

# Betalingservice

Since its introduction in 1974 Betalingservice has become a payment instrument, which most Danes know and use. Thus, 96 per cent of Danish households use Betalingservice and approx. 15,000 businesses, public authorities and associations (i.e. creditors) accept payments with this payment instrument.

In brief, Betalingservice is a payment instrument where the creditor through Nets (formerly PBS) can make direct debits (i.e. withdrawals) from the customer's bank account. Before the transaction is carried out the customer will be advised via a payment summary issued by Nets. Thus, Betalingservice is a direct debit service. Characteristic of direct debits is that transactions are initiated by creditors on the basis of the customer's prior consent. Besides Betalingservice the so-called payment card subscription service also uses consent from the customer to the creditor's initiation of a transaction.

In 2008, approx. 170 million Betalingservice transactions were carried out, and on average there were transferred nearly 1 billion DKK a day. From 2003 to 2008, the number of transactions on average increased by approx. 4 per cent per year. Accordingly, Betalingservice is a widely used payment instrument. According to a Norwegian study, direct debits generally involve lower costs than other payment instruments. Hence, a high use of Betalingservice contributes to economic efficiency.

Betalingservice payments are carried out automatically which is a great benefit to both the sender of the payment – i.e. customer – and the receiver – i.e. creditor. Betalingservice has several features that make it particularly suitable for payments where the customer and the creditor have a continuing contractual relationship, and where payments are periodically recurring. Regarding this type of payments, other payment instruments seem not nearly as attractive to customers and creditors as Betalingservice. Thus, Betalingservice has a strong market position, and Nets is the key provider of direct debit in Denmark.

Since Nets is the key provider of direct debit, and there exist a widespread use of Betalingservice and the product has a strong position, it is appropriate to carry out a competition analysis of Betalingservice, including a closer look at Nets' earnings, costs and pricing. Since banks take an active part in a Betalingservice transaction, it is also relevant to consider what part they play in the process. To ensure that the advantages of Betalingservice to the fullest extent will benefit companies and ultimately customers, it is crucial that there are no drawbacks in

the system. Thus, it is important that the market provides the products and product features demanded by customers at the lowest possible price.

The analysis is based on information provided by Nets. Some information relates to Nets' costs in specific areas etc. The Danish Competition and Consumer Authority (DCCA) have had access to the information, but in Nets' view the information is a trade secret and therefore not to be published. The DCCA has complied with this request and therefore some parts of the analysis lack information and some figures show an index rather than a factual level.

The main conclusions of the analysis are summarized in Box 1

## **Box 1: Main conclusions**

### **Major advantages when using Betalingsservice**

Betalingsservice is an efficient payment instrument, which - compared to most other payment instruments - provides substantial benefits for both creditors and customers.

### **Increased earnings on Betalingsservice and a relatively high profit margin**

In 2003-2008 Nets had increased earnings on Betalingsservice. Nets increased profit before tax per transaction with 70 percent and the total pre-tax profit was more than doubled in the period. At the same time the profit margin on Betalingsservice was approx. twice as high as the average profit margin in the private sector.

### **The price of Betalingsservice has risen equally with consumer prices**

The average price per Betalingsservice transaction increased from 4.33 DKK in 2002 to 4.90 DKK in 2008. This increase of approx. 13 percent corresponds roughly to the overall inflation measured by CPI.

### **Nets' costs per Betalingsservice transaction has not decreased significantly**

Nets' inflation-adjusted costs per transaction declined by 5 percent in 2003-2008. During the same period there was an increase in the number of transactions by 23 percent. The increase in the number of transactions has not led to substantially lower costs per transaction.

### **The largest cost is the payment to banks for their involvement in Betalingsservice**

Customer and creditor banks take an active part in the Betalingsservice process. For the services the banks are carrying out – called decentralized production – Nets makes a payment. Decentralized production is the largest cost related to Betalingsservice and together with distribution costs it amounts to around 2/3 of the

total costs.

