

## Universal service in banking

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TILEC

# TILEC Report

## UNIVERSAL SERVICE IN BANKING

Report by TILEC\*

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14 March 2006

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## EXECUTIVE SUMMARY

1. This report sets out, in general, the steps of designing and implementing a universal service regime, and discusses how they would apply to the banking sector. Generally speaking, a cost-benefit analysis on the different options of a universal service obligation (USO), plus the option of not interfering at all, should be carried out as a starting point. Next, the choice for the optimal instrument or mechanism can be made. Intervention is only called for if there is a problem, if it is best tackled in the banking sector, and if the intervention leads to a welfare improvement. A cost-benefit analysis will require addressing these issues explicitly, before intervening.
2. The general steps of designing and implementing a universal service regime are:
  - a. As a starting point, the policy goals of universal service obligations (USOs) must be specified explicitly.
  - b. Once the policy objectives have been specified, one can determine the service/quality level definition of the universal service by addressing the following questions: What services should be available at a certain quality level and at reasonable or regulated prices? In which areas should the specified services be available?
  - c. Supposing that the market process does not lead to the provision of the specified service/quality level, and given the delineation of the universal service, it can be determined whether and, if so, which firms should be designated as universal service providers. Alternatives to designating certain or all firms in the market are: franchising the obligation and relying on self-regulation by firms.
  - d. Finally, if necessary, a compensation mechanism may be designed and implemented that helps universal service providers to recover the cost as a result of the obligation. The available options are: (i) providing subsidies, tax benefits, or vouchers to consumers; (ii) creating a compensation fund in the market or using a government subsidy to compensate USO providers; and (iii) making the USO providers responsible for the financing (through implicit or

explicit cross-subsidies, or mark-ups in retail prices), which may imply the granting of monopoly rights.

3. Although EC law imposes constraints on the use of the available options in order to minimize market distortions, it does not impose a market failure test. Furthermore, since interfering with strategic and tactical considerations of firms may distort the functioning of a market, and hence reduce welfare both in the short and in the long term, the demarcation and implementation of a universal service should be limited to what is necessary to reach the specified policy objectives.
4. Both the characteristics of a country (demographics, the geographical nature) and those of a certain industry (cost and demand characteristics, the scope for innovation) will determine whether obligations are needed and, if so, how they should be defined, organized and implemented. Hence, a country and sector-specific assessment of such characteristics and developments must be made. Indeed, there is no “one-size-fits-all” solution, neither with regard to different countries, nor with regard to different sectors. Without further analysis, especially of welfare costs and effectiveness of the different options that exist, there is no obvious way of designing and implementing a USO for a given sector. Experience in other sectors may not correspond in a straightforward way to the sector under consideration.
5. With regard to the welfare trade-offs of designing and implementing a USO, a cost-benefit analysis will be needed to draw final conclusions. Nevertheless, some general observations can be made: financing at the supply side (i.e., through cross-subsidies, mark-ups, a compensation fund) may distort allocative efficiency in the banking sector. Other ways of financing make it possible that the burden is carried by society as a whole. This may be efficient as banking services create externalities for the overall economy and distortions of competition in the market for banking services are avoided. Furthermore, designating all banks to take care of the product dimension of a USO (e.g., consisting of only a basic bank account service) may be the most effective way of implementing it, provided that the USO has a minimal scope. However, with regard to the geographical dimension of a USO, designating all banks leads to unnecessary cost duplication, so that it is worthwhile to consider other options, such as self-regulation and a franchising mechanism in combination with an

auction. In addition, technological developments in a sector are very relevant when assessing the need or desirability of universal service obligations. By interfering in these processes without having made it clear in advance that there is a problem, such developments may be distorted; hence the importance of carrying out a cost-benefit analysis as a starting point.

6. With respect to recent political/policy initiatives in the Dutch banking sector (draft bills submitted in 2004 and 2005), we note that a cost-benefit analysis that addresses the actual size of the distortions of different USO requirements and ways of implementation should be carried out (e.g., taking into account technological developments related to banking based on telecommunications and Internet technology), taking all available options of financing a USO into consideration.

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## 1. INTRODUCTION

The notion of universal service<sup>1</sup> is traditionally associated with utility industries. In these industries, such as the postal services, telecommunications, electricity, and water, the traditional way of guaranteeing affordable access to certain goods or services was to create a regulated, public monopoly, in combination with, for instance, cross-subsidies and obligations with regard to geographical availability. At the end of the previous century, several of these markets were liberalized, sometimes combined with privatization of the former monopolist. To guarantee the continued availability of services, universal service obligations (USOs) were imposed, typically on the incumbents only.

An illustrative example is TPG Post's (currently called TNT) obligation to provide a universal service in the Netherlands.<sup>2</sup> Part of this obligation is that, in each urban area with at least 5,000 inhabitants, there has to be a full service point, while the large majority of the Dutch population must be within 5 kms of at least one such service point. Besides geographical obligations, TPG Post also faces accessibility requirements related to end-user tariffs, such as the requirement that the price of a stamp must not be too high. In general, with respect to USOs, there are two dimensions. First, a product dimension: *what* services should be available at reasonable or regulated prices? Second, a geographical dimension: *where* should these services be available? In order to be able to

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<sup>1</sup> In this report, we chose to use the term “universal service” for reasons of convenience (the current discussion in the Netherlands turns around a “universal banking service”) and because we find that the EC model of universal service provides the best-developed analytical framework. The issues raised under the heading “universal service” have been addressed in other jurisdictions and in other sectors using other concepts, such as “public service”, “*service public*”, “*Daseinsvorsorge*” or “services of general interest” (including “services of general economic interest”). It is beyond the scope of this report to discuss the similarities and differences between these various concepts. Section 2.3 and the appendix provide the necessary details for the purposes of this report.

<sup>2</sup> See also subsection 3.3.

answer these two questions, a related one should be addressed first: in which market niches and geographical regions will an unregulated market fail to provide the desired service/quality level?

The banking industry is not subjected to the type and degree of regulation that is typically observed in utility industries. This is not to say that there is no regulation in the banking industry, and that there can be no monopoly segments; there is and there might be. However, while in utility industries, the regulations are motivated by the network characteristics (large sunk investments leading to natural monopolies), the regulations in the banking sector are very different and are motivated by other types of market failures: externalities and information problems. Nevertheless, because of the payment system's value for society, the possibility of imposing a USO in the banking sector surfaces from time to time in policy discussions. For instance, worries are sometimes expressed about basic banking services not being available or affordable for certain low-income groups and about insufficient availability of services in rural areas.

In this report, we will first provide an overview of the economic and legal aspects of universal service in general. Next, we will discuss socially optimal types of universal service in banking, if any.<sup>3</sup> Closely related literature, on which this report builds, is Crémer et al. (2001) and Van Damme et al. (1998). The contribution of this report is to connect the existing literature to the banking sector. In addition, this report can be read as a general, self-contained introduction to universal service.

The structure of this report is as follows. Section 2 provides a basic overview of the notion of universal service (subsection 2.1), the rationale behind it and the costs caused by universal service obligations (subsection 2.2). It also gives some legal background (subsection 2.3). In the concluding subsection (2.4), by way of a summary, a stylized framework for defining and implementing a USO is presented. In section 3, selected experiences with universal service are presented. In subsection 3.1 international

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<sup>3</sup> We ignore regulation aiming at financial system stability and information asymmetries between banks and depositors, and focus exclusively on universal service.

experience with USOs is discussed, in particular concerning “basic bank accounts”, in banking. Subsection 3.2 contains a more elaborate discussion of the Netherlands with regard to the geographical dimension of bank services. Subsection 3.3 gives an illustrative overview of USOs in the Dutch postal sector. In subsection 3.4 some preliminary concluding observations are made. Section 4 is focused on universal service in banking, and implications are derived for socially optimal implementations of universal service policy. Subsection 4.1 provides examples of potential elements of a USO in banking. It also presents the main welfare costs and benefits for implementing a USO in the banking industry. Subsection 4.2 gives an overview of the welfare costs caused by different ways of implementing and financing a USO, with regard to access to services, and geographical accessibility, respectively. In subsection 4.3, worries recently expressed in the Dutch Parliament are discussed that have led to a draft bill that has been proposed to ensure that basic services are available to all citizens. Section 5 contains the conclusion.

## 2. THE CONCEPT OF UNIVERSAL SERVICE

This section provides a basic overview of the notion of universal service (subsection 2.1), the rationale behind it and the costs caused by universal service obligations (subsection 2.2). It also gives some legal background (subsection 2.3). The concluding subsection (2.4) summarizes by presenting a stylized framework for defining and implementing a USO.

