The ICA Publication Series

# Consultation paper on competition in the financial market

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# 1. Introduction

One of the factors that will play a key role in the resurrection of the Icelandic economy is the manner in which financial activities will be conducted here. Conditions in financial markets will dictate how successful the business sector and individuals will be in building solid foundations for their future prosperity.

There have been sweeping changes to the scope and nature of banking operations in Iceland following the collapse of the banks. Icelandic banks now operate almost exclusively in the domestic market and cannot as yet be considered to provide conventional commercial banking activities. The banks have been reorganising their lending portfolios, work that will form a considerable proportion of their activities over the next few years. At the same time, there are fewer income opportunities in the market, tasks involving the financial restructuring of management companies are labour intensive and the authorities are making increased demands on the banks as a result of the collapse.

Participantss in the financial market and the authorities are necessarily formulating policies for the future in light of the new economic reality. These parties, including the three commercial banks that took over the activities of the fallen banks in Iceland, i.e. Arion Bank hf., Íslandsbanki hf. and NBI hf., have been contemplating the option of merging banks on the Icelandic market.

Concentration in the banking system is currently greater than it has been for decades, and interest in further mergers may be expected, both due to the poor position of financial undertakings and to the opportunity that mergers are believed to provide for rationalisation on the financial market. The number of financial undertakings continues to drop, most recently through the merger of SpKef and Landsbankinn in March 2011. The emergency legislation from October 2008 was applied in that merger, so it was not subject to the provisions on mergers contained in the Competition Act.

Moreover, competitive conditions on the financial market have in other respects been discussed by the Competition Authority in recent years. It is clear that the current conditions on the Icelandic financial market raise some questions, including the ability of new and smaller financial undertakings to gain a foothold on the market.

The Competition Authority’s goal with this consultation paper is to provide indications of competitiveness on the financial market under the present conditions, present the Competition Authority’s general views on mergers in financial markets and encourage the authorities and other stakeholders to pay attention to competition issues when formulating policies for the financial market. The consultation paper is also intended to lay further foundations for the Competition Authority’s policy formulation as regards the financial market and possible actions the Authority may take if appropriate.[1]

[1] In recent years, the competition authorities have discussed the operation of commercial banks to a considerable extent. Thus, the Competition Authority thoroughly analysed the Icelandic commercial banking market in its decision on the merger of Kaupthing Bank hf. and Sparisjódur Reykjavíkur og nágrennis hf.

In this consultation paper, the focus is first and foremost directed at the commercial banks and savings banks. The Competition Authority's investigations into the financial market have hitherto for the most part been directed at banking services to households and SMEs. Nevertheless, this consultation paper uses, as appropriate, the term financial market, which has a wider application than banking market, and also the term financial undertakings as a synonym for commercial banks, savings banks, other lending companies and securities firms. In this consultation paper, the term Landsbankinn is generally used instead of NBI.

The conclusions chapter at the beginning of the paper summarises the issues that the Competition Authority believes are of the greatest importance for the report's subject matter and requests that financial undertakings and other stakeholders submit their opinions. The two chapters thereafter address international developments; one touches on discussions about banks and competition following the financial crisis, and the other addresses statistics on the size of banks and concentrations in various banking markets. The following three chapters are on the Icelandic banking market. The first describes the new circumstances on the market, the drop in number of companies and the activities of the banks; the second discusses the characteristics of financial markets; the third discusses market share and concentration in the banking market. The final chapter contains a summary of the Competition Authority's decisions as they relate to the banking market since its collapse.

The discussion in this paper as regards mergers of commercial banks and other competitive issues is based on the Competition Authority's initial evaluation of available information. This discussion, therefore, does not constitute any binding position to any items linked to the provisions of the Competition Act and its implementation. The purpose of this document is to generate ideas and dialogue on matters that might bolster competition in the financial market and thereby speed-up the reconstruction of the business sector.