#### **Nets' payment structure for decentralized production is unusual**

Nets' payment to the banks vary with the number of Betalingsservice transactions and the payment *per transaction* to the customer bank is higher the more transactions the customer has on his monthly payment summary. If for instance a customer has six transactions in a month the payment to the customer's bank is 34 times higher than if the customer had only two transactions. Thus, there is a 34-fold increase in payment to the bank by a tripling of the number of transactions. This payment structure is unusual and the structure does not seem to reflect the change in the banks costs with an increased number of transactions.

In this context Nets has stated the following: "The structure of payments to the banks is selected to motivate banks to maximize the number of payments on the customer payment summary. This target has now been reached. Instead, there is now a need to change banks' incentives towards an increase in the share of electronic payment summaries. Therefore, Nets will consider the future structure for payment of the banks."

#### **Nets' payment to customer banks is high in a European context**

Nets' payment to a customer bank is comparable with interchange fees in other EU countries, although the comparison should take into account that Betalingsservice is a more comprehensive product than direct debit products in other countries. Compared with the interchange fees in those EU countries where customer banks – like in Denmark – do not recover their costs directly from customers, Nets' payment to customer banks is significantly higher.

#### **Some creditors surcharge the price of Betalingsservice to their customers**

26 creditors, who account for 11 percent of the total number of Betalingsservice transactions, are charging their customers for the use of Betalingsservice. For some of these creditors the fee exceeds the price they pay to Nets themselves. Generally, the Competition Act does not restrict creditors' ability to collect fees. In general, pricing is free and thus companies can set their prices themselves. However, according to the Marketing Practises Act, a fee can only be called a "Nets-fee" ("PBS-fee") if it does not exceed the amount that the creditor pays to Nets.

### **Earnings**

Betalingsservice is the primary product in Nets' business line "payment services" as Betalingsservice accounts for 94 percent of the turnover in that area. In 2008

Nets had a net turnover of more than 1 billion DKK on "payment services", and since 2003 profit before tax has more than doubled.

In 2003-2008, Nets had increased earnings on Betalingsservice. Profit margin (operating profit as a percentage of net turnover) for the period was 13.4 percent on average. By comparison it may be mentioned that the average profit margin in the private sector was 6.4 percent during the same period.

In 2003-2008, Nets increased profit before tax per transaction with 70 percent, while the number of transactions was increasing.

### **Prices and product development**

The most basic Betalingsservice product consists of a transaction – carried out by Nets – between customer and creditor. Furthermore, Nets sends a payment summary to the customer, where each transaction is mentioned in one line. The price for this service is now 4.32 DKK, paid by the creditor. However, average price per transaction is higher than the price of the basic service, since Nets also offers a number of additional services (such as extra lines of text on the payment summary) that creditors make use of. If the average use of extra lines of text is included, the average price per Betalingsservice transaction increased from 4.33 DKK in 2002 to 4.90 DKK in 2008. This increase of approx. 13 percent corresponds roughly to the overall inflation measured by CPI.

In 2003-2008, the number of yearly Betalingsservice transactions increased by 23 per cent. There are indications that operation of Betalingsservice results in economies of scale and hence the increased number of transactions is expected to lead to lower costs per transaction. Lower costs per transaction could also speak for lower prices. Considering this, the price increase is noteworthy. Nets' increased earnings from 2003-2008 indicates that Nets has achieved efficiency gains, but these gains have not resulted in lower prices.

Product development at Nets has primarily consisted of additional features to the basic Betalingsservice product for an extra charge, as well as a higher degree of customer service through online banking. In other EU countries a more simple solution than Betalingsservice is often provided. For example, it is usually creditor himself who advise the customer that a transaction is about to be effected. Several of these EU countries also have a high use of direct debit. In these countries direct debit products are offered by individual banks that are competing with each other – also by the sale of direct debit products. Contrary to this, Nets – which is jointly owned by banks – is the sole provider of Betalingsservice in Denmark.