### 2.1 What is universal service?

We can take the notion of universal service as it is found in EC law as a useful starting point. The European Commission defines “universal service” generally as “the minimum set of services of specified quality to which all users and consumers have access in the light of specific national conditions, at an affordable price”.<sup>4</sup> With these elements in mind, universal service comprises the following characteristics<sup>5</sup>.

#### 1. *Minimum set of services*

These are services that, from a societal perspective, are viewed as so essential that they must be made available to everyone.

#### 2. *Quality*

The service must conform to certain quality standards, whose precise content is determined for each sector.

#### 3. *Availability to all users*

This implies that the service must be available to all users irrespective of (i) location and (ii) financial means. It must be avoided that liberalization would lead

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<sup>4</sup> Commission Communication on Services of General Interest in Europe [2001] OJ C 17/4 at para. 39. See also the Green Paper on Services of General Interest, COM(2003)270 (21 May 2003) and the White Paper on Services of General Interest, COM(2004)374 (12 May 2004), which confirm this definition.

<sup>5</sup> Ibid.

to part of the population being excluded from certain services. Accordingly, the service must also be made available to those users where, in consideration of the price (see (4) below), no profit can be made.

#### 4. *Affordability*

The service must remain affordable for everyone. Which price level is considered affordable is left to each Member State to figure out in light of local conditions. Furthermore, it is generally not required that the price be the same for all users irrespective of location.

The parameters of universal service as outlined above can then be defined more precisely for specific countries and markets. Note that, in general, a USO addresses (i) a product dimension (what services should be available at reasonable or regulated prices?) and (ii) a geographical dimension (where should these services be available?).

In the case that a USO is introduced into a market, policy makers will have to decide which firms will be responsible for providing the universal service. The options are the following<sup>6</sup>.

1. Designating specific firms as USO providers.
2. Designating all firms in the market as USO providers, that is, imposing the USO on the sector as a whole.
3. Franchising of the USO, that is, there is an endogenous determination of firms that will provide the universal service (e.g. through an auction in which the firm asking for the lowest subsidy wins a license).
4. Collective action under the threat of public intervention (“self-regulation”).

With regard to option 4, which can be seen as self-regulation by the sector, it should be noted that, even though firms agree on the desirability of certain USOs, individual firms may not be eager to move first. By doing so, a firm would risk to increase its cost level in a unilateral way, and hence to deteriorate its competitive position. Therefore, in order to

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<sup>6</sup> See also Van Damme et al. (1998), subsection 2.2.

prevent such a coordination problem, it may be desirable that the government helps or provides an incentive. In situations in which firms view a USO as undesirable, the threat of intervention may be needed.

## **2.2 The rationale and cost of a universal service**

At a general level – not specifically for banking or any other sector – one can distinguish the following normative (i.e., with the purpose of maximizing social welfare or as a means of redistribution) economic justifications for a USO can be distinguished<sup>7</sup>.

### *1. Remedy for market failure caused by network externalities*

In markets with network externalities, total participation may be too low from a social viewpoint. Telecommunications is a primary example. A USO can aim to provide access to the network at reduced (possibly subsidized) prices, in order to increase participation. This justification also has some relevance in banking. For instance, the larger the number of people with a payment account allowing for money transfers to and from other people (or organizations), the easier it is to establish commercial relationships with others.

### *2. Redistribution policy instrument*

A USO that aims to provide access to a good at subsidized rates may be an alternative to more standard instruments, such as income taxation or direct subsidies. This type of USO typically benefits consumers associated with a high cost of serving them (e.g., rural households). Note however that, from a welfare viewpoint, such a policy is inferior to the provision of direct transfers to high-cost customers in a world where the provider of the goods can price-discriminate (enabling high-cost customers to afford the necessary mark-up in the retail price).

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<sup>7</sup> See e.g. Crémer et al. (2000).

### 3. *Public good provision*

If society may consider a certain product or service to have public good characteristics, then a USO can be a means to support the provision of that product or service. This justification does not seem to be directly relevant for banking.

### 4. *Regional policy instrument*

A USO, for instance, in the form of mandatory uniform pricing, may be used as an instrument to stimulate the development (or prevent the decline) of certain geographical areas. Examples are the provision of basic public services in rural areas.

It is important to note that, rather than being the outcome of welfare maximization, a USO can also be the result of lobbying by interested parties. For instance, the notion of universal service was introduced in the US in 1934 in order to make a case for AT&T's monopoly position in telephony. By re-inventing itself as a "universal service provider", AT&T successfully argued that it needed a monopoly position to carry out this vision.<sup>8</sup>

Implementing a USO is typically costly, both for the provider of the universal service and for society. The cost of the USO consists of the following two elements<sup>9</sup>.

#### 1. *Profitability cost*

The reduction in profits incurred by the USO provider due to the USO, that is, the burden imposed by the USO. It is calculated as the difference between profit levels with and without a USO.<sup>10</sup>

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<sup>8</sup> See e.g. Mueller (1996).

<sup>9</sup> Crémer et al. (2001).

<sup>10</sup> Two approaches are commonly used to calculate the profitability cost: the method of Net Avoidable Cost and the Fully Distributed Cost approach (see e.g. Crémer et al. (2001) and Van

## 2. *Welfare cost*

The reduction in welfare implied by the USO, that is, the deadweight loss caused by the USO. This cost, which can be approximated by the reduction in the sum of consumer surplus and producer surplus, is calculated as the difference between welfare with and without a USO.<sup>11</sup>

Because of the profitability cost, it may be desirable, or even necessary, to implement a compensation mechanism, for instance, aiming at recovering the profitability cost of the USO providers. The policy options with respect to financing the profitability costs of the USO are the following<sup>12</sup>.

### 1. *Internal financing at the supply side*

The USO providers are directly responsible for its financing (this may imply or require the granting of monopoly rights) through

- a. Cross-subsidies (implicit or explicit);
- b. mark-up in the prices of the designated services of the USO provider.

### 2. *External financing at the supply side*

- a. Providing a subsidy from the treasury to USO providers;
- b. creating a compensation fund (all firms contribute to the financing of the USO).

### 3. *Financing at the demand side*

- a. Providing subsidies or tax benefits to selected consumers;
- b. providing vouchers to selected consumers.

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Damme et al. (1998)). It is beyond the scope of this report to go into the details of these approaches.

<sup>11</sup> It might be possible that welfare is higher with a USO. However, as a USO typically aims at redistribution, it will tend to distort welfare.

<sup>12</sup> Adapted from Van Damme et al. (1998).



In section 4, we will discuss these options in more detail, within the sector of the banking industry.

### **2.3 The legal background of universal service in the EU**

Although the evolution of EC law has given “universal service” a distinctive European meaning, the concept has been imported from Anglo-American legal systems, and from US federal law, in particular. The main competing model in Europe was the French *service public* model. To provide further background, both these models are briefly explained and compared in Appendix 1. That comparison shows that the theoretical differences, which may appear striking at first glance, do not necessarily translate into massive divergences in practice. In the French *public service* model, the authority takes the initiative and is thus directly involved in the provision of the service. There is no assessment of whether the market could deliver on the policy objectives and little attention is paid to the impact of *service public* on the functioning of the market. In contrast, the Anglo-American universal service model, which inspired the relevant EC law, is based on a dialogue between the polity and the economy: through political processes, the public authority defines the policy objectives concerning the provision of universal service, and then proceeds to intervene if and to the extent which the market would not in and of itself fulfill these objectives. At each step in the process, care is taken to minimize the impact on the economy.

In the rest of this subsection, we will discuss the legal aspects of universal service in the EU in some more detail.<sup>13</sup>

*Origins and application of universal service in EC law*

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<sup>13</sup> Prosser (2005).

In Article 86(2), the EC Treaty states that, under certain conditions, firms entrusted with the provision of “services of general economic interest” (SGEIs) can be exempted from the application of the Treaty rules (including competition law). “Services of general economic interest” is a term specific to EC law, which is meant to echo what Member States variously understand as *service public*, *openbare dienst*, *Daseinsvorsorge*, etc.<sup>14</sup> These SGEIs have been given an enhanced status under EC law within the addition of Article 16 EC with the Treaty of Amsterdam.<sup>15</sup> They are also recognized in the Charter of Fundamental Rights.<sup>16</sup> These provisions have been taken over in the proposed European Constitution, whose fate is now uncertain.<sup>17</sup>

When these SGEIs are harmonized at EC level in order to improve the functioning of the internal market, the concept of “universal service” is used to designate that harmonized version of the SGEI. The main characteristics of universal service are defined at EC level, with the Member States being in charge of implementation.

In Europe, “universal service” was first used in telecommunications regulation.<sup>18</sup> At this point in time, “universal service” is found in the EC directives establishing regulatory

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<sup>14</sup> These national concepts were thought to be too divergent and too vague to be used at EC level.