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(SPRON) in September 2008. In November 2008, the Competition Authority directed an opinion to the banks which contained a discussion on their decisions on the future of companies in competitive markets. Moreover, the Authority provided an extensive discussion on banks and the reorganisation of companies in a detailed discussion paper that was published at the end of 2009. Furthermore, the Competition Authority has discussed circumstances in the financial market in a number of decisions relating to bank takeovers of commercial companies after the collapse

# 2. Conclusions

## 2.1 Mergers and competition on international financial markets

*Financial markets are in a unique position*

Financial activities play an important role in the economy of every nation. They distribute funds from savings owners to borrowers, ensure secure payment processing and create a venue for the price formation of financial instruments. In this manner, a financial market lubricates the workings of the economy and drives it forward. Companies operating in the financial market base their existence on trust and credibility; diminished trust can have systemic effects on other companies in the sector and finally on the economy as a whole. This is different to what is the norm in most other goods and services markets, where the bankruptcy of one company creates opportunities for their competitors.

*Guarding competition*

Most countries in the world have experienced an economic downturn following the financial crisis, although to varying degrees. Companies in many countries are fighting to remain in business and to retain their assets under difficult circumstances. The number of companies in important markets has fallen, and it is likely to decrease even more due to bankruptcies. Competition restrictions and oligopolistic markets may arise, and it can be tempting for governments to turn to protective policies. In light of this, competition authorities throughout the world have extensively discussed the financial crises and its effect on competition in markets. Competition authorities everywhere have pointed out the importance, especially during times of economic downturn, of guarding competition and apply, for this purpose, active and strict competition rules. The solution to economic crises is not in reducing or relaxing the monitoring of competition restrictions. Experts who have researched economic crises have pointed out the importance of competition to hasten economic recovery. The drive for rationalisation and innovation that the discipline the competition provides is thus extremely important.

*The financial crisis can lead to positive changes to options available to consumers*

Many government policy-formulating committees on financial markets have recently released their reports. The latest is the report issued by the UK Independent Banking Commission (IBC) from 11 April 2011, chaired by Sir John Vickers. The Commission recommends that Lloyds Banking Group (LBG) be required to divest itself of some of its branch offices to increase competition, as the Bank's share of current accounts in the UK is approximately 30%. The EU Commission had already imposed the obligation on the Bank to sell approximately 600 branch offices to strengthen competition, while the ICB is of the opinion that the LBG divestiture will have to be more extensive. The ICB furthermore believes that entry barriers to the banking market and that consumers' cost of switching between banks considerably restricts competition in the banking market. ICB recommends that the cost of switching be lowered by requiring banks to ensure that the transfer of customers between banks is executed swiftly and smoothly and, moreover, that a system be established whereby deposits into previous accounts are automatically routed into the new account without any inconvenience for the consumer. Finally, it proposes that consumers be allowed retain their account number even if they have switched banks.

*Bank mergers generally result in minimal rationalisation*

Financial crises indicate that something has gone seriously wrong with the organisation of financial markets and operations therein. Moreover, financial crises generally lead to the formation of a certain vacuum as a result of extensive changes made to bank ownership. Under such circumstance, it is normal for the authorities and market entities to seek means to reorganise the market to prevent such mistakes from occurring again. Experience shows that the debate often starts to revolve around bank mergers. The trend over the past two decades has been toward increasing the number of mergers, together with the considerable growth of banks. Numerous economic studies have been carried out on the consequences of bank mergers. The majority of such studies conclude that bank mergers do not result in greater rationalisation. This is interesting in light of the great interest that bank owners and management generally have for mergers. The reason may be that bank owners overestimate economy of size in the sector or that it is easier to deal with cuts in operations following a merger.

*Mergers somewhat fewer*

The wave of mergers in developed banking markets reached a peak at the turn of the last century and has somewhat slowed since. There have been some emergency mergers as a result of the financial crisis. An example of this is the merger of Lloyds Banking Group and HBOS in the autumn of 2008, when the UK government acquired over 40% of the merged bank. The merger of Norway’s two largest banks, Den norske bank and Gjensidige Nor, into DnB Nor in 2002 is extremely noteworthy. Norway’s Competition Authority concluded that the merger would have significant restrictive effects on competition and that concentration in retail banking services would increase radically in many of Norway’s regions. For this reason, the Authority intervened in the merger. The merger was only allowed to proceed with extensive divestiture of subsidiaries and branches for the purpose of protecting competition. The main difference between conditions in the banking market in Norway and Iceland is that the banks that are closest to DnB Nor in size are foreign branches and subsidiaries of overseas banks, while the Icelandic banking market is isolated.