## **Costs**

Nets' costs by operating Betalingsservice are not available to the public, as Nets – in accordance with the Financial Statements Act – do not itemize its financial statements on specific products. By request of DCCA Nets has calculated the costs associated with the operation of Betalingsservice.

Nets has a number of variable costs associated with the operation of Betalingsservice, while other costs are mainly fixed. When a part of the costs is fixed Nets should be able to gain economies of scale, i.e. cost per transaction decreases when the number of transactions increases.

In 2003-2008, Nets' inflation-adjusted costs per transaction declined by 5 percent. Thus, an increase in the number of transactions by 23 percent in the same period did not result in significantly lower costs per transaction.

Each month Nets sends on average 3.8 million payment summaries to customers, which results in substantially postage costs. Payment summaries are mailed and/or sent electronically to the customer's online bank or e-box. In 2008, approx. one third of all summaries were sent exclusively via online banking or e-box. Compared to 2007 the use of electronic media has more than doubled. As a result of this, Nets has saved postage costs.

As payment summaries are increasingly distributed electronically rather than by post, the banks have taken over some of the costs that Nets has saved on postage. This is due to the fact that it is the banks that send out electronic payment summaries. However, there is reason to believe that over time Nets will get significant cost-savings by switching to electronic payment summaries. Consequently, if Nets lowers the price per transaction, creditors will be able to save an amount running into millions – a saving which ultimately will benefit the customers.

## **Nets' payment to the banks**

Customer and creditor banks take an active part in the Betalingsservice process. Besides handling the accounts, the banks are responsible for a part of the customer and creditor service. For the services the banks are carrying out – called decentralized production – Nets makes a transaction-based payment. Thus, a model is chosen where banks do not get paid directly by the customers and creditors that are served, but are paid by Nets instead.

The main explanation why Nets' costs per transaction have not declined significantly is an increase in the costs related to decentralized production.

According to Nets, payment to the banks for decentralized production is made in order to ensure that the banks maintain a high level of service, readiness and

knowledge of Betalingservice in relation to customers. The price was set by Nets at a time when neither Nets nor the banks had calculated how much it costs the banks to provide expertise and resources related to Betalingservice.

Mid-2010 Nets investigated the costs of two chosen banks. In consequence of this, Nets' considers that the banks receive a fair payment for the services they provide to Nets considering the involved costs and the value that the banks bring to Betalingservice. The DCCA has had no access to the information from the two banks.

Decentralized production is the largest cost related to Betalingservice. In this context, the banks mainly get paid per completed transaction. The vast majority of the charges for decentralized production goes to banks where the customer has his account. A small portion goes to the creditor bank, and there is also a payment in cases where the customer and the creditor have the same bank.

The payment per transaction to the customer bank is higher the more transactions the customer has on his monthly payment summary. If for instance a customer has six transactions in a month the payment to the customer's bank is 34 times higher than if the customer had only two transactions. Thus, there is a 34-fold increase in payment to the bank by a tripling of the number of transactions.

This payment structure is unusual and it is considered that the structure does not reflect the change in the banks costs with an increased number of transactions. It seems unlikely that the banks' costs per transaction increase sharply as the customer gets a higher number of transactions. To the extent there are economies of scale, the cost per transaction actually will decrease as the number of transactions increases. In relation to this, the trend in Nets' payment structure is the exact opposite.

The unusual about the payment structure is that the payment to the customer's bank per transaction increases as the customer gets more and more payments on his payment summary. Consequently, Nets' costs per transaction increases with a greater extension of Betalingservice. Normally, a firm seeks to minimize its costs and the price per transaction either decreases or remains constant as the number of transactions increases.

In this context Nets has stated the following: "The structure of payments to the banks is selected to motivate banks to maximize the number of payments on the customer payment summary. This target has now been reached. Instead, there is now a need to change banks' incentives towards an increase in the share of electronic payment summaries. Therefore, Nets will consider the future structure for payment of the banks."