<sup>15</sup> Article 16 EC reads: “Without prejudice to Articles 73, 86 and 87, and given the place occupied by services of general economic interest in the shared values of the Union as well as their role in promoting social and territorial cohesion, the Community and the Member States, each within their respective powers and within the scope of application of this Treaty, shall take care that such services operate on the basis of principles and conditions which enable them to fulfill their missions.”

<sup>16</sup> At Article 36: “The Union recognizes and respects access to services of general economic interest as provided for in national laws and practices, in accordance with the Treaty establishing the European Community, in order to promote the social and territorial cohesion of the Union.”

<sup>17</sup> Article 16 EC is now Article III-122, and Article 36 of the Charter is now Article II-96.

<sup>18</sup> The words first come up in the Commission Green Paper on the development of the common market for telecommunications services and equipment, COM (87) 290 def.

frameworks for electronic communications (formerly telecommunications),<sup>19</sup> postal services,<sup>20</sup> and electricity.<sup>21</sup> There is debate on whether universal service should be expanded to cover broadband Internet access as well.<sup>22</sup> It is not clear whether the notion of universal service will also be used in the transport sector. For various reasons, including a different wording in Art. 73 EC, EC transport regulation continues to use “public service” instead, which can lead to confusion with the French notion of *service public*.<sup>23</sup>

### *Legal framework for law-making*

What type and level of discretion do Member States have to implement a USO? In the absence of harmonization at EC level, Member States remain in principle free to organize their SGEIs as they see fit, but EC law imposes a number of constraints in any event (arising, among other things from Articles 86 and 87-88 EC).<sup>24</sup> In the end, the notion of universal service as it has been developed in EC law is very relevant even in the absence of harmonization at EC level, since it offers a decision-making path which respects the

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<sup>19</sup> Directive 2002/22 of 7 March 2002 on universal service and users’ rights relating to electronic communications networks and services (Universal Service Directive) [2002] OJ L 108/51. Universal service in electronic communications is defined at Art. 3-10 as a set of services (access and use of a fixed communications networks, directory assistance, public payphones and measures for disabled users) available to everyone on the territory of a given Member State at an affordable price.

<sup>20</sup> Directive 97/67 of 15 December 1997 on common rules for the development of the internal market of Community postal services and the improvement of quality of service [1998] OJ L 15/14, as amended by Directive 2002/39 of 10 June 2002 [2002] OJ L 176/21.

<sup>21</sup> Directive 2003/54 of 26 June 2003 concerning common rules for the internal market in electricity [2003] OJ L 176/37.

<sup>22</sup> See e.g. Van Eijk (2004).

<sup>23</sup> Advocate General Stix-Hackl chose to follow universal service terminology when discussing harbor services in her conclusions in Joined Cases C-34 to C-38/01, *Enirisorse SpA*.

<sup>24</sup> See Article 16 EC.

open market economy (as reflected in the constraints arising from the EC Treaty) while allowing States to cater to policy needs.

Indeed the concept of universal service is meant to fit within an open market economy; it leaves as much room as possible to the workings of the market. In light of experience at EC level, and in particular of the Universal Service Directive for electronic communications,<sup>25</sup> universal service follows a multi-stage decision-making path.

- (i) Member States are not obliged to impose universal service obligations (USOs) if market forces suffice to ensure that a service meeting the requirements of the definition of universal service is provided.<sup>26</sup> Note that there is no compulsory or reviewable market failure test:<sup>27</sup> it is up to the political actors to make the determination whether a USO must be imposed or not.
- (ii) Should a Member State determine that a USO must be imposed, then it must select one or more firms upon which to impose such an obligation. Preferably, this should be done in an open, transparent and non-discriminatory procedure (including, for instance, a tender procedure).<sup>28</sup> The obligation can be imposed nationwide or on a regional basis.
- (iii) Should a USO be imposed, then financial compensation, if any, is limited to the net cost of providing universal service, and then only if that represents an

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<sup>25</sup> Directive 2002/22, *supra*, note 18.

<sup>26</sup> *Ibid.*, Art. 3 and 8(1).

<sup>27</sup> This means that, in the current state of EC law, there is no legal requirement that the public authorities show, to a definite standard of proof, that the workings of market forces alone do not suffice to ensure that the public policy objectives underlying universal service provision will be met. In other words, once the political actors choose to introduce a universal service regime, there is no legal means to challenge that very decision on the grounds that it was not shown that the market could not by itself provide a satisfactory level of service.

<sup>28</sup> Such a procedure is compulsory for electronic communications: *ibid.*, Art. 8(2). In the absence of such a procedure (i.e., if a USO is imposed outright via decree or otherwise), there is a greater likelihood that problems will arise under EC law.

unfair burden on the firm providing the USO (taking into account, for instance, the intangible benefits arising from providing universal service and the administrative costs of running a compensation mechanism).<sup>29</sup> Compensation exceeding the net cost of the USO is likely to be incompatible with EC law. In electronic communications, a number of Member States have accordingly decided not to provide for any compensation to the firm under a USO.

- (iv) Should financial compensation be envisaged, the financing mechanism itself must be transparent and minimize market distortions.<sup>30</sup> Possible mechanisms include<sup>31</sup>.
- a. conferring a (partial) monopoly on the firm under a USO. Proceeds from the services under monopoly can then cross-subsidize the provision of the USO. This mechanism is very rough and imprecise; moreover, it seriously affects the functioning of the market. It seems more appropriate as a transition device in the course of liberalization;
  - b. compensating the firm under a USO through user fees (e.g., former system of viewer fees for public broadcasting) or transaction charges. This mechanism also suffers from imprecision, in that the fees/charges might not correspond to the net costs as later assessed;
  - c. setting up an industry fund to cover the net costs of the USO. Firms are then required to “play or pay”, i.e., contribute to the provision of the universal service or pay into the fund to compensate those who provide such service;
  - d. compensating the firm under a USO directly from State funds. This can occur either via an ex post assessment of the net cost which is then paid out to the firm by the State or via a procurement procedure. This option is

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<sup>29</sup> *Supra*, note 18, Art. 12-13.

<sup>30</sup> *Ibid.*, Art. 13-14.

<sup>31</sup> Geradin (2000), p. 197-198.

subject to applicable EC law, namely State aid rules (Art. 87-88 EC), and in particular the *Altmark* judgment.<sup>32</sup>

The last two mechanisms are the only ones which can truly claim to minimize market distortions, and accordingly the more advanced regulatory frameworks – for example, electronic communications – only allow these two.<sup>33</sup>

As mentioned in subsection 2.3, the USO can also conceivably be financed on the demand side, via “vouchers” given to those citizens for whom it is thought that the market price of the universal service would be too high (people living in remote regions, low-income users). This solution has not been put forward at the EC level so far, although it should at first sight comply with EC law.

## **2.4 The economic framework for defining a USO**

To have all the practical elements gathered in one place, we will conclude this section by recapitulating the steps of designing and implementing a universal service. These steps apply, in principle, to any market where universal service obligations are under consideration. Before doing so, however, we note that the way a USO is implemented cannot be decoupled from policy objectives:

[...] an appropriate universal service policy [...] should pose simultaneously the questions of content, cost and financing of universal service. The fundamental issues then are the specification of the basic objectives of the policy and the setting up of the instruments that would help to achieve these objectives in the most effective way<sup>34</sup>.

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<sup>32</sup> ECJ, 24 July 2003, Case C-280/00, *Altmark* [2003] ECR I-7747.

<sup>33</sup> What is more, Directive 2002/22 only allows the use of a universal service fund for the services listed in the Directive itself, *supra*, note 18. Other services which a Member State would wish to include in the universal service must then be financed – if at all – via direct State grants.

<sup>34</sup> Crémer et al., 2000, p. 11.

Hence, to be able to discuss socially optimal forms of universal service obligations, it must be specified exactly what politicians and policy makers want to achieve. To that end, the policy goals of universal service obligations must be made clear and specific at the outset.

Once the policy objectives have been specified, the service/quality level definition of the universal service can be determined (see subsection 2.1). This can be done in two dimensions.

*1. Product dimension*

What services should be available at a certain quality level and at reasonable or regulated prices?

*2. Geographical dimension*

In which areas should the specified services be available?

Note that, if market forces are sufficient to ensure that a service meets the specified requirements, imposing obligations is not necessary and should be avoided as it may lead to market distortions. Suppose, however, that the market process does not lead to the provision of the specified service/quality level. Given the delineation of the universal service in the two dimensions above, it should be determined whether, and, if yes so, which, firms will be designated as universal service providers. As mentioned in subsection 2.1, alternatives to designating certain or all firms in the market are (i) franchising the obligation and (ii) relying on self-regulation by firms.

