹³ Banks are also often joint initiators of new forms of financing. Banks view alternative forms of financing as complementary to their own offering. Smaller credit applications are less appealing to banks because of the relatively high risks and costs involved. They would rather use their limited available resources for larger applications with lower risks and costs, and a higher margin.

If alternative forms of financing continue to grow, banks could opt for more intensive cooperation with alternative finance providers. However, if that growth leads to full substitutes for bank loans – and thus to real competitive pressure on the loans that banks also wish to offer themselves – banks could position themselves differently. This could influence the future growth of alternative forms of financing.

5.3 Influence of the government on the development of alternative forms of financing

The Dutch government chooses to play an active role in the area of alternative forms of financing, for instance by supporting new initiatives, financially or otherwise, or increasing awareness of these new

⁹³ For example, see Rabobank's website. <https://www.rabobank.nl/bedrijven/zakelijk-financiering/alle-financieringsvormen/gredits/?intcamp=z-financiering-alle-financieringsvormen&inttype=tegel-gredits&intsource=bedrijven.zakelijk-financiering-alle-financieringsproducten>.



forms of financing. The government should ensure that new initiatives are not unnecessarily impeded or prejudiced.

ACM sees two important priorities for the government that are important for the further development of alternative forms of SME financing. First, regulations for and oversight of alternative forms of financing should not be more burdensome than is strictly necessary. In its study into entry barriers to the banking sector, ACM (2014) calls for prudential legislation and oversight that are consistent with the risks that a lender carries with it for financial stability and the real economy. Providing a clear regulatory framework for new forms of financing is also very important.⁹⁴

Second, the one-sided favoring of banks, with government guarantees for example, can impede the growth of alternative forms of financing. The government namely offers various guarantee schemes that mostly make use of the existing financial infrastructure, such as banks and investment funds. Since these guarantees run mostly through the banking channel, bank lending is stimulated further. Favoring banks over alternatives should be done with caution and restraint.

⁹⁴ In March 2015, the Dutch Parliament adopted a legislative bill for a specific regulatory framework for credit unions. The new rules for crowdfunding are expected to enter into force on January 1, 2016.



6 Conclusions and recommendations

In this study, ACM has investigated competition in the SME loan market. It has done this in two ways. First, the expected profit margin on SME loans has been analyzed. The expected profit margin is an indication of the competitive pressure that banks are experiencing when they grant a loan or overdraft. Second, ACM has measured the degree of competition by analyzing different sources of market power.

The margin calculation shows that competition among banks for SMEs has decreased. The expected profit margin has increased since 2011 and especially in 2013 and 2014. In hindsight, however, the three major banks have achieved a lower return on the SME portfolio than expected. This effect is mainly caused by underestimating risk costs in advance.

The analysis of the sources of market power further shows that competition in the SME loan market is not optimal. ACM believes a possible reason for this lies in the increase of capacity constraints that banks experienced after the onset of the credit crisis. These capacity constraints limit the opportunities for competitors to discipline each other and lead to less competition.

ACM has also identified a risk of tacit coordination in the SME loan market. Tacit coordination means that banks reach a common understanding to limit their competition with each other. The structural monitoring of each other's market share, the absence of external pressure because of entry barriers, the limited number of providers, and increased capacity constraints all increase this risk. The publication by banks of the base rate on their websites also increases this risk of coordination. The structure of the base rate is unclear and moreover gives SMEs limited insight into the actual interest rate they will pay.

The search and switching behavior of SMEs does not ensure additional competition. There are significant search and switching costs in the demand side of the market. For example, there is limited information available on banks' websites on the final interest rate and acceptance criteria. An SME receives this information only after an extensive application process. The lack of account number portability for overdrafts and the high early repayment penalty when switching during the fixed-rate period accounts for the high switching costs for these two products.

Lastly, alternative forms of financing, due to their limited presence, do not yet exert any significant competitive pressure in the SME loan market.

6.1 Recommendations

ACM makes four recommendations for structurally improving competition in the SME loan market.

Lower the entry barriers

The entry of new SME financing providers is important to reduce capacity constraints and the risk of tacit coordination. In its 2014 report on barriers to entering the Dutch retail banking sector (*Barriers to*



entry into the Dutch retail banking sector), ACM made several recommendations for lowering entry barriers to the Dutch banking sector. ACM continues to push for the follow-up of its recommendations.

