*Norges Bank's submission of 27 August 2003 to Kredittilsynet (the Financial Supervisory Authority of Norway)*

# Application concerning a merger between DnB Holding ASA and Gjensidige NOR ASA



We refer to the letter dated 26 May 2003 from Kredittilsynet (the Financial Supervisory Authority of Norway) requesting an opinion on the application concerning a merger between DnB Holding ASA and Gjensidige NOR ASA, as well as Den norske Bank ASA and Gjensidige NOR Sparebank ASA.

Owing to its special nature and major importance to society, the financial sector is subject to more control and regulation than other business sectors. This means, for instance, licensing requirements for start-ups as well as for changes in the structure of existing financial institutions. Norges Bank has a special responsibility to promote financial stability and foster robust and efficient financial infrastructures and payment systems. Therefore, in this assessment we attach importance to the financial soundness of the proposed group, risks to the payment system and consequences for the authorities' ability to handle any crises and for the system of guarantee funds. Because competition is essential for robust and efficient financial infrastructures and payment systems, the impact of a merger on competition will be evaluated. The discussion of competition will be restricted to the market for banking services.

## Main points in the application

- Merger of the parent companies DnB Holding ASA ("DnB") and Gjensidige NOR ASA ("NOR") with DnB as the acquiring company. The name of the merged entity will be DnB NOR ASA.
- Merger of the two banks Den norske Bank ASA and Gjensidige NOR Sparebank ASA, with the latter bank as the acquiring company.
- For the time being, the life insurance businesses in Gjensidige NOR Spareforsikring ASA and Vital Forsikring ASA will continue to be run through existing companies. The activities of DnB's and NOR's other subsidiaries are to be coordinated to the extent and manner that is reasonable from a business standpoint. The merged group will seek to concentrate similar activities in one company.

As justification for the merger, the two banks adduce the increasing importance of economies of scale seen in light of the internationalisation of the Norwegian financial services market. DnB and NOR will merge as equal parties and seek to develop a strong and more competitive group. Although the group's main focus will be on the Norwegian market, DnB and NOR state in their application that the group will be of a size and strength that may make expansion possible outside of Norway in areas where the new company has advantages. DnB and NOR estimate annual net synergies of NOK 1 360 million for the group as from 2007. Restructuring expenses are estimated at NOK 1 860 million.

## Financial stability and the group's financial soundness

Robust and efficient financial markets as well as payment systems and financial institutions that enjoy the general confidence of money and capital markets and depositors promote financial stability. In general, a failure in a larger financial group will have more wide-ranging consequences than a failure in a smaller financial group. Thus, it is important to assess the impact on financial stability of a merger of the two largest Norwegian financial groups.

A merger will result in the concentration in a single financial services group of a larger share of the total risk relating to the provision of credit and other financial services. Thus, the stability of the financial system will become more dependent on the risk management, risk handling and internal control of this group. If there is an operational failure or an error in strategy at DnB NOR, the consequences may be more serious than if this were to happen at one of the groups today. Disturbances in macroeconomic developments or in the securities markets may also increase the risk of financial instability if the merged group adapts itself in such a way that it is vulnerable to such developments.

However, a merger will provide an opportunity for a somewhat greater degree of national as well as international diversification. Losses in connection with weaker developments in individual industries or regions may be lower in relation to capital for the new group than for the sum of the two banks.

If the expected cost savings are realised, the group's ability to cover losses from ongoing operations will be improved.[1] Its size may also make the group more attractive in international capital markets, enabling it to raise new capital on more reasonable terms. Economies of scale relating to the development of systems for mea-

[1] In the literature there is a great deal of discussion as to whether economies of scale exist in banking. There is no unambiguous view that such economies of scale do not exist.

suring, managing and handling risk for increasingly complex financial products may also help to make DnB NOR a sounder institution.

Whether or not a merger between DnB and NOR will make the financial system more stable will depend on whether such gains are realised and on how capital adequacy is affected by the strategic choices, including the choice of risk profile, made by the merged group.[2] To help to ensure that the stability of the financial system is not weakened by a merger, if approved, there is a need for close supervisory monitoring of DnB NOR's activities, not least in respect of choice of risk profile and systems for managing risk.

