Developments in the Nordic financial industry - a central banker's perspective

Address by Governor Svein Gjedrem, Nordic Financial Services Conference, Stockholm 18 September 2000

What is the future of the Nordic financial services industry? Who are the winners in the consolidation process? What is the potential of e-business and the Internet?

This is just a sample of the important and challenging questions that will be discussed at this conference. Fortunately, it is the task of my fellow speakers - and not mine - to try to answer them. Given their background as significant market participants, I am sure that they will provide us with some valuable insights.

Today, most central banks follow structural developments in the financial sector from the sidelines. This has not always been the case. The post-war period was characterised by heavy regulation. The domestic authorities controlled market prices, financial flows and the structure of the financial sector. There was little foreign influence. Gradually, markets were deregulated and became more internationally integrated. The central banks' main instrument is now the setting of interest rates. The main objectives of central banks have stayed the same: monetary and financial stability.

Although deregulation is now completed in the industrialised countries, its full impact on the financial structure remains to be seen. In addition, technological developments, internationalisation and increased focus on shareholder value are creating pressures for structural change.

Together, these forces are reducing the cost of providing traditional financial services and are paving the way for new ways to channel savings and manage risks.

Structural developments in the financial sector can be important for monetary and financial stability. Central bankers thus follow developments with great interest. Today I will examine some aspects of the changes taking place and their potential consequences for monetary and financial stability.

Let me run through the structure of my speech. First, I'd like to touch upon some characteristics of the Nordic economies as a background to the financial sector issues I will discuss later. Second, I will define the two stability terms that I have just introduced. Third, I will discuss the growing importance of securities markets. I will then reflect upon cross-border integration in the banking sector and consequences of the Internet. Finally, I will take a quick look at what challenges structural changes may pose to the authorities, and then conclude.

Some characteristics of the Nordic economies

The economies of the four largest Nordic countries have some well-known features that distinguish them from most other developed countries.

For a start, they all have fairly large public sectors, as illustrated by the level of public sector employment. Compared with Anglo-Saxon countries, the differences are striking. The large public sectors are the result of a deliberate choice to ensure equal access to certain services like health care.

The emphasis on equality and social security also underlies the "cradle to grave" public welfare systems in the Nordic countries. These systems require large public transfers.

Both the large public sectors and the high level of transfers necessitate a high level of taxes. In addition, the tax systems have been focused on redistributing income.

Another Nordic feature is the high share of labour union membership. Wage negotiations have traditionally been rather centralised and income is fairly equally distributed.

There is a risk that these features of the Nordic societies weaken both incentives and competition. In that sense, the Nordic countries clash with the "Anglo-Saxon model". However, both the standard of living and other general indicators of well-being are at the top internationally. Hence these countries must also possess growth-enhancing characteristics. The most important is probably their openness both to trade and the exchange of know-how. We also like to think that the traditional working ethic of the Nordic people is still in place and plays an important role. Nordic enterprises have shown flexibility in adapting to changing market and technological conditions. The restructuring of the financial industry is a relevant example.

There are also differences between the Nordic economies. One such area is industry structure.

Sweden and Finland both have relatively large manufacturing sectors. They have some major industrial and technological "locomotives", in addition to a pool of small companies. Several of these are suppliers to the larger companies.

Denmark has many small and medium-sized enterprises. Perhaps due to location and transport links, Denmark is a centre for trade and the location for the Nordic headquarters of a number of international companies. The Norwegian enterprise sector, on the other hand, is heavily influenced by our natural resources.

Monetary and financial stability

I would now like to address the key objectives of most central banks: monetary and financial stability. What do these two terms mean?

Monetary stability is interpreted somewhat differently in various countries. The most common definition is price stability - that is to say the stability of the internal value of money. Sometimes it is interpreted as exchange rate stability - in other words the stability of the external value of domestic money.

Finland, Sweden and Norway all experienced severe banking crises in the early 1990s. Most people in these countries have a clear idea of what a financial crisis is. In a sense, financial stability is the absence of financial crises. A robust financial system has solid cushions that reduce the risk of problems spreading from one institution or market to other institutions or markets, or across borders. This risk constitutes a systemic risk, which is the risk of failure of the financial system.