*Banking market with substantial concentration*

Banking markets are generally considered to be considerably concentrated markets. On average, the share of the four largest banks in each market is approximately 60% of the national market in OECD countries. Account, however, must be taken of the fact that structures and regulatory frameworks differ. Thus, the share of the four largest banks is only approximately 25% in Luxemburg and the US, which are the developed countries with the least concentration in the banking market. The share of the four largest banks in Sweden, Norway and Finland, however, is more than 90%. The general trend is toward greater concentration, although this is not universal. Numerous bank mergers have played a large role in increased concentration.

## 2.2 Competition and rationalisation in the Icelandic financial market

*Smaller entities provided restraint before the collapse*

During the years before the collapse, there were three large entities in the Icelandic financial market as well as a large number of smaller ones in an ever-growing market. The focus of the larger commercial banks on operations overseas provided the smaller entities with greater opportunity in the domestic market. The smaller entities provided the large banks with certain market restraints and were often swifter to provide innovations. Nevertheless, the financial market had all the symptoms of an oligopolistic market and was regarded as such.

*Competition has decreased*

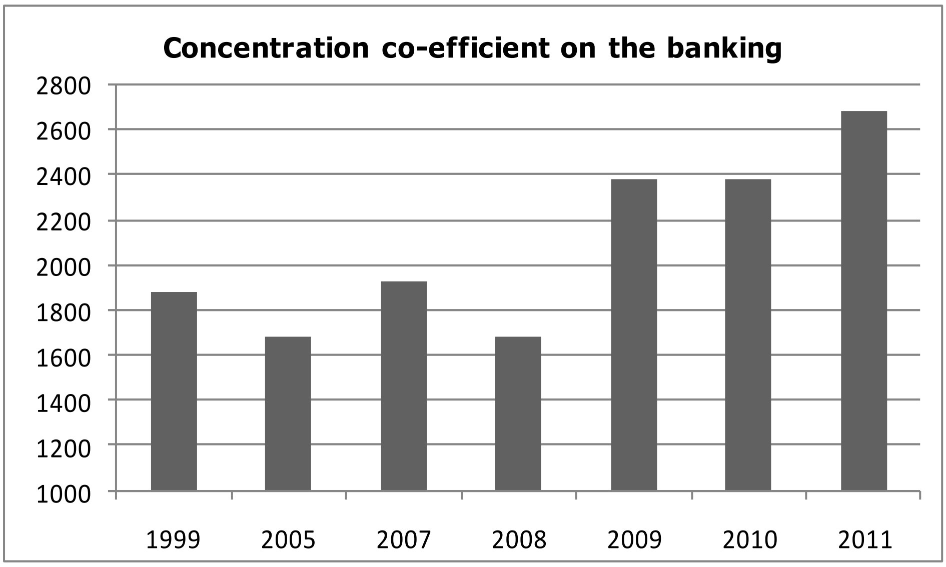
Conditions have now completely changed. The financial market has shrunk, and some of its sub-markets have disappeared. Credit demand is at a minimum, as households and companies are generally extremely leveraged. With the collapse of the stock market and currency restrictions, investment options are limited. Since the collapse, the banks' energies have been spent on internal affairs and reorganisation of lending portfolios. The number of financial undertakings in operation has fallen. Savings banks and more specialised lending companies in particular have discontinued operations. Concentration has increased with the reduced number of financial undertakings. Moreover, the Competition Authority has had to allow co-operation between financial undertakings for the purpose of resolving complications arising from the economic crisis.

*Concentration has increased*

Concentration has increased substantially since the collapse and has not been greater in the Icelandic banking sector in recent decades. Concentration measures just less than 2,700 points after the merger of Landsbankinn and SpKef on the Herfindahl-Hirschman Index. Before the collapse, the concentration co-efficient was under 2,000 points. A market is considered extremely concentrated if the co-efficient exceeds 1,800 points.[2]

[Concentration co-efficient on the banking market]

[2] Concentration is here measured according to the market share of deposits held by commercial banks and savings banks.




*Market share has not changed to any extent*

The market share of the banks has for the most part remained unchanged over the past ten years, although the takeovers by Arion Bank and Landsbankinn of the deposits of SPRON and SpKef have increased the deposits share of the larger banks, especially that of Arion Bank. A new entity, MP Bank, has begun operations in the commercial banking market in place of those that have discontinued operations.