Finally, a compensation mechanism may be designed and implemented that helps universal service providers to recover the cost caused by the obligation. In subsection 2.2, the following available options were listed: (i) allowing USO providers to use cross-subsidies or mark-ups in their prices; (ii) creating a compensation fund in the market or

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using a government subsidy to compensate USO providers; and (iii) to provide subsidies, tax benefits, or vouchers to consumers.

The framework for law-making in the EU (see subsection 2.3) imposes some checks and balances that contribute to a motivated implementation procedure. Whilst EC law does not impose a market failure test, it still requires Member States and EC institutions to comply with the principle of proportionality. Accordingly, since interfering with strategic and tactical considerations of firms may distort the functioning of a market, and hence reduce welfare both in the short and in the long term, the demarcation and implementation of a universal service should be limited to what is necessary to reach the specified policy objectives. Indeed, as discussed in subsection 2.3, EC law imposes constraints on the use of the available options in order to minimize market distortions.



### **3. UNIVERSAL SERVICE: SELECTED EXPERIENCES**

This section presents selected experiences with universal service. Subsection 3.1 discusses international experience with USOs, in particular concerning “basic accounts”, in banking. Subsection 3.2 contains a more elaborate discussion of the Netherlands with regard to the geographical dimension of bank services. To allow readers to make a comparison, subsection 3.3 gives an illustrative overview of USO in the Dutch postal sector. Based on these observations, subsection 3.4 makes some preliminary observations related to the desirability of “tailor-made” universal service obligations in a specific industry.

#### **3.1 International experiences in banking: Product dimension**

In this subsection, we will provide selected country experiences as far as they concern basic bank accounts. Given the limited scope of this study, it has not been possible to gather up-to-date information on other jurisdictions. In its 1997 Report, the Commission indicated that Germany, Austria and Sweden impose USOs in the banking sector.<sup>35</sup>

The observations below illustrate that the institutional arrangements to organize and implement universal service obligations vary throughout the EU. In the Netherlands and in France, self-regulation contributes to policy objectives of affordability of bank services. The UK exhibits a somewhat similar approach, but with an explicit role for the government as a first-mover. In Belgium, the approach is through a legislative process.

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<sup>35</sup> Report to the Council of Ministers: Services of general economic interest in the banking sector (17 June 1998), available at

<[http://europa.eu.int/comm/competition/state\\_aid/others/report\\_bank/report\\_bank\\_en.html](http://europa.eu.int/comm/competition/state_aid/others/report_bank/report_bank_en.html)>.

Given the proceedings concerning State guarantees to public banks in Germany, the situation there may have changed in the meantime.

### *The Netherlands*

At the end of 2001, a number of Dutch banks, representing the majority of the market (95%), committed to providing basic banking services to customers without a bank account, regardless of their credit record or possible profitability to the bank. The agreement was laid down in the *Convenant inzake een pakket primaire betaaldiensten* and requires customers to apply for a bank account as a part of their contacts with recognized social support organizations (the municipal social services, the Salvation Army, etc.).<sup>36</sup> Since its entry into force, a considerable number of accounts (at least 1,000, but possibly a considerably larger number) has been opened for previously non-banked customers.

### *Belgium*

Belgium adopted legislation on basic banking services in 2003. This basic service includes the right to make deposits, to transfer money in one's own account, to withdraw money, to make transfers, standing orders and direct debit orders. The law applies to all credit institutions operating in Belgium that offer current accounts to consumers and compels them to offer such basic services to anyone on request. Provision of basic banking services can be refused if the customer already enjoys these services (or a checking account) with the same or a different institution, or if the customer was previously found guilty of cheating, abuse of confidence or forgery of documents. The credit institution cannot charge more than € 12 per year for these basic services.<sup>37</sup>

### *France*

In France, the association of French banks and most of its members voluntarily adhered to a Charter of basic banking services in 1992. The signatory banks agreed that they would make current accounts available under "terms and conditions that make them affordable for lower income customers". Customers who open such an account and channel their income into it (however small or irregular) are entitled to a bankcard,

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<sup>36</sup> The Convenant is available at <<http://www.nvb.nl/scrivo/asset.php?id=11965>>.

<sup>37</sup> <[http://mineco.fgov.be/protection\\_consumer/bank\\_exclusion/bank\\_exclusion\\_nl\\_002.pdf](http://mineco.fgov.be/protection_consumer/bank_exclusion/bank_exclusion_nl_002.pdf)>.

statements of accounts, possibilities to pay at a distance (debit card or transfer forms) and checking.<sup>38</sup>

### *United Kingdom*

In the UK, the government took the initiative to phase out order books and *girocheques* in order to stimulate financial inclusion (i.e., to increase the number of people with bank accounts).<sup>39</sup> By 2005, all benefits, pensions and tax credits had to be paid directly into accounts offered by banks and building societies. Introduced after an agreement among 12 banks and building societies, the “basic bank account” was introduced, which is a bank account with limited features designed for people who might not meet the criteria for opening a regular account. These accounts neither provide an overdraft facility nor, in most cases, a check book. In addition, the “Post Office card account” was introduced, which is a basic card facility introduced by the Post Office, just for receiving benefits, pensions and tax credit payments, and cash withdrawal only at Post Office counters. At the start of the phasing out of order books and girocheques (April 2003), there were approximately 14 million people collecting benefit payments in cash from Post Office branches, including 3.5 million claimants without a bank account. In June 2004, there were 5.4 million “basic bank accounts”, of which 1.7 million were accessible through Post Office branches, as well as 834,000 post office accounts, of which 726,000 were accessible through Post Offices branches.<sup>40</sup>

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<sup>38</sup> Devroe (2000), p. IV-47.

<sup>39</sup> Information based on British Bankers’ Association, “Universal Banking Services”, 05-01-2003, available at <<http://www.bba.org.uk>>, visited on 8 February 2005.

<sup>40</sup> British Bankers’ Association, “Basic Bank Account growth heralding financial inclusion”, 14-09-2004, available at <<http://www.bba.org.uk>>, visited on 8 February 2005. Apparently, the basic bank account was an initiative of the banks themselves, possibly pressured by the government. We do not know how it is financed, nor if there is price regulation.

### 3.2 Experience in the Netherlands: Geographical dimension<sup>41</sup>

It is outside the scope of this report to include an overview of country experiences with geographical components of a USO.<sup>42</sup> Nevertheless, it can be noted that, in general, differences of geographical characteristics across countries will make it unlikely that USO models that fit a particular country can be adopted in a straightforward manner by other countries.

The closing of bank offices in the Netherlands gave rise to some concern. As a result, in September 2002, the Minister of Finance established the “Maatschappelijk Overleg Betalingsverkeer” (MOB), which, under the presidency of Dutch Central Bank (DNB), serves as a platform for discussion on issues relating to payment services and their accessibility. Since then, the MOB has published several reports and papers relating to the accessibility of banking services.

Already before the MOB was established, the NVB had issued a report in April 2002. That report stated that the number of bank offices had declined from 7,750 to 5,400 between 1991 and 2001, while in the same period, the number of ATMs had increased from 3,354 to 7,000. 90-95% of all cash withdrawals were by means of these ATMs (with cost of about € 0.75 for each withdrawal), which implied that there were still some 60 million cash withdrawals in bank offices (with costs of around € 5 per withdrawal) in 2001. At that time, shops also started to offer more and more cash-back facilities. The

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<sup>41</sup> For more recent developments, see subsection 4.3.

<sup>42</sup> A report “Money Matters in the Bush: Inquiry into the Level of Banking and Financial Services in Rural, Regional and Remote Areas of Australia” by the *Parliamentary Joint Committee on Corporations and Financial Services* (January 2004) reviews developments in the provision of banking and financial services in rural and remote areas in Australia and recommends, *inter alia*, improving the quality of information of the availability of services. Another report, “Availability of Services in Rural Scotland”, Scottish Executive (October 2000), maps the location and accessibility of various services (including banking) in Scotland’s rural and remote communities.

report listed various bottlenecks, as well as initiatives of several banks that were under way.

In December 2004, the working party on accessibility of MOB published its most recent report, describing the current situation, as well as suggestions for solutions. This report noted that the problem was more a social issue in rural areas (*“leefbaarheid op het platteland”*) than an issue of accessibility of banking services alone, so that the solution had to be viewed in a broader perspective and had to be investigated targeted solutions in cooperation with the various stakeholders.

Some relevant data from that report are the following.

