Lars Heikensten: Swedish banks in an international perspective

Speech by Mr Lars Heikensten, Governor of the Sveriges Riksbank, Royals Vinterträdgård, Grand Hôtel, Stockholm, 10 November 2005.

Diagrams for this speech can be found on the Sveriges Riksbank's website www.riksbank.com.

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Swedish banks' competitiveness

I would like to begin by thanking the Bankers' Association for inviting me to participate in this panel discussion on Swedish banks' competitiveness. Before I set about giving my view on the matter, I think it is important to stress that there are several different perspectives on competitiveness and competition. So, the conclusion will vary depending on the angle from which you look at the issue. The composition of the panel reflects these different perspectives well, which should guarantee an interesting discussion.

I would like to define a bank's competitiveness as a measure of how efficient the bank is at providing a given quantity of financial services at a certain level of quality. For the Riksbank, the competitiveness of Swedish banks is important both from a stability point of view and an efficiency perspective. Competitive banks have greater resilience to different kinds of pressures regardless of whether they stem from increased competition or poorer economic performance. They also are more efficient and can provide more and better financial services at a low cost.

How to measure competitiveness, though, is by no means self-evident. It is fairly uncomplicated to observe business profitability and cost efficiency in a bank with the aid of measures such as return on equity and the C/I ratio. But a high return on equity and low C/I ratio is not necessarily a sign of an efficient banking sector, but can just as easily indicate weak competition and high margins. Similarly, from an economic point of view it is hazardous to place too much trust in the equity market's valuation or a rating agency's credit rating since these partly represent a different perspective. For example, for investors it is only positive if a bank – all other things being equal – operates in a market where competition is low and margins are high.

Against this background, it is important to supplement the business analysis with an assessment of the quality and the price of the financial services provided by banks. I suppose the best indicator of the quality of a bank's service range is how well the bank's services fare in the competition from other banks and financial institutions. If the barriers to entry are high and there are few alternative suppliers, a high market share can hardly be taken as a sign that the bank's service offering is particularly high quality or worth its price, even though that can of course be the case. If, on the other hand, the banking sector consists of a number of strong players and there also are plenty of alternatives, it is much more conceivable that a large market share or high profitability is a result of a genuinely competitive product range.

A European investor perspective

So what do we know about Swedish banks' competitiveness – how do they fare in an international perspective? Looking at the European banking sector from an investor's point of view, we can note that the profitability of Swedish banks is very average. In a selection of the 25-30 biggest listed banks, the Swedish banks come close to the median value for return on equity (see Figure 1).[1]

The Swedish banks' net interest margin – net interest income in relation to interest-bearing assets – also appears mediocre at first glance. But if we take into account their very low loan losses, then for three of the four major Swedish banks the "loan-loss-adjusted" net interest margin is actually higher than for the European median bank. Also as regards cost efficiency, measured in terms of the C/I ratio, the Swedish banks are among the best.

[1] This and the following comparisons are based on full-year results during the period 2002-2004.

But if Swedish banks are relatively good at earning money on lending without incurring excessive loan losses and moreover are cost-efficient, it seems a bit strange that this does not result in an even higher return on equity. One explanation could be that Swedish banks are just unusually well-capitalised. However, a quick look at the core capital ratios of European banks shows that Swedish banks instead have relatively low capital levels. The only possible remaining explanation is that Swedish banks are not as good at generating income from services other than lending. And right enough the results also reveal that Swedish banks' non-interest income is among the lowest in Europe (see Figure 2).

So what is a European bank investor's assessment of Swedish banks? Judging by equity market prices there is some scepticism towards Swedish banks. As regards both valuations of their book capital – the price-to-book ratio – and P/E ratios, the Swedish bank shares are trading at a small, but nonetheless clear, discount in relation to the European banking sector. The possible reasons for such a valuation discount are either that the expected profitability is lower for Swedish banks or that they are judged to be riskier than their European counterparts. I think, though, that the latter hypothesis that Swedish banks are comparatively risky can be rejected – Swedish banks' high credit ratings, low loan losses and stable earnings tend to suggest the opposite. In other words, it seems as if the equity market is sceptical because it judges Swedish banks' potential for improvement or growth to be limited.

