The Competitive Edge of the Nordic Financial Sector

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Research Project: “Nordic Finance and the Good Society”

- A research project on how the financial sectors can stand strong in the future and create more jobs
  - The project will focus on business strategies and governance, but will also address policy and regulation issues

- Through a number of research articles and a concluding report, the project aims to find new Nordic strategic profiles for the financial sectors, which can be a road to growth

- Global research team (CBS, IMD, Yale, Oxford, SDU, AAU, KU, Hanken, Lund etc.) with more than 20 researchers

The initial research is supported by leading players:
- Industry Players: Danske Bank, Carnegie and SparInvest
- Political support: Nordisk Råd
- Unions: Finansforbundet and Nordic Financial Unions
- Industry associations: Finans Danmark and Lokale Pengeinstitutter (LOPI)
- Educational institutions: CphBusiness, Copenhagen Business School (CBS)

- Funding of DKK 12 mil is secured – The project runs through 2018.
The New Landscape
Understanding the New Normal: The Role of Demographics

- We have a rapidly aging population - both in the US and in Europe

- Real impact on GDP: 1.25 % on (40 % drop compared to the past) (Source: Gagnon, Johansen, etc)

- Abundance of capital (which used to be the scarest part in the previous decades)

- Very different risk profile with a changing age profile
3 Megatrends are Challenging the financial Sector

- New business models and digitalization
- Regulation (EU/Nordic standards)
- New demand patterns (consumers and B2B)

These factors and general framework conditions will decide the future of the current players.
Risk of Hypercompetition

The issue of some industries exposed to hypercompetition was highlighted already by Schumpeter in the 30’s - and later on by D’Aveni.

Their findings are:
- Speed of change is industry-specific
- Competitive advantage is only transitory
- Continuously focus on innovation and recreating business model
- “The winner takes it all” - syndrome

In Europe, the typical industries exposed to hypercompetition are: IT, telecom, medicine (expiry of patent) and **now the financial sector**
Consolidating Taxonomy in the Financial Sector

- Market Structures
  - New market-platforms
  - Better and faster machines

- Payment
  - Nex methods of payment
  - A cashless society

- Investment
  - reinforced investors
  - Eksternal processes

- Deposit and Loans
  - Alternative loans
  - Changing consumer preferences

- Insurance
  - Insurance division
  - Composite insurance

The Risk of New Generation Business Model for the Incumbents

- “The winner takes it all” - syndrome (PayPal, Mobilepay, etc.)

- Speed (market penetration) is exceptional fast

- They are scalable and in many cases born as global players

- New players have very little fixed overheads (no branches, no legacy costs, different employee costs, etc.) compared to the current industry incumbents
De-regulation

- Collapse of Bretton Woods (in 1971)
- Movement of Capital (EU)
- Borderless Society

New Regulation

- Basel II / Basel III
- Capital Market Directive
- MiFID
- Investment Service Directive
- Etc.

Avalanche of new regulation
We are inside the limits of the EU rule book, but...

- What should be our guiding corporate governance model? (Nordic, French, Anglo-Saxon, etc.)

- The local FSA and what will be their role towards the local industry? Latest changes and signals might open up for a new dialogue

- Could Nordic regulation become a competitive advantage?

- The Nordic sector isn’t measured against other leading financial sectors
Are Traditional Banks a Good Investment?

- Regulation will mean smaller returns for shareholders (and need for more capital)
- Low inflation will create lower margins
- Studies (from Switzerland) shows that returns will fall with 6-8%
- This will create less interest in investing in banks
Interest Margins are Declining

New Players:
- Santander
- Norwegian
- IKANO
- Maersk
- Etc.

Will create additional pressure
Market Expectations for Companies Listed on the Stock Exchange

The Stock Market tends to favor:

- (-) Growing markets (low inflation, aging population, etc.)

- (+) Predictable business models

- (+) High margins (The Nordic has 50% cost/income ratio)

- (+) Stable income (Yes, in the current environment)