There is reason to expect that DnB NOR will be subject to greater attention from a broader selection of lenders and credit rating agencies than the two banks individually are today. The monitoring by the market may thus serve to discipline DnB NOR. Attempts to increase the group's profitability at the expense of an adequate risk profile would carry their own punishment more quickly than before in the form of a higher risk premium on funding from the capital markets.

## The impact on Norwegian payment systems

Today, DnB and NOR are settlement banks for their respective groups of savings banks. These settlement systems are the source of various types of risk for participating banks and for DnB and NOR. There is reason to assume that DnB NOR will wish to merge the settlement bank activities of the two banks.

The participating banks' use of DnB or NOR as a settlement bank gives rise to risk because DnB or NOR may experience financial difficulties. The banks participating in these settlement systems increase or reduce their claims on DnB or NOR depending on the size of the positions that arise in the settlements. A bank's claims on another bank are not covered by deposit guarantees. If financial problems should arise in the merged bank, far more banks will be affected than if such problems were to arise in one of the settlement banks today. However, calculations show that participating banks' positions vis-à-vis DnB NOR are limited relative to their core capital. Liquidity risk also appears to be limited.

DnB NOR may also suffer losses if one of the participating banks experiences financial problems. This is due to the fact that DnB NOR guarantees that the settlement will be completed vis-à-vis the other participating banks. However, calculations show that the maximum loss that DnB NOR may suffer in this connection will normally be small relative to DnB NOR's core capital.

Operating a settlement system is a source of operational risk, i.e. the risk that computer systems or communication between banks will fail or break down. Among other things, this risk depends on the technical solutions that are chosen and is to a large extent a question of cost. Awareness among operational staff of operational risk is also important. If IT operations are merged, the impact of a failure in this system will be greater than if this failure affects one of the systems today. However, this may be compensated for by devoting more resources to security. Although Norges Bank is able to set requirements in this connection, the responsibility for operating the settlement system and handling the operational risk lies with the bank.

## Crisis management

### *The authorities' role*

In crisis situations where the existence of a business appears to be threatened, the regulations that apply to financial institutions differ from those that apply to other businesses. If neither the bank's management and owners nor the guarantee funds can solve liquidity or capital adequacy problems, the authorities will have to consider appropriate crisis management.

According to the Guarantee Schemes Act, a bank that does not have a financial basis for continued operation and for which a private solution whereby it is acquired by or merged into another bank is not possible, will at the outset be placed under public administration. However, a bank may be so important to the financial system that other solutions to the crisis may be more appropriate.

In the event of a crisis, large entities pose considerable challenges to the authorities, challenges that may grow with the size and complexity of a financial institution. However, the banking crisis demonstrated that the authorities were capable of dealing with a crisis involving a larger portion of the Norwegian banking system than DnB NOR will constitute. If the supervisory authorities closely monitor DnB NOR, and this group also has a clearly outlined organisation and effective control systems, the basis for rapid and effective crisis management would be better.

One concern in relation to large entities is that there may be expectations that such financial institutions will be rescued irrespective by the authorities if they experience financial difficulties ("too big to fail"). This may lead to inadequate monitoring of the bank's activities and insufficient risk awareness on the part of lenders and credit rating agencies alike. Such an impairment of market discipline may contribute to moral hazard. In the view of Norges Bank, there should be no basis for such expectations. Situations that threaten the financial system to the extent that the authorities must take special action cannot be established in advance. Thus, one can-

[2] The results of the G10 report "Report on consolidation in the financial sector" (BIS, 2001) show that the financial soundness of individual institutions does not necessarily increase as a result of consolidation in the financial sector and the formation of large, complex financial institutions, because some realise gains in the form of regional and supranational diversification by increasing their risk-taking. Further, the size and complexity of these institutions may lead to an increase in operational risk. When this is juxtaposed with the greater impact of such institutions' financial problems, the risk to the financial system may also increase.

not – regardless of the prevailing economic climate – decide in advance that certain banks are so important or so large that they cannot be placed under public administration. If public administration is not deemed appropriate in a given situation, the owners will nevertheless have to reckon on losing invested capital and the management will have to be replaced. This applies regardless of the size and complexity of the bank and will also apply to DnB NOR after a merger, if approved. Nor will Norway be in a unique position internationally with regard to having large entities: Sweden, Denmark and Finland have an equal or larger concentration in their financial sectors.