- (i) In 2000, the Netherlands had about 6,000 bank offices, 2,660 inhabitants per bank, one bank office per 7 km<sup>2</sup>, 2,300 inhabitants per ATM and one ATM per 6 km<sup>2</sup>.
- (ii) At the end of 2003, there were 5,157 bank offices and 7,576 ATMs;
- (iii) In 2002, 13% of all cash withdrawals was by means of cash-back facilities offered by shops, most of which were in supermarkets. In total, this involved 75 million transactions with a value of € 3.4 billion;
- (iv) Rabobank aimed to have an ATM within a distance of 1.5 kms and an office with physical service within 3 kms;<sup>43</sup>
- (v) Postbank aimed to have full service in all villages with at least 10,000 inhabitants and to have money service points in all villages with relatively many clients.

Note that the above data are not directly comparable to those of the postal sector (see subsection 3.3), but, as the Minister of Finance has stated, they do not immediately seem to give rise to concern.<sup>44</sup> Finally, we note that the March 2005 report “Rapportage Maatschappelijk Overleg Betalingsverkeer 2004” states that 80% of cash withdrawals is

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<sup>43</sup> Hence, the retail network of Rabobank seems to be denser than that of TPG.

<sup>44</sup> Formulating the requirements as is done for post seems desirable.

through ATMs and 13% through cash-back, leaving 7% for bank offices, which is still considerable.

Cooperation between banks and service providers from other sectors in the economy can be observed. For example, in small villages, Rabobank participates in service shops together with TPG, Essent and Tempo Team. There are about 1,500 of these small villages in the Netherlands; the intention is to open such shops in at least 200 (in mid-2005, there were 25 branches spread over the country). At the same time, Postbank offers money service points. These exist in small villages (fewer than 1,000 inhabitants) in which there are relatively many costumers of this bank. At the moment, there are some 400.. ABN AMRO, together with ANBO experiments with mobile banking offices. Money cash-back facilities in shops are also increasing in importance.

### **3.3 Experience in the postal sector in the Netherlands: Geographical dimension<sup>45</sup>**

It is interesting to make a comparison with another sector in which universal service considerations, related to the geographical dimension, play an important role.<sup>46</sup> Post is such a sector. We will confine ourselves to discussing the situation in the Netherlands.

TPG Post has the obligation to provide universal postal services in the Netherlands. As part of that obligation, TPG has to operate a certain number of outlets. The main obligations that are imposed on TPG in this domain are embodied in formal regulations, such as the *Barp* (“*Besluit algemene richtlijnen post*”),<sup>47</sup> but there are additional obligations resulting from an agreement reached between TPG Post and the responsible *Secretary*, the “*Vestigingenplan 2001-2005*”. The requirements are:<sup>48</sup>

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<sup>45</sup> See De Bijl et al. (2003) for a discussion of universal service in the postal sector.

<sup>46</sup> In post, the affordability issue is not much of a concern.

<sup>47</sup> Available at <<http://www.ez.nl/content.jsp?objectid=20863>>.

<sup>48</sup> The formulations below may not correspond exactly to the official ones; for more information, see the official documents.

1. In each connected urban area with at least 5,000 inhabitants, there has to be a service point offering full postal service;
2. If, in a connected urban area, the number of inhabitants is at least 50,000, then, for every 50,000 inhabitants, there has to be an additional full postal service point;
3. If the number of inhabitants is less than 5,000, then there should be a service point offering full service or almost full service within a distance of 5 kilometers;
4. A postal service point (with almost full service) can only be closed if the following three conditions are met:
  - a. The service point is located in a village without a shopping area (at least 4 shops).
  - b. There exists a service point with almost full service not more than 5 kms away.
  - c. Turnover generated by stamps is less than € 25,000 per year.
5. Service points in hospitals and homes for the elderly will not be closed, and service levels will not be reduced, without consultation with the management; if stamps are currently offered, this will also be the case in the future.

Yearly, the relevant Dutch regulatory authority OPTA investigates whether these conditions are satisfied. For instance, in its monitoring report over the year 2003, *OPTA* concluded that TPG met all the requirements from the *Barp* and also most of the requirements arising from the agreement with the *Secretary*. Indeed, TPG marginally missed the target: in 11 out of the 1,932 service points with full or almost full service (0.6%), it was not possible to send all international packages.

We will now describe the outcome of OPTA's monitoring in more detail. There are 15 villages with at least 5,000 inhabitants that do not have a full service point. However, these villages are not connected, hence, TPG satisfied requirement (1). TPG also satisfied requirement (2). OPTA reported that of the 1,883 "rural villages" in the Netherlands,

there are 31 in which requirement (3) is not satisfied. These villages in total have 8,943 inhabitants, which is said to be 0.35% of all inhabitants in rural areas in the Netherlands (hence, 2.55 million people live in rural areas). As 99.65% can be said to be “almost all”, requirement (3) is satisfied. Requirement (4) is not a formal requirement in the Barp, but it results from the agreement with the Secretary. In 2003, in 15 “small villages”, the last service point was closed. In none of these cases was the closing the initiative of TPG. Furthermore, in all of these cases, an alternative was available less than 5 km away. Concerning the final item, some service reduction has been taking place in hospitals and homes for the elderly, but this was because entrepreneurs no longer wished to offer these services.

TPG has also made agreements with the *Secretary* concerning the service level in the future:

- (a) There will at least be 902 service points offering full postal service; 95% of the Dutch population will be within 5 kms of at least one such service points, with in rural areas the percentage being 85%;
- (b) There will at least be 2,000 service points offering almost full service or full service;<sup>49</sup>
- (c) There will be at least 1,000 new service points offering the most frequent postal services.

At the end of 2003, TPG operated 1,169 full service points, 763 almost full service points and 645 other service points. Nationwide coverage was 98.8% and coverage in rural areas was 93.1%. TPG is reducing the number of post offices, which it is operating together with ING bank. The plan is that, at the end of 2005, there will be 800 post offices, 102 service points with full service and 1,200 service points with almost full service. At that time, including business points, there should be 3,102 service points in total. Next to this, there will be some 5,800 shops or locations where stamps can be bought. TPG reports

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<sup>49</sup> It would be interesting to know whether the banking sector satisfies requirements (a) and (b).



that the average distance to a full service point is 1,140 m, to an almost full service point it is 760 m, to a place where stamps can be bought it is 510 m.<sup>50</sup>

### **3.4 Some observations**

The overall conclusion that can be drawn at this stage is that there is no one-size-fits-all solution, neither with regard to different countries, nor with regard to different sectors. It is beyond the scope of this study to present a complete overview and comparison of experiences with universal service obligations in different countries and sectors. Nevertheless, a couple of observations can be made. In particular, both the characteristics of a country (demographics, the geographical nature) as well as those of a certain industry (cost and demand characteristics, the scope for innovation) will determine whether obligations are needed and, if so, how they should be defined, organized and implemented. For instance, the geographical requirements for the Dutch postal sector cannot be decoupled from the distribution of consumers over the different rural and urban areas. Also, the need to impose obligations in the postal sector should be seen in the light of technological developments – think of telecommunications and the Internet – that may make existing requirements redundant to a certain extent. Obviously, a country and sector-specific assessment of such characteristics and developments has to be made, in order to understand the implications for universal service.

Let us leave country and demand characteristics aside and briefly discuss some technological developments that are specifically relevant for the banking sector. We note, however, that at this moment, it seems too early to judge whether these developments have sufficient importance with regard to access to banking services. For instance, consider the development of advanced software applications, allowing for increased ability to offer customized, narrowly targeted products and pricing strategies. The potential effect of this development is that it may allow for customized services that can

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<sup>50</sup> It would be interesting to have the numbers split between urban and rural areas, and to have a comparison between post and banking.

be effectively targeted at consumers who have most to gain in terms of financial inclusion. Furthermore, the development of Internet-related applications, allowing for an increased ability to target and reach customer segments through on-line banking, may help banks to reach consumers in rural areas with no branch office in close proximity. However, if there are no alternatives available, it may lead to the exclusion of consumers without sufficient computer and Internet skills. The development of mobile-telephony applications may lead to new ways of identification and payments, and may, just as The Internet, contribute to reaching consumers. Similar remarks can be made about applications of chip technology, that may lead to more effective ways of identification and payment. In combination with a computer and the Internet, or alternatively, with an advanced telephone, money can be transferred to chip cards through electronic communication networks. Concluding, these types of developments may become relevant in the near future and should be taken into account when assessing the desirability of universal service obligations in the banking sector.

#### 4. UNIVERSAL SERVICE IN BANKING

It is conceivable that the notion of universal service could be applied to banking, that is, that certain policy objectives would be defined, with the State then carefully studying whether the market delivers on these objectives and, if not, how a universal service regime could be implemented which would minimize market distortions. So far in practice, universal service has been used essentially in network industries, more specifically in those that were traditionally termed “utilities”, but there is no reason in principle why the notion of universal service could not be applied outside that realm.