Disturbances that might develop into a systemic risk can be transmitted through financial institutions and financial markets. Robust institutions and stable markets are thus important. Robust institutions are solid institutions that enjoy general confidence. Stable markets are markets where there are no "excessive" price variations.

Banks are in a special position. They transform short-term deposits into long-term loans. They are responsible for payment settlements, and bank deposits serve as a means of payment. The volume of amounts outstanding in the interbank market is sizeable. As a result, problems in one bank may rapidly spread to other banks. The financial strength of banks is thus important for financial stability, even more so in countries where banks are the main financial intermediaries.

Long-term profitability has a decisive influence on financial strength. Obviously, there are many factors that can influence the future profitability of banks. The topics you will discuss during these two days are of great importance.

Financial unrest spreads through payment and settlement systems. These systems can also be a source of risk. This occurs when banks credit customers before they have received settlement from the payer bank. Payment and settlement systems must thus be designed to reduce settlement risk. This is an issue high on the agenda of most central banks.

Interdependence of monetary and financial stability

The objectives of monetary stability and financial stability are interdependent. High - and thereby in practice varying - inflation and unstable exchange rates can threaten financial stability through several channels:

First, it is more difficult to assess the risk of an investment project. Inflation makes it difficult to differentiate between a change in prices for a good or service and a change in the overall price level. It makes it more difficult to determine the discount rate to be applied.

Second, fluctuations in the inflation rate are often accompanied by interest rate variations. A sharp rise in interest rates can also result in substantial losses on financial assets such as bonds and equities. Loans that have been granted against collateral in the form of such assets are even more exposed to losses.

When rising inflation and inflation expectations necessitate a substantial tightening of monetary policy, a crisis may ensue. In several countries the financial system has been on the verge of collapse during such a period of adjustment. This was the case in the US in the early 1980s and in the Nordic countries around 1990.

Interest rates are the central banks' most "direct" tool for contributing to both monetary and financial stability. Financial stability primarily contributes to price and exchange rate stability by facilitating the use of policy instruments for monetary stability purposes. Unstable institutions and markets constrain the use of interest rates. Tighter liquidity and higher interest rates may increase the uncertainty concerning the stability of the financial system.

This suggests that situations may occur where there is a conflict between the two objectives. Asset prices are an important link between monetary and financial stability. For example, a surge in property prices, with a risk of a subsequent fall, may threaten to undermine banks' collateral and increase loan losses. This can put financial stability at risk. A surge in asset prices without accompanying pressures on prices for goods and services raises a dilemma for central banks. There is no consensus on how to handle this dilemma. Central banks have avoided targeting specific asset price levels. Nevertheless, history provides some examples of when more emphasis might have been placed on asset price developments in the formulation of monetary policy.[1]

Structural changes in the financial sector have the strongest impact on monetary stability through the way it may alter the transmission mechanism of monetary policy. For example, if structural changes increase competition in the banking sector, banks may adjust their retail interest rates more rapidly in response to changes in central bank and money market rates. This means that monetary policy may influence savings and investment decisions more quickly.

The four largest Nordic countries have chosen different monetary policy regimes:

- Finland is part of the euro area,
- Denmark is a member of ERM II,
- Sveriges Riksbank targets inflation,
- whereas Norges Bank focuses on long-term exchange rate stability.

I want to emphasise that the objectives of monetary and financial stability can be achieved by different regimes, including the ones chosen by the Nordic countries. Denmark has for several years run a successful fixed exchange rate regime. Denmark's success must be seen in the light of a combination of factors. First, ERM membership and Denmark's long-term commitment to a stable exchange rate have enhanced confidence in the current regime. Second, fiscal policy has successfully supported the fixed exchange rate. For many other countries with less economic policy discipline, traditional fixed exchange rate regimes have proved fatal. Internationally, there is a tendency of a shift away from the traditional fixed exchange rate regime. Countries that place overriding emphasis on exchange rate stability must bind themselves more firmly to the mast either by establishing a currency board or by abandoning their national currency. Other countries allow their currency to float and establish a nominal anchor such as an inflation target.