A merger of the banking groups will not change Norges Bank's role or responsibility in a crisis. Should a situation arise in which the financial system is threatened, Norges Bank, in consultation with other authorities, will assess the need for, and, if necessary, initiate measures that may help bolster confidence in the financial system. Extraordinary provisions of liquidity in the event of liquidity problems are among Norges Bank's instruments.



### *Ownership structure and crisis management*

Through the Government Bank Investment Fund, the central government owns 47.8 per cent of the shares in DnB. The merger will reduce this stake to about 28 per cent in the merged entity. The central government has previously indicated that its holdings in DnB may be reduced, but not to less than 34 per cent. If the central government intends to hold an equally high stake in the merged bank, the merger will mean that the central government's direct involvement in the Norwegian banking system will be substantially higher than today.

Norges Bank assumes that decisions involving central government holdings in the merged entity are a political matter, but wishes to point out that negative control in an important Norwegian bank raises certain questions relating to the central government's role with regard to handling financial crises. As the supervisory and competition authority and through its economic policy as a whole, the central government has numerous tasks and makes a number of decisions affecting banks' developments and financial soundness. Conflicts may arise between the considerations that the central government has to address as owner and the central government's other tasks. Prior to the banking crisis, the central government did not have any stakes in Norwegian banks. A high level of central government involvement in the banks might weaken the central government's capacity for action if the banks' situation were to become critical again, since the central government, as owner, must be assumed to have a considerable joint responsibility for the situation.

### *The system of guarantee funds*

If the merger becomes a reality, it is obvious that the commercial banks' and savings banks' guarantee funds should be merged. The two bankers' associations are now discussing how a prospective merger can be implemented. Norges Bank argued for a single fund in its comments on the Banking Law Commission's Report no. 2 (NOU 1995: 25) on the Guarantee Schemes Act.

There is little that weighs against a merger of the two guarantee funds. The business profiles and balance sheet structure of the commercial and savings banks have become increasingly similar. Since the savings banks have been allowed to convert to limited liability companies, this trend may intensify in the future.

Although the changeover to a single fund may, at the outset, be accomplished regardless of other possible changes in this Act, it is the opinion of Norges Bank that the Guarantee Schemes Act should be evaluated anew. As part of Norges Bank's comments on the Banking Law Commission's Report no. 6 (NOU 2001: 23) on the activities of financial undertakings, we wrote the following: "Furthermore, an assessment of the guarantee fund scheme should be made on a broad basis in which one looks at how Norwegian practice affects the competitiveness of Norwegian banks vis-à-vis other countries." In addition to the changeover to a single fund, it will make sense in this connection to consider the size of the deposit guarantee, the mandate for the funds and the size and formation of the deposit insurance fee.

## Competitive conditions

### *Deposit and lending markets*

DnB NOR will have large market shares in some geographical areas and businesses. Figures from 2002 indicate that DnB NOR (including Nordlandsbanken) will have a market share of about 38 per cent in terms of both bank lending (to parties other than financial institutions) and deposits (from customers). This is approximately equal to the market share of Nordea Bank Finland in Finland. Danske Bank has a somewhat lower market share for bank lending and bank deposits in Denmark, but has a higher market share measured by total assets than what DnB NOR will have in Norway.

DnB NOR's market share with regard to bank lending and deposits will be even higher in eastern and northern Norway, and highest in Vestfold county. In the securities fund market, the market share measured by DnB NOR's share of combined total assets in this market will be 44 per cent. DnB NOR's share of total loans from finance companies is even higher (47 per cent), whereas the corresponding share for mortgage companies is 8 per cent.

The merged bank will have especially high market shares in some geographical areas when banks that cooperate with Gjensidige NOR Sparebank ASA are included. It is unfortunate that two banks in the same geographical area have agreements that may hinder competition. In their application, the parties to the merger state that agreements that cover anti-competitive arrangements and market cooperation will not be continued.