In this context, we note that, at the end of 1997, in the wake of the discussion on the financing of public credit institutions in Germany at the conclusion of the Treaty of Amsterdam, the European Council invited the Commission to look at services of general economic interest (SGEIs) in the banking sector in the various Member States. The resulting report<sup>51</sup> recalls the main lines of EC law concerning SGEIs and universal service (as outlined above). With respect to universal service obligations – the provision of a basic financial infrastructure covering a certain territory – the Commission merely indicated that it examined each case individually to see if the national regime complies with EC law, in particular State aid law. In fact, as discussed in subsection 3.1, in a few countries, banking sectors have begun to introduce universal service notions (“banking the unbanked”).

In the remainder of this report, we will focus on access to and affordability of banking services, and on regional policy and accessibility of branch offices. With regard to these aspects of banking, we will derive implications for socially optimal implementations of universal service policy. Subsection 4.1 contains an overview of the main options that can be included in the definition of universal service, applied to the case of the banking

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<sup>51</sup> Report to the Council of Ministers: Services of general economic interest in the banking sector (17 June 1998), available at [http://europa.eu.int/comm/competition/state\\_aid/others/report\\_bank/report\\_bank\\_en.html](http://europa.eu.int/comm/competition/state_aid/others/report_bank/report_bank_en.html).

sector. It also presents the main welfare costs and benefits for implementing a USO in the banking industry. Next, in subsection 4.2, an overview will be given of the welfare costs caused by different ways of financing a USO, with regard to access to services and geographical accessibility, respectively. Finally, in subsection 4.3, worries will be discussed that were recently expressed in the Dutch Parliament and that have led to a draft bill, proposed to ensure that basic services are available to all citizens.

#### **4.1 Defining universal service and designating USO providers in banking**

As a starting point, it is useful to illustrate how the elements of a universal service (see subsection 2.1) can, in theory, be elaborated specifically for the banking sector. The following table provides such an illustration.

In table 4.1, note that availability and affordability may be related to each other (the level of fees for bank accounts and financial transactions determines whether there is true access). In particular, access may also be determined by the functionality of interfaces used for financial transactions. Note also, as was outlined in subsection 2.2, that the universal service model under EC law typically imposes constraints on the use of these options, in order to minimize market distortions.

<b>Element of Universal Service</b>	<b>Potential application in banking</b>
1. Designated minimum set of services	- basic bank account
2. Specified quality level	characteristics and features of basic bank account, such as possibilities to: <ul style="list-style-type: none"> <li>- transfer cash to and from the account</li> <li>- receive a debit card and PIN code associated with the account</li> <li>- transfer cash into e-money and vice versa</li> </ul>
3. Availability for all users	- customer eligibility requirements <ul style="list-style-type: none"> <li>- access in certain/all geographical regions</li> <li>- access for people with specific functional disabilities</li> <li>- access for people without computer/telephony skills</li> </ul>
4. Affordability	maximum levels for: <ul style="list-style-type: none"> <li>- fees for bank accounts</li> <li>- fees for financial transactions</li> <li>- tariffs related to customer eligibility requirements (e.g., the cost of obtaining an ID)</li> </ul>

**Table 4.1:** Illustration of a USO in banking (hypothetical)

If a USO is introduced, policy makers will have to decide which banks will be responsible for providing the universal service. This can be done in various ways: designating specific banks as USO providers; imposing the USO on all banks; franchising the USO (e.g., through an auction in which the bank asking for the lowest subsidy becomes the USO provider); and through collective action under the threat of public intervention (“self-regulation”). Table 4.2 describes the costs and benefits of these different options.

	<b>Advantages</b>	<b>Disadvantages and costs</b>
Designating specific banks	- minimal implementation	- lobbying/influencing costs w.r.t. which banks will be USO providers
Designating all banks	- 'fair' (the competitive playing field is not affected) - straightforward implementation - no lobbying/influencing costs w.r.t. which banks will be USO providers	- an inefficiently high number of banks will provide the USO (possibility of cost duplication, depending on nature and scope of the USO)
Franchising	- effective methods exist for selecting the most efficient providers (e.g., auctions)	- transaction costs related to setting up the selection mechanism (e.g., auction) - auction design is not straightforward
Self-regulation	- effective use of decentralized information	- possibility that the market will not deliver if government pressure is ineffective

**Table 4.2:** Policy options for designating USO providers

A cost-benefit analysis on the different options of a USO, while excluding no option beforehand, should be carried out as a starting point for policy. Based on that, the choice for the optimal instrument or mechanism can be made. Note that intervention is only called for if there is a problem, and moreover, a problem that is best tackled in the banking sector. Also, the intervention should lead to a welfare improvement. A cost-benefit analysis will require these issues to be addressed explicitly, before intervening.

Keeping these general considerations in mind, we will now make a few observations based on the options listed in table 4.2. Note that, if self-regulation (for other purposes) has worked well in the past in the banking sector, it may be a good reason to choose it as a way of implementing the USO as well. In particular, it requires little public intervention except for stimulating banks to set it up – in order to solve coordination problems – and perhaps using the threat of regulation if it does not get off the ground. Assuming self-

regulation does not work, designating all banks to supply the USO may be an effective way of implementing it, assuming that the USO is such that this option does not lead to inefficient cost duplication. For instance, if the USO only encompasses some straightforward elements with limited scope in the product dimension, designating all banks may be efficient. An example is a USO consisting of a basic account service. However, as regards the geographical dimension of a USO, the other options are likely to be more efficient. Franchising based on an auction mechanism may then be more effective, although a cost-benefit comparison should be made with the other options, as designing and implementing such a mechanism is not straightforward.<sup>52</sup> Concerning franchising, the following remarks can be made.

- (i) The transaction cost for the system may be high, in particular, the net cost may be difficult, or costly to determine.
- (ii) The above may already hold in the case of a pure bank, but it takes on special importance in the case of multi-product firms. As seen earlier, it can be expected that, if ultimately multi-product firms (i.e., multi-product service centers) offer these services, it will be even more difficult.
- (iii) The system involves banks subsidizing, under certain circumstances, not only banking services, but also other services like post or supermarkets. Costs may be higher than costs of alternative mechanisms.
- (iv) There is the possibility that the system might distort the market. Market parties might adopt a “wait and see” attitude, counting on the subsidy, and expecting the Minister to act. If the Minister does not act, there might be an inefficiency.
- (v) In general, the system has a strong flavor of micro-management on the part of the public authorities, which may result in delays in moving to more innovative systems.

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<sup>52</sup> It is beyond the scope of this report to address the optimal franchising mechanism.

## 4.2 Financing a USO in banking

In this subsection, we will discuss the potential costs and benefits of the different options of financing a USO: internal financing by banks (USO providers are forced to cover the costs themselves and will use implicit or explicit cross-subsidies, or mark-ups in the prices of the designated services);<sup>53</sup> external financing by banks (USO providers receive a subsidy from the government, or are allowed to create a compensation fund in which all banks participate); and financing by the government at the demand side (the government provides subsidies, tax benefits, or vouchers to selected consumers).

*Access to services (availability and affordability)*

Table 4.3 gives an overview of USO financing methods related to non-geographical elements, in particular related to the availability and affordability of services.

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<sup>53</sup> In some sectors, such as post, the USO provider gets some monopoly rights so that it becomes easier to cover the cost of the USO.



Method of financing		USO implementation	Welfare costs
<i>Internally at supply side</i>	Cross-subsidies	USO providers are responsible for recovering cost of providing basic payment services to unprofitable customers	- Price distortions reduce allocative efficiency
	Mark-ups for the designated services	USO providers are responsible for recovering cost of providing basic payment services to unprofitable customers	- Price distortions reduce allocative efficiency
<i>Externally at supply side</i>	Transfer from the treasury	Government compensates cost of providing basic payment services to unprofitable customers	- Welfare costs elsewhere in the economy because of distortionary taxation
	Compensation fund	Sector compensates cost of providing basic payment services to unprofitable customers	- Sector may increase prices to recover costs, leading to reductions in allocative efficiency
<i>At demand side</i>	Subsidies / tax benefits	Customers themselves pay for basic payment service; indirect compensation of specific customers' costs related to basic payment services	- Welfare costs elsewhere in the economy because of distortionary taxation - Wasteful if customers do not spend benefits for intended purpose
	Vouchers	Customers themselves pay for basic payment service; direct compensation of specific customers' costs related to basic payment services	- Welfare costs elsewhere in the economy because of distortionary taxation

**Table 4.3:** Financing options related to the access elements of a USO

Table 4.3 illustrates that each way of financing generates its own welfare distortion. The table makes clear that, for concrete cases, a cost-benefit analysis should address the actual size of the distortions and compare them with the benefits to certain customer groups. Internal financing, as well as external financing through a compensation fund, all lead to distortions of allocative efficiency in the banking sector itself. The other ways of financing lay the burden outside the banking sector, making it possible that the load is carried by society as a whole. Given that banking services create externalities for the overall economy, it may actually make sense that all citizens (who all use banking services anyway) indirectly contribute to the USO cost. The added benefit is that the functioning of the banking services market, in particular competition in that market, is not distorted. On the other hand, difficulties in cost containment may arise. Overall, it will be clear that there is no straightforward answer to the question about the optimal way of financing a USO.