The assessment of Swedish banks' growth potential as limited has several possible explanations, which are more or less benevolent depending on whom you ask. Swedish bank managers sometimes claim that the competition in the Swedish banking market is fierce and that it is easier to generate earnings abroad. Foreign bank analysts prefer to emphasise the relative smallness and maturity of the Swedish and Nordic banking market – the major structural deals have already been done and all households already have a home loan. However, bank managers and analysts seem to agree that the potential for improving return on equity is limited.

To sum up, we can conclude that Swedish banks are neither more nor less profitable than their European competitors. While Swedish banks are cost-efficient, unfortunately they are less successful when it comes to generating earnings on services other than lending. It reminds me in some ways of the Swedish football team before Zlatan Ibrahimovic and Henrik Larsson blossomed into the stars they are today – disciplined and effective in defence, but fairly lacking in goals and imagination in attack.

The structure of the Swedish banking sector

So, is Swedish banks' average profitability and smaller valuation discount a result of their inability, despite their efficiency, to benefit from higher margins due to tough competition, or is it because the banks operate in an oligopoly and are incapable of developing new, profitable products. In the former case the relatively low profitability is a symptom of an efficient and competitive banking sector. But in the latter situation the authorities should be concerned, while investors possibly can see interesting but risky development potential.

The Swedish banking sector was one of the first in Europe to be consolidated, largely because the banking crisis speeded up the restructuring process. The consolidation enabled Swedish banks at an early stage to rationalise overlapping branch networks and to reduce staff numbers. Even though several EU countries now have caught up with or even passed by us in terms of consolidation, the Swedish banking sector stands out by having the lowest number of both branches and employees per capita in the EU15. That might indicate that the limited improvement potential is due to Swedish banks already being highly efficient.

But a low number of branches and employees is not necessarily the same thing as an efficient banking sector if it means that the range of financial services is being rationed. It may be the case that the Swedish banking sector is stingy rather than efficient. The Swedish banking sector is in fact relatively small, in terms of assets in relation to GDP, but this is probably not explained by low lending, which is average, but by the fact that relatively speaking Sweden together with Finland has the lowest level of deposits among all EU15 countries. On the other hand, that is because in comparison with households in many other countries Swedish households make greater use of other forms of saving than bank accounts. Given that Swedish banks also have a very strong position in terms of savings in funds and life insurance it therefore is difficult to dismiss the Swedish banking sector's lower branch and employee numbers by saying that the range of products is stingier than elsewhere.

In one area, though, the Swedish banks are stingiest in Europe, and that is with regard to how easy they make it for their customers to access their bank funds through cash withdrawals – undeniably a fairly significant aspect for a bank customer. Interestingly, Sweden has the lowest number of ATMs per capita of all the EU15 countries – and some 20 per cent lower than Finland, which is second from bottom (see Figure 3). It could quite simply be that Swedish bank customers prefer to use charge cards instead of cash, but that is not the case. On the contrary, Swedes make far more ATM withdrawals than the average European. That leads to the common sight in Sweden of long queues winding their way up to ATMs, which in fact is very unusual is most other countries (if we disregard planned economies). Swedish banks simply ration their customers' possibilities to make ATM withdrawals. It is perhaps not that strange that Swedish banks are not overly eager to provide an expensive service that is difficult to charge for. That does not necessarily have to be the consequence of weak competition but it results nonetheless in a poorer product for the customer.

On the other hand, Swedish banks are doing very well in other areas. I already have mentioned the very strong position enjoyed by Swedish banks in the market for long-term saving, compared with many other European banks. Another well-known Swedish example is the high Internet use of both companies and households in their dealings with their banks.

Swedish banks have also been relatively quick to expand abroad. In relative terms, the Swedish banking system is one of the most European banking markets, along with the Belgian and Dutch systems. However, that only applies to the Swedish banking system's "outward" Europeanization – Swedish banks' expansion outside Sweden. As regards the presence of European banks in the Swedish market, "inward" Europeanization, the Swedish banking market is one of the least integrated, beaten even by a "closed" market like the Italian one. Assuming that Swedish authorities have not discriminated against foreign players, this pattern could perhaps also be taken as a sign of Swedish banks' high competitiveness.