*Entry barriers are considerable*

Competition-restrictive entry barriers to financial markets have historically been extensive in Iceland and above average in international comparison. There is little to indicate that these conditions are changing even though the entry of new entities to payment processing and clearing systems has improved the situation. On the contrary, it could be argued that increased instability and uncertainty in the economy, the establishment of currency restrictions, an increased regulatory framework and the increased expenses of financial undertakings due to monitoring, insurance and taxes are scaring investors away from the sector and are more onerous for new and smaller companies. Furthermore, the Competition Authority has been of the opinion that unfair conditions, e.g. technical conditions or excessive pricing, have sometimes been employed to prevent entry to financial markets and that costs imposed on consumers when switching between financial undertakings prevents their mobility between companies.

*Operating costs rise between years*

The Icelandic banking system is too expensive to run given the current scope of the banking system, and rationalisation, therefore, is necessary. Concurrently with reduced activities and increased requirements, the managers of financial undertakings must meet owner requirements for profitability. This rationalisation, however, has not begun except to a small extent. This may in part be attributed to the fact that managers are spending great deal of time on reorganising lending portfolios. The aggregate operating costs of Arion Bank, Íslandsbanki and Landsbankinn in 2010 rose in real terms by 12% when compared with 2009. The number of employees has risen by just under 200 between 2009 and 2010. The number of branches has been reduced by three during the period.

*High IT costs*

IT is one of the largest cost items in banking operations. The importance of this item has increased exponentially with increased technology, as good and secure IT systems can provide a financial undertaking with competitive edge. IT costs, including wages, amount to just under a quarter of the operating costs of Arion Bank, Íslandsbanki and Landsbankinn. With the added operating costs of smaller financial undertakings and Teris, the company responsible for operating the IT services for many savings banks, it may be assumed that the annual IT costs of the banking system amounts to approximately ISK 16–17bn.

*Financial undertakings increasingly focus on outsourcing*

As a result of the demand for rationalisation in the financial market, financial undertakings may be expected to seek ways to reduce the cost of back-office operations and IT, by e.g. outsourcing basic operations and maintenance services to operators specialising in such activities. Such outsourcing may be economical and preferable, particularly for smaller financial undertakings, although we must be wary of a joint ownership by larger banks of an operator in such an important competitive issue. Landsbankinn has recently announced its purchase of shares in Arion Custody Services. At the same time, work progresses on ensuring IT services for the surviving savings banks. In Denmark, large IT companies owned by small and medium-large financial undertakings and pension funds are responsible for the centralised processing of electronic information and for developing new IT systems. These companies are important for smaller financial undertakings that would otherwise be in a poor competitive position. Denmark's largest banks, however, do not outsource these activities.

*Banks differently funded and owned*

In the opinion of the Competition Authority, the largest competitors in the financial market, i.e. Arion Bank, Íslandsbanki and Landsbankinn, are all similar as regards type and cost structure, something that has not changed since before the collapse. However, Landsbankinn holds a special position in two fields. On the one hand, the Bank's ownership differs from the other banks in that the majority of its shares are held by the ISFI (Icelandic State Financial Investments), which is subject to special legislation. On the other hand, its access to foreign funding is greater than that of the others, as the bank is substantially financed with foreign currency bonds.

## 2.3 Future environment of financial markets

*Market conditions can change quickly*

When competition on the market is examined from the viewpoint of the Competition Authority, it is necessary to keep in mind that circumstances may change over time. This clearly applies to the Icelandic financial market, which has changed considerably over recent years and will clearly continue to do so. The majority of Icelandic financial undertakings have failed, and new undertakings have taken their place. In addition, significant changes have been made to legislation applicable to the market and its monitoring. The market is operating under extraordinary conditions, such as currency restrictions. In addition, it is known that the ownership of two large financial undertakings, Íslandsbanki and Arion Bank, will probably change within the next few years. Moreover, the financial strength of the banks is not known, and some time will elapse before the banks complete the reorganisation of their lending portfolios and traditional banking operations can begin in a normal fashion.

*The role of the Competition Authority*

The role of the Competition Authority will first and foremost be to decide whether mergers prevent active competition and to strengthen active competition on the market in accordance with the provisions of the Competition Act. The Competition Authority's decision on whether to intervene in a merger will always take account of circumstances in the market as they are at that time and the intentions under examination each time. The long view must be taken when assessing the effect of mergers and competition in the market, i.e. to take account of the analysis of the current position and the likely future development, rather than the past. Information on the past is, of course, very useful due to the indications such information provides on the likely future development.