#### *Regional distribution of branch offices and geographical accessibility*

Table 4.4 gives an overview of all methods of financing related to the geographical elements of a USO. Note that the description of the USO implementation is different in tables 4.3 and 4.4, while the welfare costs associated with the different methods of financing are qualitatively the same (of course the actual cost level will be different for the two dimensions of a USO). Table 4.4 shows, just like table 4.3, that internal financing, as well as external financing through a compensation fund, create distortions of allocative efficiency in the sector itself, whereas the other ways of financing lay the burden on society as a whole, without distorting competition in the banking services market (but they may introduce other disadvantages and costs, as mentioned above).

Furthermore, in order to make a full cost-benefit analysis, technological developments like those sketched in subsection 3.4 should also be taken into account. Several of these developments, in particular those related to banking based on telecommunications and Internet technology, may offer more cost-effective ways to take care of the geographical

accessibility of banking services. It may, however, be necessary to help some customer groups to use these technologies. Note also that there are monetary advantages of living in rural areas, such as lower housing prices. Hence, overall it may not be a problem if customers in these areas have to make a greater effort to purchase goods and services. A general issue that has to be addressed by policy makers is whether the sector itself should be responsible for carrying the burden of the fact that, in certain areas, economic activity will always be loss-making, or whether a reduced supply of certain services in such areas is a more general problem of rural policy, related to living quality in rural areas.

Method of financing		USO implementation	Welfare costs
<i>Internally at supply side</i>	Cross-subsidies	USO providers are responsible for recovering cost of having branch offices at unprofitable locations	- Price distortions reduce allocative efficiency
	Mark-ups for the designated services	USO providers are responsible for recovering cost of having branch offices at unprofitable locations	- Price distortions reduce allocative efficiency
<i>Externally at supply side</i>	Transfer from the treasury	Government compensates cost of having branch offices at unprofitable locations	- Welfare costs elsewhere in the economy because of distortionary taxation
	Compensation fund	Sector compensates cost of having branch offices at unprofitable locations	- Sector may increase prices to recover costs, leading to reductions in allocative efficiency
<i>At demand side</i>	Subsidies / tax benefits	Customers themselves pay for travel costs; indirect compensation of specific customers' travel costs	- Welfare costs elsewhere in the economy because of distortionary taxation - Wasteful if customers do not spend benefits for intended purpose
	Vouchers	Customers themselves pay for travel costs; direct compensation of specific customers' travel costs	- Welfare costs elsewhere in the economy because of distortionary taxation

**Table 4.4:** Financing options related to the geographical elements of a USO

### 4.3 Policy discussion in the Netherlands

In the Netherlands, worries have been expressed in Parliament about basic banking services not being available or affordable for certain low income risk groups and about services no longer being available at the appropriate level in rural areas. A private member's bill has been proposed to ensure that such basic services will continue to be available everywhere, and for all citizens.<sup>54</sup> At the moment, the market offers adequate levels of service for most persons living in urban areas in the Netherlands. The bill would compel banks to ensure that basic payment services are accessible and available for all citizens, safely and at reasonable prices. In particular, if the package of basic payment services is – in the judgment of the Minister of Finance – insufficiently accessible in a certain geographical area, and if the Minister believes that the market would not guarantee delivery of such services, it is proposed that a tender for these services could be organized. In this tender, banks would compete for the right to offer basic banking services in this specific geographical area (not only to their own clients, but also to clients of other, competing banks). The bank asking for the lowest subsidy would win the bid.

The recent draft bill in the Netherlands states that throughout the country there should be bank offices, or at least service points (instead of ATMs), where the following transactions, known as basic payment services, could be made:

1. taking cash from a basic account;
2. transferring cash to the basic account;
3. transferring money from the basic account to the own savings account and vice versa;
4. changing Euro notes and coins into other Euro notes and coins;
5. receiving a debit card and a PIN code associated with the basic account;

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<sup>54</sup> The *initiatief-Wetsvoorstel toegankelijkheid en bereikbaarheid basisbetaaldiensten*: “Initiatiefwet Banken” (submitted 7 July 2004), and “Aanvulling op het wetsvoorstel ‘Wet toegankelijkheid en bereikbaarheid basisbetaaldiensten’ ” (submitted 24 September 2005).

6. transferring sums into e-money or cash or into the basic account;
7. opening another basic account or a savings account;
8. paying bills, including a means of paying in an expedited fashion;
9. any other transactions so designated by law.

The core provisions of the draft bill are as follows. First of all, Article 2 would oblige banks to ensure that basic payment services are accessible and available for all Dutch citizens, safely and at reasonable prices. In the previous subsections, we discussed the welfare implications of the various policy options, at some points illustrated with the case of the Netherlands. But first we note that policy makers considering the implementation of a USO should begin by addressing (i) the optimal composition of the designated minimum set of services and their quality levels (What is the optimal composition of the basic payment service? What are the optimal quality levels? Should the USO imply a uniform service level, or is it optimal to allow for differences across regions or customers?); and (ii) the desired availability and affordability (To whom, where, and at what prices should the designated services be available?). In particular, the composition of the basic payment service should be related to the actual needs of the customer groups targeted by the USO, and should be put in the perspective of technological developments. For instance, the emergence of banking by way of electronic communications (Internet, telephony) may alleviate the problem caused by an absence of branch offices at certain locations, especially if it is combined with assistance in the use of electronic communications for specific customer groups. It can be noted that, in its opinion on the draft bill, the *Raad van State* also seriously questioned the need for such a measure and the sufficiency of the reasoning put forward to justify the draft bill.

Secondly, beyond this general obligation imposed on all banks providing basic payment services, the bill also provides, in Article 3, for a specific mechanism if market forces (complemented with that general obligation) would not suffice. If, according to the Minister of Finance, the package of basic payment services is insufficiently accessible in a certain geographical area, and if the Minister believes that the market would not guarantee delivery of such services, the Minister can specify the terms of mandate

(*opdracht*) for the provision of these services and then organize a call for tenders. The mandate would specify the area and the services to be offered and the applicable restrictions, for instance, that each bidder commits to offering “guest use”.<sup>55</sup> In this call for tenders, banks would compete for the obligation to offer basic banking services in this specific geographical area, coupled with the right to receive compensation for the net costs of that service. The bank asking for the lowest subsidy would win the bid.

Participation in the call for tender is restricted to credit institutions. A bid has to specify, among other things, the net costs that the bidder expects to have and, ex post, the winner has to report the net cost. The draft bill defines “net cost” as the total cost made by the institution to comply with the request as far as not covered by contributions of users, minus the benefits associated with the offer, and allows the *WACC* as a return on capital. If the net costs have been sufficiently demonstrated, the winner will get paid the lowest of the actual net cost or the projected net cost specified in the bid. Note that this net cost might be difficult to determine.

The payments made to the credit institution that wins the mandate are to be financed by contributions made by all credit institutions offering basic payment services in the Netherlands, according to Article 5 of the draft bill. They will contribute in proportion to the revenue obtained from banking services in the Netherlands.

The scheme of the draft bill is to be put under the supervision of a regulatory authority, in this case, the Central Bank of the Netherlands.

It is beyond the scope of this report to analyze the elements of the draft bill. Basically, the welfare tradeoffs that were identified in previous subsections should guide any intervention in the market. In particular, a cost-benefit analysis that addresses the actual

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<sup>55</sup> “Guest use” means the bank would commit not only to offering basic banking services to its own clients, but also to allowing clients of other banks to make use of its basic banking services, even for transactions concerning a basic account in that other bank. As this could require information sharing, it might raise concerns with the antitrust authorities.

size of the distortions of different USO requirements and ways of implementation should be carried out, based on a consideration of all available options of financing a USO. The draft bill, however, proposes a particular method of financing the USO which involves a risk of inefficiency. More generally, although drawing conclusions at this stage would be preliminary, it can be argued that distortions of competition and allocative efficiency in the banking sector may be minimized when society as a whole carries the cost of a USO – note that, because of externalities, it is society as a whole that receives the benefits. However, as discussed in subsection 4.2, there are some drawbacks as well to this option as well. With regard to the provision of a basic payment package, there is little risk of distortions. With regard to geographical accessibility, designating all banks to be active in all areas does not seem to be efficient, because it would lead to cost duplication. In view of the technological developments related to banking based on telecommunications and Internet technology, as well as on various cross-sector initiatives that are taking place at the moment, more cost-effective ways may exist, although it may be necessary to help some customer groups to use these technologies.