- (-) Well-defined risks and low political risks

<table>
<thead>
<tr>
<th>Category</th>
<th>RoE Target</th>
<th>No RoE Target</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Size</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Aktiver (billions of dollars)</td>
<td>670 62.70 139.00 3,621 6.00 26.90</td>
<td></td>
</tr>
<tr>
<td><strong>Earning and Management</strong></td>
<td>669 8.03 9.85 3,619 5.44 30.03</td>
<td></td>
</tr>
<tr>
<td>Return on risk-weighted assets (RORWA)</td>
<td>619 3.47 57.40 2,646 15.26 457.36</td>
<td></td>
</tr>
<tr>
<td>Cost-to-income ratio</td>
<td>658 61.43 39.77 3,543 62.25 39.26</td>
<td></td>
</tr>
<tr>
<td><strong>Asset quality</strong></td>
<td>666 5.18 6.32 3,618 6.35 13.12</td>
<td></td>
</tr>
<tr>
<td>Non-earning assets to total assets</td>
<td>619 0.26 0.52 2,647 0.03 0.09</td>
<td></td>
</tr>
<tr>
<td>Loss on loans</td>
<td>633 0.49 1.22 3,199 1.15 12.67</td>
<td></td>
</tr>
<tr>
<td>Total risk-weighted assets (billions of dollars)</td>
<td>619 0.26 0.52 2,647 0.03 0.09</td>
<td></td>
</tr>
<tr>
<td><strong>Capital adequacy</strong></td>
<td></td>
<td></td>
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<tr>
<td>Total capital ratio</td>
<td>654 17.57 17.97 2,842 19.28 13.42</td>
<td></td>
</tr>
<tr>
<td>Tier 1 capital ratio</td>
<td>591 16.15 18.97 2,336 17.89 13.34</td>
<td></td>
</tr>
<tr>
<td>Equity-to-total assets</td>
<td>670 8.84 8.85 3,620 14.24 17.40</td>
<td></td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td>606 43.54 288.25 2,995 528.6 219,283</td>
<td></td>
</tr>
<tr>
<td>Loan-to-deposit ratio</td>
<td>657 41.46 87.04 3,388 28.82 69.22</td>
<td></td>
</tr>
<tr>
<td>Liquid assets to deposits and short-term funding</td>
<td>657 41.46 87.04 3,388 28.82 69.22</td>
<td></td>
</tr>
<tr>
<td>Deposits and short-term funding to total liabilities</td>
<td>667 60.64 26.34 3,451 79.90 25.85</td>
<td></td>
</tr>
<tr>
<td><strong>Dividend</strong></td>
<td></td>
<td></td>
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<tr>
<td>Dividend payout ratio</td>
<td>130 43.91 62.31 194 43.40 57.78</td>
<td></td>
</tr>
</tbody>
</table>

Only in 40 % of the cases were RoE targets achieved.
# Do we have the right Nordic ingredients?

<table>
<thead>
<tr>
<th>Cases</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mortgage system</td>
<td>Conceptually the best world</td>
</tr>
<tr>
<td>Private Equity</td>
<td>Strong pool of players</td>
</tr>
<tr>
<td>Ship financing</td>
<td>Norway, a global leader</td>
</tr>
<tr>
<td>Start-up / IPO</td>
<td>Number one in Europe</td>
</tr>
<tr>
<td>Asset Management</td>
<td>Nordic managers are ranked in the top by Morningstar</td>
</tr>
<tr>
<td>Pension system</td>
<td>OECD = best in the world</td>
</tr>
</tbody>
</table>
But – Classic Nordic Business Models

Current challenges:

- They are **not initially created as global business models** (exceptions are few (Saxo Bank))
- **Younger consumers love their brands** and are not loyal to their bank or financial advisors
- **It is based on higher margins.** This is problematic when margins suffer from low inflation, growing competitiveness, and increasing regulation
- **Wrong IT platforms.** They are often from a time with mainframes and datacentres.
- Employees’ competence profiles are being challenged.
- **Are capital intensive** (Can they create a reasonable return for the shareholders?)
A Sustainable Sector?
The Solution of Fundamental Problems in the Society – The Big Picture

- The real estate market is responsible for up to 50% of all CO2 emissions on a global plan (forget about your car, air travels or shipping transport, etc.)

- The movement from countryside to urban area is 2.5% annually

- In 2050, MRSA resistance will be a bigger killer than cancer

- 50% of all young women will live to be more than 100 years old
The Responsibility of the Financial Sector

- 60-80 % of all buildings are financed by different debt-products, primarily from banks and mortgage institutions – but no special CSR lending

- Aggressive lending is leading to real estate bubbles in all major cities in Europe

- Farmers have a limited equity (10 – 20 %)

- People with savings expect their pensions to correspond to their needs (but all players are moving from defined benefits to defined contributions)
Transition Mechanism

All banks and financial institutions are intermediaries between lenders and borrowers. Therefore, they have a big influence on:

- Which sectors will grow or die............. (Lending to SME’s)
- Destinies of individual companies (most companies in Europe are still financed by debt)
- Growth and opportunities for each citizen
Consumer Demand and Perception
Time for New Business Models?

The market determines where the demand will be largest in the future – Nevertheless:

- European companies would like to have the right capital structure (which demands the right combination of equity and debt). Should banks only be providing loans?

- Financial advice is essential. Many customers would like to have access to new financial products but in an independent way.

- Platforms for pooling of risks (housing / cars, etc) - Old Nordic model
The Consumer Test - Sharing of Goods and Services
Perception of the Financial Sector

- This is a general area of concern and wrong perception "Investors are old, male and cigar smoking"
- We need to highlight the link to growth, start-ups and regional development in order to change this picture
- Female profile
Perception – Choice of Brands

Consumers
- There is no other sector where **trust and brand values are so important** as in the financial sector (Source: Quelsch, 2003, Park, 1999)
- Traditionally, less than 3% of the consumers changed banks (Source: Danske Bank) but unfortunately:
  - Many consumers have lost their trust in their banks during the crisis.
  - Only 4% of the younger customers (under 35) has no relation to branch office or a financial advisor.