The growing importance of securities markets

Let me now turn to an important structural development in the financial sector: the growing importance of securities markets.

In most developed countries, securities markets are growing at the expense of financial intermediation. In the Nordic countries, this trend is most obvious in the savings market. Sweden is an example. Deposit savings have been reduced, whereas savings directly or indirectly in securities markets have increased. This affects banks' earnings and funding structure. The trend is similar in Norway.

In the euro area, there has been a sharp growth in issues of private securities after the introduction of the single currency. This growth was to some extent expected, as the common currency creates a huge investor base for security lending. One particular factor that contributed to the strong growth was the considerable number of business takeovers and mergers in 1999, perhaps influenced by the euro. Securities are a common form of financing such operations. A growing number of small, higher risk companies could also make use of this market.

In general, the euro is having a considerable influence on the development of securities markets in Europe. A number of factors are improving market liquidity and efficiency, for example the elimination of exchange rate risk, greater price transparency, harmonisation of market practices and changes in market infrastructure.

In most European countries, credit has traditionally been channelled through financial intermediaries such as banks. The structure is different in the US, where the securities markets are larger and the banking sector is smaller.

Among the Nordic countries, Finland has the largest stock market capitalisation relative to GDP. This is mainly due to one company, Nokia. Sweden also has a comparatively large stock market. This can perhaps be seen in connection with the structure of the enterprise sector in Sweden, which has been dominated by some very large, export-oriented companies. This economic structure might also have contributed to the development of Sweden's relatively large and internationally active banks. Denmark and Sweden have relatively large debt securities markets. This is mainly related to house financing.

Larger and more efficient securities markets - both in equities and debt instruments - provide more financing alternatives for companies and investment alternatives for savers. Companies financed in the securities markets are continuously monitored through a transparent process. Well-functioning securities markets may thus increase the profitability of capital and hence economic growth, by making sure that capital is allocated to the best new investment projects and by facilitating the restructuring of existing companies. In other words: competition for capital contributes to creative destruction.

In my opinion, larger and more efficient securities markets will also reduce the risk of financial instability. Let me give you a recent example. The Long Term Capital Management crisis in 1998 showed that banks and securities markets can complement one another in crisis situations. During the crisis, the market for securities with credit risk dried up for a short period. Banks then increased their lending, and thereby averted a more extensive shortage of credit. More frequently, financing through securities markets has been used as a substitute for bank loans in the event of banking problems. The goal of financial stability thus implies both well-functioning banks and securities markets. The optimal balance between the two is difficult to define, but in most countries - including the Nordic countries - the financial system would be more robust with larger, more developed securities markets than is the case today. This could also enhance the growth prospects of the respective economies.

Developments in the banking sector

Having discussed the relationship between banks and securities markets, I would now like to turn to developments within the banking sector.

Competition in the banking markets is increasing. Banks face competition from other banks and financial institutions. As mentioned, there is also increasing competition from securities markets on both sides of the balance sheet. In addition, new operators are entering the market, either on their own or in co-operation with existing market operators. Distribution of financial services on the Internet is one example. Joint ventures between supermarkets and banks is another.

Unless the banks adapt to this new environment, their long-term profitability might suffer. The restructuring of the banking industry can be viewed as an attempt to respond to these competitive pressures.

Cross-border integration

In the last few years we have experienced a wave of mergers and acquisitions in the financial industry. Internationally, consolidation within countries has been predominant. This indicates that reducing costs and strengthening market position are often the preferred strategies. However, the development of "national champions" might be a run-up to increased cross-border activity.

The Nordic and Benelux countries are important exceptions to this international trend. The five largest Nordic banking groups - MeritaNordbanken and Unibank - which are now part of Nordic Baltic Holding - Handelsbanken, FöreningsSparbanken, Den Danske Bank and SEB - all define the Nordic region as their home market. They have established branches, co-operations and merged with or acquired institutions in other Nordic countries. Some of them also focus on other countries in Northern Europe, such as the Baltic states, Poland and Germany. However, their business strategies vary somewhat.