## 5. CONCLUSION

This report started by setting out the general steps of designing and implementing a universal service. As a starting point, it must be made clear and specific what the policy goals of universal service obligations are. Once the policy objectives have been specified, the service/quality level definition of the universal service can be determined by addressing the following questions: What services should be available at a certain quality level and at reasonable or regulated prices? In which areas should the specified services be available? Supposing that the market process does not lead to the provision of the specified service/quality level, and given the delineation of the universal service, it is possible to determine if and, if so, which, firms are designated as universal service providers. Alternatives to designating certain or all firms in the market are franchising the obligation and relying on self-regulation by firms. Finally, a compensation mechanism may be designed and implemented that helps universal service providers to recover the cost caused by the obligation. The available options are: (i) letting USO providers take care of cost recovery themselves through cross-subsidies or mark-ups in their prices; (ii) creating a compensation fund in the market or using a government subsidy to compensate USO providers; and (iii) providing subsidies, tax benefits, or vouchers to consumers.

EC law – as reflected in the universal service regimes which have been developed in EC secondary legislation, and which are assumed to be representative of the state of EC law on the matter – imposes significant constraints on the use of the available options in order to minimize market distortions. In general, EC law follows the economic analysis and gives it legal strength. Whilst EC law does not impose a market failure test, it still requires Member States and EC institutions to comply with the principle of proportionality. Accordingly, since interfering with strategic and tactical considerations of firms may distort the functioning of a market, and hence reduce welfare both in the short and in the long term, the demarcation and implementation of a universal service should be limited to what is necessary to reach the specified policy objectives.

Both the characteristics of a country (demographics, the geographical nature) as well as those of a certain industry (cost and demand characteristics, the scope for innovation), will determine whether obligations are needed and, if so, how they should be defined, organized and implemented. Hence a country and sector-specific assessment of such characteristics and developments has to be made. In addition, technological developments in a sector are very relevant when assessing the desirability of universal service obligations. Indeed, there is no “one-size-fits-all” solution, neither with regard to different countries, nor with regard to different sectors.

With regard to the welfare tradeoffs of designing and implementing a USO, a cost-benefit analysis will be needed to draw final conclusions. Nevertheless, one can make some preliminary observations. Collective action by the sector pressured by the threat of intervention (“self-regulation”) seems the least intrusive one and should perhaps be considered first. Financing by the supply side (i.e., cross-subsidies, mark-ups in retail prices, or a USO fund in which all banks participate) may lead to distortions of allocative efficiency in the banking sector itself. An alternative is to let society as a whole carry the burden, which may be efficient as banking services create externalities for the overall economy, and distortions of competition in the market for banking services are avoided. Furthermore, designating all banks to take care of a limited USO (e.g., consisting of only a basic bank account service) may be effective in the case of a USO with minimal scope in the product dimension. However, if the USO has a geographical dimension, other options may be more efficient.

The observation that a cost-benefit analysis that addresses the actual size of the distortions of different USO requirements and ways of implementation should be carried out, applies in particular to the recent draft bill about affordability and accessibility of payment services in the Netherlands. In view of the technological developments related to banking based on telecommunications and Internet technology, as well as on various cross-sector initiatives that are taking place at the moment, more cost-effective ways may exist. Concerning technological developments, it may be necessary to help specific

customer groups to use new technologies, as they may be relatively complex for some people who are not used to them.

Without further analysis, especially of welfare costs and effectiveness of the very different options that exist, there is no obvious way of designing and implementing a USO. This observation is typically true for all sectors, and hence also for banking, as experience in sectors such as telecom and post may not correspond in a straightforward way to the banking sector.

As a concluding remark, let us note that generally speaking, a cost-benefit analysis on the different options of a USO, while excluding no option beforehand (including the option of not interfering), should be carried out as a starting point for policy. Based on that, the choice for the optimal instrument or mechanism can be made. Note that intervention is only called for if there is a problem, and moreover, a problem that is best tackled in the banking sector. Also, the intervention should lead to a welfare improvement. A cost-benefit analysis will require these issues to be addressed explicitly, before intervening.

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## APPENDIX 1: THE ANGLO-AMERICAN AND FRENCH MODELS

Although it can be argued that, in the meantime, the evolution of EC law has given “universal service” a distinctive European meaning,<sup>56</sup> there is no denying that the notion was inspired by Anglo-American legal systems in general, and by US federal law in particular. The main competing model in Europe was the French *service public* model. Both models will be briefly explained and compared below.

### *The Anglo-American model of universal service*

In the US, “universal service” first appeared in the Communications Act 1934. It is worth noting that at the outset, this notion was used to argue in favor of establishing a telephone monopoly in the US. Lack of interconnection between competing networks forced users to take up multiple subscriptions. This provided AT&T – then the dominant player – with the arguments to re-invent itself as a “universal service provider” and request to be endowed with a monopoly to carry out this vision. Such a monopoly was created and maintained until the liberalization of long-distance telephony in the 1970s, the break-up of AT&T in 1982 and the lifting of local telephone monopolies in 1996.<sup>57</sup>

In an ironic twist, the same notion was then invoked in the 1990s to support the lifting of remaining monopolies. With the obligation to make a certain level of service available to everyone at affordable prices, the universal service regime was meant to provide a safety cushion against an undesirable potential consequence of liberalization, namely the exclusion of certain groups of users.

### *The French model of service public*

Under French law, *service public* is a fairly inchoate concept used variously to identify the activities of the State, to designate the institutions carrying out these activities or even to delineate the realm of administrative law. These multiple meanings render that notion

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<sup>56</sup> See the Commission documents referred to *supra*, note 2.

<sup>57</sup> Debène and Raymundie (1996), pp. 183-184. See also Devroe (2000), p. IV-8.

difficult to understand, and even more difficult to transpose outside of the specific context of French law. The first meaning is of greatest interest here.

French law defines *service public* as “an activity of general interest, carried out directly by a public entity (*personne publique*) or delegated to another entity, usually a private one, which activity is subject to a specific legal regime (equality, evolutiveness, continuity)”.<sup>58</sup> This implies that the *service public* is a service of general interest for which the public authority deems that a collective need exists. The will of the authority thus plays a central role: it decides whether to undertake service provision itself or to delegate it to private operators which then receive special prerogatives. The three core principles of equality, evolutiveness and continuity should positively distinguish the *service public*, but in fact it can be shown that, nowadays, the user of the *service public* is in many respect put in a worse legal situation than if he or she was bound to a private entity by a contract reflecting contemporary commercial practices.

#### *Comparison of the two models*

The foregoing paragraphs show that the two models share a number of points.

- both are concerned with services of general interest;
- both include principles of equality, evolutiveness and continuity;
- in both models, the public authority undertakes responsibility for the service. This follows from the central role of the authority in the French model. In the Anglo-American model as well, the authority always remains the ultimate guarantor of the universal service, and as such it can never fully withdraw from at least monitoring the situation.

The last point already introduces the major difference between the two models. The French public service puts the polity ahead of the economy. The authority determines what is a public service and then takes care of providing it or delegating it to a private

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<sup>58</sup> Debène and Raymundie (1996).

party which receives prerogatives. The authority is thus directly involved by the provision. There is no assessment of whether the market could deliver on the policy objectives and little attention is paid to the impact of *service public* on the functioning of the market. Rather, it is more or less assumed that the *service public* is entirely removed from the realm of the market economy. In contrast, the Anglo-American universal service model, as taken over at the EC level, rests on a dialogue between the polity and the economy. Through political processes, the public authority defines policy objectives concerning the provision of universal service, and then proceeds to intervene if and to the extent that the market would not in and of itself fulfill these objectives. At each step in the process, care is taken to minimize the impact on the economy.

It follows that *service public* tends to be conceived primarily in national terms (i.e., a national provider), whereas universal service can in principle be provided by any firm.

The supporters of *service public* often criticize the notion of universal service for focusing on minimal baskets of services that must be available to every citizen, i.e., a sort of service public for the poor and needy. In contrast, *service public* is presented as more global, embodying a vision of how the service should be provided in general, with room for considerations of industrial policy or technological evolution.

Finally, it can be noted that universal service includes principles such as quality standards and affordability, which are not part of the core of *service public*. In all fairness to French law, it should also be underlined that, under the influence of developments at EC level, the doctrine of *service public* has been slowly moving in the direction of universal service, so that the theoretical differences which may appear striking at first glance do not necessarily translate into massive divergences in practice.