*The arrangement of monetary issues can completely change the market*

When analysing future prospects for competition in the Icelandic financial market, taking account of the fact that radical changes can occur in the arrangement of monetary issues, which can completely change the market, is unavoidable. Everyone knows that Iceland has applied for EU membership and that membership in the EU will probably mean the adoption of the EUR in place of the ISK at some future date. Such change of currency would have a significant impact on the Icelandic financial market, as well as on competition in the market. Even without currency restrictions, an independent currency means that the Icelandic financial market will be more isolated from the markets of neighbouring countries than it would be if Icelanders used the euro. There would be a fundamental change to interest rate levels in Iceland with the adoption of the euro, and changes to rates would be subject to other laws than previously.

*Finland's experience*

In this context, it may be useful for Icelanders to examine Finland's experience. Finland has adopted the euro, the only Nordic country to do so. The country did so following an economic crisis that could be attributed to the financial sector. The Finnish banking system has changed a great deal over the past few years. For instance, the activities of financial undertakings whose majority shareholders are foreign have substantially grown proportionately. In 2009, approximately two-thirds of Finland's banking system was majority-owned by foreign entities, if account is taken of the size of the balance sheets.

*No assessment made of the effects of a currency change*

The Competition Authority has not made any assessment of what the effects of a currency change would have on the Icelandic financial market or competition in Iceland in general, although it is clear that such effects would be considerable. Due to the uncertainty this causes, all projections on the progress and competition in the Icelandic financial market must, to take everything properly into consideration, be based on two scenarios, one with the adoption of the euro and the other with the continued use of the króna.

*The economic environment and administrative actions are of paramount importance*

The ever-changing economic environment certainly has an effect on the competitive environment of financial undertakings. Thus, the establishment of the currency restrictions had a significant impact on the financial market. The currency restrictions can lead to a number of harmful consequences; they distort price formations and isolate the Icelandic financial market even further, even though their establishment was considered necessary for other reasons. The merger of financial undertakings is likelier to have fewer harmful competitive effects if the currency restrictions are abolished, provided that barriers do not prevent the entry of new competitors or the strengthening of smaller companies. Regulatory frameworks are also more detailed in financial markets than in other business sectors and therefore have significant effects on the competitive ability of financial undertakings. An international financial crisis such as the one that occurred near the end of the last decade requires a detailed examination of the rules and will probably lead to stricter regulation. Thus, investigations are underway on whether to establish further rules on risk management and the required equity base of financial undertakings. Also debated is whether it is a good idea to separate commercial banking operations from investment banking operations. Such rules can have a significant effect on the organisation of financial markets and the size and strength of financial undertakings. In general, it could be said that an increased and more complicated regulatory framework will make it more difficult for smaller financial undertakings to begin operations in a financial market.

*The participation of foreign entities is desirable*

The participation of foreign banks in the domestic financial market is important from both competition viewpoints and financial stability. Although the normal operations of commercial banks are generally restricted to the home state, foreign ownership of banks is common. Foreign banks, however, have not seen any advantage in beginning operations here in Iceland and will, all things being equal, not see an advantage in doing so in the near future. This weakens the Icelandic banking system and makes it more homogenous. The reorganisation of the ownership of Arion Bank and Íslandsbanki, for the most part owned by the foreign creditors of their predecessors through Icelandic holding companies, could, however, lead to opportunities for an active foreign shareholding. The fact that foreign entities acquired a shareholding of just under 25% in MP Bank in its recent reorganisation is a positive step.

*What will happen to the savings banks and smaller financial undertakings?*

Closer to us in time is the decision on the continued operation or reorganisation of financial undertakings other than the three commercial banks. The policy formulation work of the authorities plays a key role here, as the authorities are directly or indirectly involved in the cases of most of the undertakings. The position of these companies differs, although they face an uncertain future. The undertakings in question are Byr, Saga Investment Bank, Lýsing and SP fjármögnun as well as all the surviving Icelandic savings banks. The reorganisation of MP Bank was completed in April 2011 with new shareholders and a share increase. It is also important what the authorities do with public investment loan funds such as the Housing Financing Fund (HFF) and the Institute of Regional Development. Due to its importance in the financial market, policy formulation for HFF is vitally important for the future and development of the competitive environment. Moreover, one must not forget the possible involvement of the pension funds, by far the largest source of domestic savings, in the future ownership of financial undertakings.