What is the reason behind this Nordic expansion? It is easy to point to integrated markets, through trade and direct investment. However, this cannot be the only explanation as there are also other neighbouring countries in Europe that are closely integrated. A common history, small cultural differences and similar languages - at least within the Scandinavian countries - are probably of particular importance to Nordic integration.

There are also more industry-specific explanations. Strategic positioning - perhaps as a defensive measure against competition from non-Nordic institutions - is one explanation. It could also be that Nordic expansion is just a first step towards further international expansion, perhaps in selected market segments. I'm sure there are people in the audience who are better qualified to predict future developments than I am. I will instead focus on another important issue: production costs and the size of markets.

Geographic expansion gives institutions an opportunity to sell existing products to new customers in new markets. As a result, the institutions can spread their costs over a larger customer base. However, one may question whether regional or national markets or even the Nordic market - at least in some product segments - are large enough to give the institutions' production activity the necessary size. This raises the question of whether to separate production and distribution. Many institutions, particularly smaller ones, may find it beneficial to distribute other companies' products. Different co-operation agreements make it possible for small players to offer a broader product range than they would have been able to on their own. We have seen several examples of this in Norway, particularly among savings banks. At the same time, some larger institutions may benefit from offering their products for distribution through other institutions.

This may contribute to keeping Nordic banks - both large and small - competitive in the retail market. In the segment of large enterprises, however, production and distribution are perhaps more difficult to separate. This may imply that many Nordic banks are too small to compete for the business of large and advanced customers. Competition in this segment is perhaps more international than Nordic.

How does cross-border integration change the risk outlook for the financial system? If it improves the long-term profitability, and thus the robustness of institutions, it is clearly advantageous. Spreading production costs over a larger customer base may improve profits. In addition, cross-border competition might lead to efficiency gains and a spillover of best practices. However, there are also counter-arguments. For example, increasing the size of operations may reduce management focus.

In general, more integrated financial markets can spread financial unrest between countries more easily. This could have a negative effect on financial stability. On the other hand, banks with activities in several countries should be in a stronger position to cope with a recession or a crisis situation in a given country than banks whose activity is confined to one single country. This is positive from a financial stability point of view.

The Internet as a distribution channel for financial services

Let me now turn to the impact of the Internet on the banking and financial services industry.

The Internet creates new opportunities for traditional banks. For example, banks should be well positioned to become key operators in trading on the Internet. They have a large customer base and strong brand names, and can offer payment transmission services, advertising space and links on their home pages. Internationally, many banks have agreements with Internet or telecommunication companies for the development of Internet banking and marketplaces on the Internet. This is probably just the beginning of a trend towards increased co-operation across industry boundaries.

The Internet poses great challenges as well. It is clearly intensifying competition in the industry. This is partly because it is easier for customers to compare prices and terms and partly because it is simpler for new operators to penetrate the market. The Internet may also change the relative positions of existing market participants.

Many Nordic banks have established some form of Internet banking. So far, most services offered on the Internet are relatively simple, for example loan applications, bill payments and account transfers. These are probably the most important services for the majority of customers. Several banks also offer trading in shares and fund units on the Internet. The product range and user-friendliness can be expected to increase in the period ahead. I'm sure discussions during this conference will give you an indication of future product developments.

Nordic countries rank at the top globally in terms of access to the Internet. Nordic banks thus have a unique opportunity to serve a substantial share of customers via the Internet. This also has relevance to cross-border integration. Banks that focus on Internet distribution are perhaps particularly interested in markets where there are many Internet users.

Although estimates vary, it is safe to say that the Internet will significantly reduce the banks' variable costs. However, substantial IT investments may be necessary to keep pace with technological and market developments. In isolation, this may contribute to increasing banks' fixed costs.

As a result, the competitive environment may change. There is a danger of over- investment. Sunk costs account for a large share of overall costs. This may lead to marginal pricing as the fight for volume intensifies. This could have a negative effect on bank profitability.