The payment structure in connection with decentralized production is laid down by Nets' board of directors which consists of representatives from Nets' owners - until 2010 the banks and the National Bank of Denmark. Thus, it is representatives from the banks that have decided which incentives the banks should have to take part in the process of Betalingsservice. This may have resulted in a less independent pricing of decentralized production than if the banks had not had such a dual role.

Nets is a result of the merger in 2009 between PBS and the Norwegian company Nordito, which also offers solutions for payment cards and payment systems. As a result of the merger the Danish banks' influence on the board has decreased and the banks' dual role is therefore less pronounced. Out of 12 members of the board (including four employee representatives from Nets), there are now three members representing Danish banks.

In many EU countries there is no central provider of direct debit products, as the case is with Nets in Denmark. On the contrary, direct debit products are offered by banks that consequently compete on price and quality of the products. In a number of countries a system is introduced whereby the customer bank entirely or partially covers its costs by a transfer of funds from the creditor bank. This transfer of funds from the creditor bank to the customer bank is known as an interchange fee, or MIF.

Nets' payments to customer banks are comparable to these interchange fees, because the payments are meant to take into account the same need as an interchange fee – that is, a payment to the customer bank for its services.

In September 2009 the European Parliament and the EU Council issued a new Regulation on cross-border payments in the Community. The Regulation has set limits on how high the common interchange fees may be related to transactions with the joint European direct debit solution, SEPA Direct Debit. Until November 2012 interchange fees related to SEPA Direct Debit transactions must not exceed 0.088 euro per transaction. After November 2012 the interchange fees must be reduced to zero.

Compared with the interchange fees in other EU countries with the same fee structure as in Denmark, and with the mentioned limitation in the regulation on cross-border payments, Nets payment to customer banks is significantly higher. However, it should be taken into account that Betalingsservice is a more comprehensive product than SEPA Direct Debit and direct debit products in other countries. With Betalingsservice there is a central handling of customer mandates, where the customer bank is responsible for revising customer data when the customer switches bank, account number, etc. With SEPA Direct Debit and direct debit so-

lutions in other countries it is creditor himself who handles modifications to customer data. With Betalingsservice the creditor also has a guarantee of coverage for payments up to 1,000 DKK.

The regulation on cross-border payments has no direct effect on Nets' payment for decentralized production, because Nets' payment is not considered to be an inter-change fee, i.e. an inter-bank transfer.

### **Surcharging the Betalingsservice fee**

Nets has informed that 26 creditors have chosen to charge their customers a fee when using Betalingsservice. These creditors account for 11 percent of the total number of transactions which is approx. 18.8 million transactions annually. However, there may be more creditors than the 26 known who have chosen to charge customers a fee.

From a social point of view it should be ensured that payments in general are carried out with the most effective payment instruments as possible. Price structures - including the fees on individual payment instruments - should support that customers and consumers choose the most efficient payment instruments, among which Betalingsservice ranks.

Rational companies will charge in a way that customers are encouraged to choose the form of payment that is the most profitable from a business point of view. Rational customers will choose to buy their goods and services on the basis of the total price (including possible fees related to the payment instrument). With a rational business and customer behaviour fees on Betalingsservice will not restrain efficiency.

The Marketing Practises Act regulates the creditors' ability to change existing fees or to introduce new fees in an ongoing contractual relationship. The Act says nothing about how large a fee or how big an increase in a fee may be. Furthermore, it does not regulate which types of fees that must be charged. However, depending on the circumstances a fee may be an infringement of good marketing practice. In relation to Betalingsservice the Consumer Ombudsman is of the assessment that a fee can only be called a "Nets-fee" ("PBS-fee") if the charge is equivalent to the amount that the creditor pays to Nets. Charging of a "Nets-fee" in excess of this will generally be misleading and in violation of the Marketing Practises Act.

Generally, the Competition Act does not restrict creditors' ability to collect fees, including fees related to the use of Betalingsservice. In general, pricing is free and thus companies can set their prices themselves.