Brands
- A brand is unique and almost impossible to copy (Source: Aaker, de Chernatony)
Financial Literacy – A Global Problem

The fundamental problems are:

- Only one in ten students across participating OECD countries and economies is able to tackle the hardest financial literacy tasks (OECD 2012)
- A 2015 Standard & Poor study on global financial literacy found that just 30 - 35% are literate
- Gender gaps in financial literacy or “The Gender Gap That No One’s Talking About” (Huffington Post – August 2016)

Unique opportunity to create a new perception of the financial sector
Are there growth opportunities from a Nordic perspective?

<table>
<thead>
<tr>
<th></th>
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</thead>
<tbody>
<tr>
<td>Nordic Countries</td>
<td>1.7</td>
<td>26 mil.</td>
</tr>
<tr>
<td>EU</td>
<td>1.5</td>
<td>338 mil.</td>
</tr>
<tr>
<td>USA</td>
<td>1.8</td>
<td>319 mil.</td>
</tr>
<tr>
<td>China</td>
<td>8.7</td>
<td>1357 mil.</td>
</tr>
<tr>
<td>India</td>
<td>3.9</td>
<td>1252 mil.</td>
</tr>
<tr>
<td>Korea</td>
<td>5.4</td>
<td>50 mil.</td>
</tr>
<tr>
<td>Singapore</td>
<td>4.5</td>
<td>5 mil.</td>
</tr>
<tr>
<td>The World</td>
<td>1.4</td>
<td>7,300 mil.</td>
</tr>
</tbody>
</table>

Source: World Bank 2015

Growing middle class +1 mia.
We are part of the largest financial market in the world (EU).
Export possibilities – An opportunity?

- The European Banking and Capital Market Union will open for an unprecedented market of financial services to more than 508 mil habitants.

- Increasing demand for saving products and the European asset management industry grew annually alone with + 5 % from 2008 to 2015 (source: Mckinsey)

- Strong potential export platform (Nordic Corporate Governance, competencies, ratings, IT infrastructure etc.)

- But the Nordic export track record outside the asset management and IT industry is limited.
Do We Have Other Parameters of Competitiveness – Are the Nordic Countries Unique?

<table>
<thead>
<tr>
<th>Parameter</th>
<th>Nordic average rank</th>
<th>Other countries’ average rank</th>
<th>F-test</th>
<th>T-test</th>
<th>T-test as control of BNP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legislation</td>
<td>3.6</td>
<td>106.1</td>
<td>837.31***</td>
<td>29.84***</td>
<td>2.79***</td>
</tr>
<tr>
<td>Government effectiveness</td>
<td>4.6</td>
<td>104.0</td>
<td>658.04***</td>
<td>25.65***</td>
<td>1.94*</td>
</tr>
<tr>
<td>Quality of regulation</td>
<td>11.4</td>
<td>103.8</td>
<td>250.61***</td>
<td>15.83***</td>
<td>0.81 ns</td>
</tr>
<tr>
<td>Control of corruption</td>
<td>4.0</td>
<td>104.2</td>
<td>662.89***</td>
<td>25.75***</td>
<td>2.67***</td>
</tr>
<tr>
<td>Vote and responsibility</td>
<td>4.3</td>
<td>106.1</td>
<td>583.07**</td>
<td>24.15***</td>
<td>3.52***</td>
</tr>
<tr>
<td>Political stability</td>
<td>14.3</td>
<td>104.3</td>
<td>219.96***</td>
<td>14.83***</td>
<td>2.13**</td>
</tr>
<tr>
<td>Leadership in general</td>
<td>3.9</td>
<td>106.6</td>
<td>682.54***</td>
<td>26.13***</td>
<td>2.75***</td>
</tr>
</tbody>
</table>

Kilde: Steen Thomsen, 2014
Global Competitiveness & The Financial Sector

- **Competitiveness** pertains to the ability and performance of a country or company to sell and supply goods and services in a given market.

- Empirical observation confirms that resources (capital, labor, technology) and talent tend to concentrate geographically (Easterly and Levine 2002).

- The process of “clusterization,” the creation of “value chains,” or “industrial districts” highlight the advantages of networks.

Could the Nordic region become a leading financial cluster?
Nordic Digitalization compared to other countries

The Nordic countries are leading EU digitalization

Source: The European Commission
Digitalization and technology

Overall, The Nordics are basically ready for this challenge

- **Factor conditions:**
  - Infrastructure
  - Employees & Competencies (but training is required)
  - Demand and customers willing to test new technology
  - Increasing strong start-up scene and strong fintech environment
The Nordic financial sector is challenged both nationally and internationally.

However, EU and globalisation gives unique growth possibilities for the Nordic banks.

Nordic financial sector is large and diverse in size.

Strong business models are in place.