Many Nordic banks have a smaller customer base for distributing fixed costs than large foreign competitors. As mentioned, some banks have tried to compensate by entering into co-operation agreements. However, it might be difficult to reduce total costs without a substantial reduction in the costs of more traditional distribution. Banks are thus facing a challenge with regard to a further scaling back of the physical distribution network.

In general, financial institutions are facing considerable challenges in adapting to new technologies, intensified competition and globalisation. Substantial investments will probably be required to keep them competitive. Both management and employees will have to devote considerable attention to these aspects. The wrong solution or approach could weaken banks' competitive position, profitability and financial strength. This may also have negative implications for financial stability. However, I don't want to give you the impression it's all doom and gloom. New technologies offer great opportunities for streamlining operations and improving efficiency. There should also be new business opportunities. Although the financial sector is undergoing fundamental changes, competent market participants should have every opportunity to thrive in a changing environment.

Consequences for the authorities

Developments in the financial sector also pose challenges for the authorities. Let me give you a few examples.

The growth of complex financial conglomerates represents considerable challenges for supervision and crisis resolution. The international trend towards one national supervisory authority is probably advantageous in this respect. The Nordic countries have led the way here.

The growth of institutions with a significant presence in several countries has increased the need for co-operation between the authorities of different countries. Bilateral and multilateral memorandums of understanding are an important tool in this respect. The Nordic supervisory authorities have recently signed a joint memorandum of understanding.

The activities of central banks are also influenced. If systemically important domestic institutions expand abroad, central banks - with responsibility for financial stability - will have to assess the risks involved. In addition, structural changes also influence central banks' role as "lender of last resort".

Although structural changes alter the risk profile of the financial system, they shouldn't be viewed as negative. On the contrary, these changes may be necessary to reap the benefits of more efficient intermediation of savings and better risk management. Changes are thus something the authorities should facilitate and adapt to - through high quality supervision and surveillance and through regulatory changes if necessary. Currently a variety of regulatory initiatives are being discussed. Important examples are the EU Financial Services Action Plan, the revision of the Basle capital accord, and the different initiatives gathered under the heading of "New Financial Architecture". However, as the current wave of consolidation progresses, the authorities must take the necessary steps to ensure an adequate level of competition. While executing this task, the authorities should recognise that the competitive environment of the financial sector has changed and will continue to do so.

Furthermore, it is important that the market surveillance function is improved. Increased transparency and harmonisation of regulation and industry practices are particularly important in this respect.

However, enhanced supervision, international co-operation and regulatory changes are not enough. Improving institutions' own risk management systems is a key challenge. It is vital that these systems develop as the structure and activities of institutions change.

Conclusion

Finally, I would like to make a few concluding remarks. Finland, Sweden and Norway all experienced a severe banking crisis in the early 1990s. That taught us how costly financial crises can be, and how important it is to prevent their recurrence.

In the last 20 years three-quarters of IMF member countries have experienced a banking crisis. Not even a perfectly healthy macroeconomic policy and an effective supervisory system constitute a guarantee against crises if participants in the financial sector behave imprudently. The most important preventive measure is thus to promote prudent behaviour. The authorities will contribute to this end. However, I would like to emphasise that responsibility for sound practices primarily rests with market participants themselves.

Banks are at the core of the financial system, and will probably remain so in the foreseeable future. However, they face increasing competition from several quarters. Unless banks adapt to this new environment, their profitability and financial strength might suffer and they may be tempted to engage in unhealthy risk taking. The authorities should look at the restructuring of the banking industry with an open mind. Structural changes may be necessary to reap the benefits of factors such as new technology and globalisation.

Thank you for your attention.

Footnote:

[1]Japan in the late 1980s has been mentioned as one example. Cf. Bernanke, Ben and Mark Gertler: Monetary policy and asset price volatility, and Yamaguchi, Yutaka: Asset price and monetary policy: Japan's experience, in New challenges for monetary policy, Federal Reserve Bank of Kansas City (1999).