Increase shopping around and switching behavior of SMEs

SMEs can increase competition among banks by comparing them with each other and switching if they are not satisfied with their current bank. Reducing search and switching costs can also contribute to this. Search costs can be reduced by providing information on the SME bank financing offering, the acceptance criteria, and improving financing rates. Switching costs can be reduced through (i) evaluating the effectiveness of the Switching Support Service for business bank accounts, (ii) closely examining the method of calculating early repayment penalty on business loans, and (iii) informing SMEs earlier about the end of their fixed-rate period. ACM will also start shortly with an investigation into the social costs and benefits of account number portability.

Reduce the risk of tacit coordination

There is a risk of tacit coordination in the SME loan market. As stated above, entry by new providers can reduce this risk. The system of base rates could also be adjusted to reduce this risk. The base rate forms only part of the actual interest rate that SMEs pay. It is also not clear what costs the base rate is based on. Consequently, the base rate only provides limited information to the SME, while it is informative to competing banks. ACM therefore recommends using a rate structure that makes it clearer what costs make up this "base rate." This makes it clearer to SMEs and third parties whether an increase in the base rate includes any passing on of costs or increase of the profit margin. This reduces the risk of coordination and provides more information to SMEs.

Do not impede the growth of alternative forms of financing

In order to reduce capacity constraints and offer alternatives to SMEs, it is vital that the growth of alternative forms of financing is not impeded. A clear regulatory framework must thus be developed for the different alternative forms of financing, as is already the case for credit unions. The regulation of alternative forms of financing and their oversight must also not be more burdensome than is strictly necessary. Steps should also be taken to avoid banks from being favored over alternative forms of financing, for example by guarantee schemes that are mostly aimed at financing by banks



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Appendix: robustness analysis of margin calculation

For the purpose of the margin calculation in Chapter 3, ACM made assumptions in relation to the costs of providing financing. In order to test the reliability of the results from Chapter 3, a number of robustness analyses have been performed. These are discussed briefly below.

The figures below show the annual average of the profit margin, measured by the difference in the number of basis points compared to January 2007. Both the basic scenario and the robustness analyses are included in each figure. The results of the robustness analyses do not give ACM any reason to draw a different conclusion as a result of the margin calculation.

Alternative calculation of CDS spreads

A weighted average CDS spread is used to calculate the costs of long-term funding. Different choices can be made for this calculation with regard to the market shares and terms of the CDS spreads. In the baseline scenario, the market share of financing from EUR 1-10 million has been used with five-year CDS spreads. The market share of overdrafts instead of loans of EUR 1-10 million has also been used as a control. For the purpose of the CDS spreads, the one-year CDS spread for variable loans and the ten-year CDS spread for loans with a fixed-rate period exceeding five years has been used. This changes have a slight effect on the margin calculation, as can be seen in Figure 16.

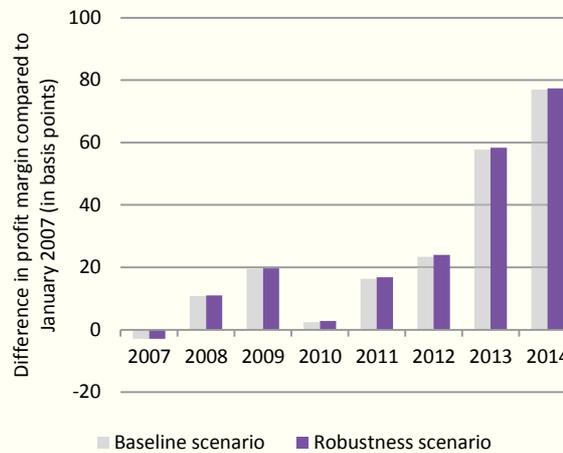


Figure 16: Robustness analysis of the calculation of the CDS spread.

Average financing costs method

In the earlier profit margin calculations that MFS performed on the mortgage market, different bases were used to determine the relevant funding mix. According to ACM, the marginal financing method, as used in the basic scenario, is the best basis. For the sake of completeness, the average financing costs method is also included in this appendix. This does not look at newly-attracted financing, but at the average