So it is not all that easy to answer the question of how competitive Swedish banks are in an international or European perspective. Nevertheless, there is much to suggest that their competitiveness is fairly good. To all appearances the Swedish banking system is efficient in its use of resources and it does not seem that this is being achieved through a poorer range of financial services – with possibly the low number of ATMs as an unusual but striking exception. On the contrary, there are several examples to show that Swedish banks' service range fares relatively well in an international comparison. On the whole, it appears that Swedish banks are organisationally efficient and good at adopting new technologies in their distribution of services, but are less advanced when it comes to developing new products and services.

Flexibility and long-term competitiveness

In the long run, a company's competitiveness is determined by its ability to adapt to changed conditions. How well-positioned are the Swedish banks to meet the banking and financial markets of tomorrow? I do not intend here and now to try to predict what the banking market will look like in ten years – that would be doomed to failure. But I would still like to take the chance to reflect on some of the trends that we nonetheless can perceive and what these might entail for Swedish banks.

Here, I would like to highlight two such trends that are somewhat related. The first is disintermediation, which entails that banks' role in the loan market is changing from own lending to only providing loans for which another investor assumes the risk. The other trend is commoditization, which means that certain kinds of financial contract – e.g. loans, funds or insurance – are becoming increasingly standardised and difficult to distinguish from one another. With that, the price should become the crucial factor in the consumer's choice of product.

These kinds of trends should be taken with a pinch of salt, of course. Changes seldom mean that all previous truths suddenly cease to be valid, and moreover changes do not happen overnight. Especially in the banking market, important changes are more likely to occur slowly and gradually over a long period.

Nonetheless, these trends, even if the impact only proves to be half as big as the financial markets' trend oracle predicts, entail interesting challenges and opportunities for Swedish banks. Together, disintermediation and commoditization should result in a more distinct division of production, distribution and risk-taking. As I am sure you know, this is what consultants call the breaking up of the value chain. Even though some banks undoubtedly will try to keep as much of the value chain as possible, it is going to become more difficult. Each part of the value chain will be exposed to competition from specialised niche players.

Allow me to give a few concrete examples. For several years now it has been noted that Swedish banks' share of savings is slowly but surely decreasing. Not because Swedish banks have performed worse than any other pension or fund manager, but simply because there are a lot of players that are at least as good, and sometimes also cheaper. The four major banks have a strong grip on the Swedish mortgage market for households. But they seem to have defended their large market shares in some measure through price cuts.

Also as regards the corporate market, the four major banks appear to have a continued strong position. But this market has grown very weakly and in real terms is smaller today than it was at the start of the 1990s. It is not that the market for company financing has shrunk, but it seems to have scaled back its connections to the major banks. That is partly because large Swedish companies can turn to foreign banks or directly to the capital market for funding. Also, it is probably partly because Swedish banks in the wake of the banking crisis have made a conscious decision to reduce their share of risky lending. However, it does not seem as if the Swedish banks have fully managed to compensate for this lower lending through increased advisory services or other ”intermediary services”.

In essence, Swedish banks have strong positions in a number of areas but these markets are either mature or else the banks' shares are shrinking. If we were to assume that the trend oracle will be right, I envisage two possible ways forward for the major Swedish banks, both of which represent extremes. The first strategy would be based on the banks' proven proficiency in terms of organisation and distribution, and to refine this strength and also become better at peripheral advisory services. Fewer resources would be invested in product development and risk-taking – products can easily be copied and risks sold on to other, hungrier investors.

The second strategy would instead be to rediscover what you could call “classic” banking, in other words healthy risk-taking underpinned by better knowledge about certain risks and conditions than the market in general. As long as higher loan losses and larger earnings fluctuations are kept at a bearable level and are compensated for by higher margins, then risk-taking in itself is not bad business.

However, as a central bank governor I do not want to inspire the banks to take on higher risk but instead would encourage them to make use of the opportunities in today's financial markets to re-package and spread risk, but like I said that is a different perspective.