## 2.4 Market-dominant positions and competitor co-operation in an oligopolistic market

*Tacit collusion is harmful to the public*

The Icelandic financial market is an oligopolistic market. In oligopolistic markets, the largest companies can be in a joint market-dominant position. This means that if the market type is arranged in a specific manner, the result may be tacit collusion. In such a market, the companies in question can get away with taking mutual account of each other rather than competing. Companies can see the advantage of marching in step in their market behaviour, e.g. they can limit the availability of goods or services to increase the sales price, keeping in mind that co-ordinated market behaviour will lead to the maximisation of joint profits. No reasoning is necessary to prove that such behaviour by companies is harmful to the public.

*Indications of joint market-dominant position*

The Competition Authority, in its decision on the merger of Kaupthing and SPRON in 2008, reached the conclusion that Glitnir, Kaupthing and Landsbankinn were in a joint market-dominant position. Now the same operations are run in Iceland under the auspices of NBI hf., Arion Bank hf. and Íslandsbanki hf. The Competition Authority's decision No. 36/2010, *Byr Savings Bank's takeover of Byr hf.*, states that according to the information that the Competition Authority had, there was nothing to indicate any circumstance other than that the joint market-dominant position remained in place. The Competition Authority is of the opinion that there are indications that the same position is currently the case with Arion Bank, Íslandsbanki and Landsbankinn and may even be stronger, but does not take a position on this question in this consultation paper. However, the Competition Authority is currently investigating cases involving the three banks' possible abuse of their joint market-dominant position.

*Preventing competition-restrictive co-operation is a priority*

In oligopolistic markets, the competitive independence of competitors is particularly important. Any form of co-operation between competitors can increase harmful oligopoly and cause damages to customers. It is therefore, in the opinion of the Competition Authority, an absolute priority task to ensure that no competition-restrictive co-operation occurs between financial undertakings. Such co-operation, e.g. exchange of information or joint projects, can contravene the prohibition of illegal collusion provided for in the Competition Act. The amendments made to the Competition Act with Act No. 14/2011 are also important in this context. They provide the Competition Authority with, among other things, the authority to intervene in circumstances or behaviour in the market that facilitate tacit collusion between companies in an oligopolistic market. Proof that the behaviour violates the prohibitive provisions of the Competition Act is not required.

*The greatest care must be shown in the work of stakeholders*

It has proved necessary to grant financial undertakings limited exemptions from the ban on illegal collusion to facilitate the resolution of various problems that relate to the collapse of the banks and the resulting economic consequences. These exemptions are governed by these unusual circumstances. They have been bound by conditions and are valid for a specific period. The Competition Authority will maintain active surveillance that the conditions are met, and any violations of the conditions will be regarded as serious. Examples have shown, both here in Iceland and overseas, that the activities of company stakeholders can be very sensitive as regards competitiveness, not least when member companies operate in oligopolistic markets. The Competition Authority, therefore, instructs both financial undertakings and their associations to take the greatest care in this respect. Serious measures will be employed in the event of any form of collusion that contravenes the Competition Act and which has not been granted an exemption.

## 2.5 The Competition Authority's views

*Account must be taken of competition viewpoints*

The Icelandic financial market is at a crossroads, and there will inevitably be changes to the ownership and composition of various financial undertakings in the next few years. The Competition Authority encourages financial undertakings, the authorities and other stakeholders to take account of competition viewpoints in policy formulations for the financial market. Active competition in the financial market is particularly important for both the business sector and consumers. It supports industrial development and the competitive ability of Icelandic companies, as well as ensuring consumers good financial services at reasonable prices. In order for this to occur, financial undertakings and their associations must respect the ban on competition restrictions provided for in the Competition Act. This also means that entry barriers must be removed, homogeneity in structure and mentality prevented and an environment for an active market and innovation created in the sector. The Competition Authority is wary of larger commercial banks buying or taking over smaller financial undertakings and of creating a comfortable market with two or three large banks that are free from the risk of external competition. This type of market is generally detrimental to the public and the business sector.