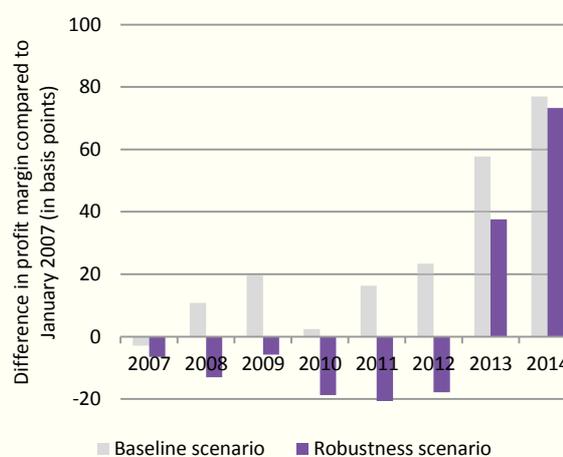


Figure 17: Robustness analysis of the average financing costs method.



funding mix as reflected in banks' balance sheets.⁹⁵ As can be seen in Figure 17, the profit margin for the period 2007-2012 is lower when the average financing costs method is used. The sharp rise in the profit margin in 2013-2014 is still present.

Other financing size as the basis for the expected risk costs

In order to test the estimate of the applied expected risk costs, the margin calculation has also been performed with a different selection of newly-granted financing. Section 3.2 (the basic scenario) is based on financing up to EUR 1 million. ACM believes this is the most logical basis as the data on the interest rate paid also relates to financing up to EUR 1 million. In the robustness analysis, ACM has also looked at the expected risk costs for a smaller selection

(financing up to EUR 250,000) and a larger selection (financing up to EUR 50 million). As can be seen in Figure 18, the selection by financing of less than EUR 250,000 has no great influence on the results. A selection by financing of less than EUR 50 million has a greater influence. The general trend of an increasing expected profit margin remains visible in both robustness analyses.

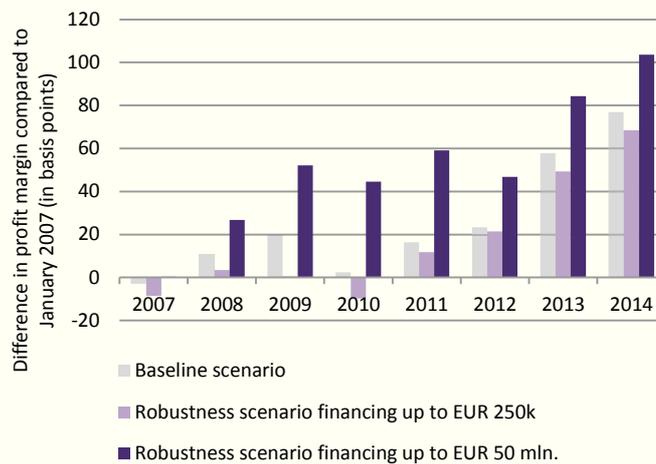


Figure 18: Robustness analysis of the selection by financing of less than EUR 250,000 and less than EUR 50 million.

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Robustness analysis of the risk costs

In order to test the assumptions relating to the extrapolation of the risk costs in 2013 and 2014, the robustness analysis is based on a stronger, trend-based increase of the risk costs (in 2014, the risk costs are 30 basis points higher in the robustness analysis). As can be seen in Figure 19, the profit margin in the robustness scenario increases less sharply in 2013 and 2014, but the general picture of an increasing profit margin remains visible.

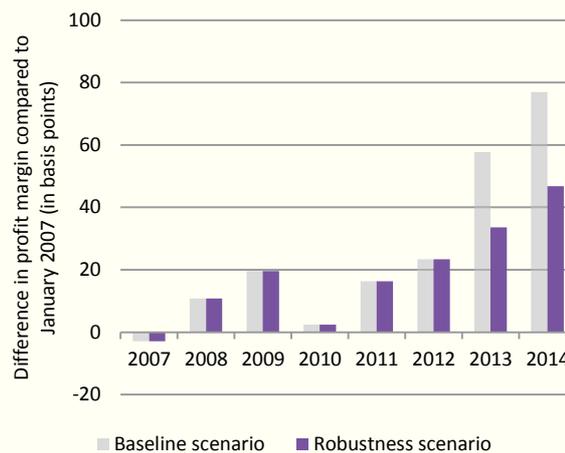


Figure 19: Robustness analysis of the risk costs.

⁹⁵ For more information about these methods, see NMa (2010b), NMa (2011), and ACM (2013).



Weighted average cost of capital

The baseline scenario assumes that

$$\text{Total funding costs} = \frac{EV}{EV+VV} \cdot R_{EV} + R_{VV}.$$

The funding costs for borrowed capital are thus taken into account for 100%. A scenario in which

$$\text{Total funding costs} = \frac{EV}{EV+VV} \cdot R_{EV} + \frac{VV}{EV+VV} \cdot R_{VV}$$

was also considered. This method seems more like the determination of the weighted average cost of capital (WACC) and, according to ACM, is theoretically a better basis.⁹⁶ The impact of this on the development of the margin is relatively small (see Figure 20).

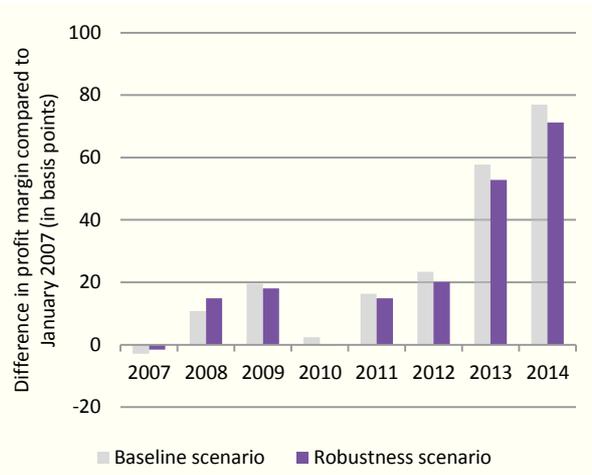


Figure 20: Robustness analysis WACC-method.

Larger share of equity in the calculation of capital costs

In the baseline scenario, ACM assumes that a bank must keep 1.31 times the leverage ratio in equity on the balance sheet for every euro in SME financing. In order to test the sensitivity of this assumption, the robustness analysis is based on a larger share of equity, namely 1.6 times the leverage ratio. As can be seen in Figure 21, this has an effect on the development of the profit margin, but the general trend remains unchanged.

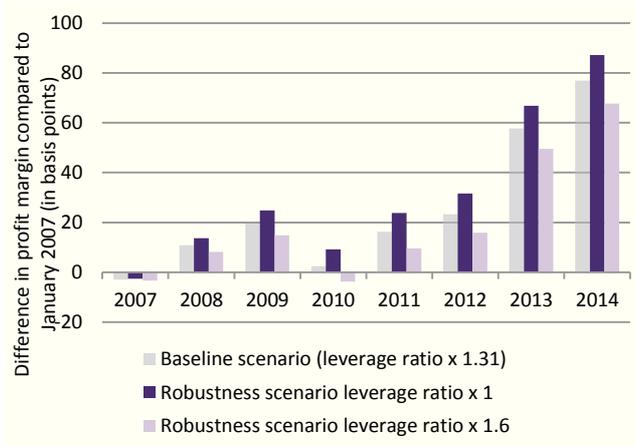


Figure 21: Robustness analysis capital costs

⁹⁶ The reason why the WACC method was not chosen in the basic scenario is because most banks seem to take 100% of the funding costs of borrowed capital into account in practice. In view of the small impact on the results, ACM has chosen to do this in the basic scenario as well. As the ratio between equity and borrowed capital increases, the difference between these calculation methods also increases, and it is increasingly more difficult to justify including 100% of the funding costs for borrowed capital.



Liquidity costs and bank tax

In response to the consultation, one of the major banks asked ACM whether the margin calculation took liquidity costs and bank tax into account. Figure 22 shows that if these costs are taken into account, the increase in the profit margin is not quite as strong in 2013 and 2014. The general trend remains unchanged.

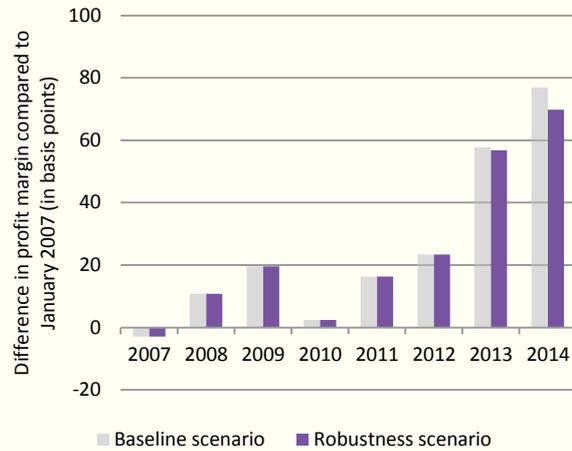


Figure 22: Robustness analysis of liquidity costs and bank tax.