*Mergers generally reduce competitiveness*

Competition has decreased since the banks collapsed and financial undertakings became fewer in number. The Competition Authority is of the opinion that extremely serious competition problems can result from the merger of commercial banks, at least in the instances where one or more of the larger banks are party to such a merger. In this respect, it is right to point out that economisation in size is a hypothetical rationalisation and not a certainty. The majority of scientific articles that have been written about bank mergers indicate that they provide insignificant rationalisation. The Competition Authority also points out the importance of an active interbank market for competition, as well as the financial instability that may result from the market containing an entity holding a substantial share of the banking system's assets. The Organisation for Economic Co-operation and Development (OECD) has recently reiterated the importance of active competition in financial markets and has pointed out that competition in this sector can support stability and act as a preventative measure against banks becoming "too big to fail". The previously mentioned report from the Vickers Commission also emphasises the importance of active competition in financial markets.

*Strong arguments are required for the merger*

According to the Competition Act, assessments of the lawfulness of a merger must take account of the rationalisation, provided that the merger is beneficial for consumers and does not prevent competition. The burden of proof of the rationalisation rests on the merging parties. In order to obtain permission for the merger of commercial banks, there must be extremely strong arguments that the advantages of the merger are greater than the social cost. It must also be kept in mind that in competition law, mergers, which otherwise would have competition-restrictive effects, may be permitted with the establishment of certain conditions, such as the requirement to sell some branches or subsidiaries. It should also be mentioned that in exceptional cases, it is possible to allow a merger that leads to the formation of a market-dominant position or the strengthening of such position, if such change to the market is inevitable due to the difficult financial position of one of the parties to the merger. An example of this is the Competition Authority's decision to allow the merger of Kaupthing and SPRON in 2008.

*Rationalisation is inevitable*

The Competition Authority agrees with the view that the banking system's operating costs are much too high and need to decrease over the next few years so that the banks can offer households and companies reasonable terms, while at the same time returning to its owners a profit on their investment. This rationalisation will not, however, be achieved exclusively by mergers. Opportunities for rationalisation may e.g. lie in the branch office network and back-office operations. In addition, there are considerable temporary costs resulting from the financial reorganisation of households and companies. The Competition Authority is of the opinion that the IT outsourcing practiced by many financial undertakings to a single operator may lead to competition restrictions unless it is clearly shown that the outsourcing does not have an effect on competition in the market.

*Entry barriers and switching costs reduce competition*

The mobility of commercial banks is extremely low. New entities wishing to enter the commercial banking market are faced with demanding, time-consuming and risky processes in quickly attracting large groups of customers, which is a prerequisite for achieving operating units of efficient size. The Competition Authority intends to examine ways to increase mobility and decrease entry barriers in the banking market and encourages other authorities and stakeholders to do the same. An example of possible ways to do so is to make it easier for bank customers to transfer their business, e.g. by allowing the account number to follow the customer to a new bank.

## 2.6 Opinions requested

The preceding text contains the main opinions of the Competition Authority as regards competition and mergers. The reorganisation of the banking system has been described after having analysed the position of the banking system and international discussions on mergers and concentrations of banking systems. This analysis is a part of the Competition Authority's policy formulation and is in preparation for the decisions in administrative issues that the Authority believes it will have to make in coming years due to e.g. the mergers of financial undertakings, the outsourcing of the activities and the reorganisation of the business sector in other respects.

The Competition Authority believes that to begin with, these decisions will certainly involve savings banks and smaller financial undertakings. In the long term, many economic factors, which are subject to uncertainties at present, will influence the decisions of the Competition Authority in this market. These include uncertainties about the financial position of a bank once reorganisation has been completed, the ownership of the banks and the decisions made by the foreign shareholders of the banks, the financing of the banking system, the development of currency issues and restrictions, economic and monetary unions with other nations, the regulatory framework on the market and general economic developments.

The Competition Authority invites companies and other stakeholders who so wish to send their comments to this consultation paper to the Authority. Such comments, corrections and additional material would assist the Authority in preparing its investigations on the extensive and important subject that this report covers, such as on rationalisation, mergers, entry barriers, the character of the banking market, market share and concentration.

The Competition Authority requests the submission of comments before 31 May 2011.