DnB NOR's large market shares imply weakened competition in parts of the banking market. The question is how much competition is weakened and whether any measures may be initiated to counteract this deterioration. Today, competition in most markets for banking services is strong. A reduction in the number of DnB NOR branches may prompt some customers to change banks, and many companies may wish to have more than one bank. Market shares may therefore fall somewhat. There are competitors who may establish themselves in areas where any market power is exploited. New technology and the Internet are contributing to this development. This applies especially to the private customer market. Large corporate customers that have a credit rating from a credit rating agency and are well known in the market will have access to financing from foreign banks as well as the securities markets. Reduced competition is likely to have the biggest impact on small and medium-sized enterprises in outlying regions, where intimate knowledge of the individual company may be essential and customer relationships limit moving from one bank to another. The savings banks' future commitment to this market will therefore be important. To ensure real alternatives to the merged bank, greater activity from savings banks aimed at customers of this sort would be desirable. Expanded cooperation, a change in the form of organisation and possible mergers are measures that may be considered to assist local savings banks in providing competition in a wider range of financial services.

Competition from abroad is also considerable and growing. First, there are several Nordic banks that define the Nordic region as their domestic market. Foreign ownership in the Norwegian finance sector is already at a high level compared with other Nordic and European countries. At the end of 2002, foreign-owned subsidiaries and branches represented about 26 per cent of the total capital in the Norwegian banking market. This is the highest share in the Nordic region. Both Nordea Bank Norge ASA and Fokus Bank ASA are parts of Nordic financial services groups. Percentages are higher in Luxembourg, Ireland and the United Kingdom, due primarily to these countries' roles as financial centres. Second, the EEA regulations provide ample opportunities for competition from foreign financial services companies through subsidiaries, local branches or cross-border activity. The rules for ownership in Norwegian financial institutions have recently been relaxed so that the possibilities for setting up cross-border businesses have increased. Third, increasing competition among providers of financial services is a high priority goal in the EU. The Financial Services Action Plan contains several specific measures intended to ensure this. Over time, this will contribute to stronger competition in Norway as well.

### *The money market*

The Norwegian money market is characterised by a small number of big players, including foreign banks, that are established in Norway. Although DnB NOR will become a significant player in the money market, the other players are probably large enough to prevent the new bank from acquiring dominating market power.

DnB is already one of the largest domestic players in the Norwegian foreign exchange market, but due to the large element of foreign players, DnB cannot be said to have power over this market either. NOR is a minor player in the Norwegian foreign exchange market.

With regard to the distribution of liquidity in the banking system, DnB NOR can attain a high level of dominance. DnB and NOR are settlement banks for a large number of smaller banks, and this, in addition to the size of the merged bank, will mean that DnB NOR will have a large percentage of the surplus liquidity in the market. It may be undesirable for a single player to control a large share of the banking system's liquidity and during certain periods to be the only provider of liquidity in the market. Weighing against the possibility that DnB NOR will have undesirable market power in the very short-term money market is the fact that there are no entry restrictions in this market, since most banks, including foreign subsidiary banks and branches, already have an account with Norges Bank. However, Norges Bank will follow developments in the money market closely and, if necessary, intervene if market power is exploited.

### *Settlement systems*

If the settlement systems of DnB and NOR are merged, there will be one bank fewer to operate level 2 settlement systems, i.e. in addition to Norges Bank's settlement system (NBO). This may lead to less competition in this market, and the impact of a failure in the merged settlement system will be greater. However, there will still be potential competitors. The market situation prior to DnB receiving a settlement bank licence in June 2001 was judged to be satisfactory.

## Summary

A merger between DnB and NOR will mean that a larger share of the overall risk of providing credit and other financial services to Norwegian businesses and households will be concentrated in a single financial services group. If a financial crisis should hit DnB NOR, its impact on the financial system will be more far-reaching than if a crisis were to hit either one of the groups today.

At the same time, a larger size will facilitate cost savings, diversification and better risk management, which may contribute to stable earnings and satisfactory financial strength. Whether or not a merger will make the financial system more stable will depend on whether such improvements are realised and, in general, on the strategic choices made by the merged group.

There is a need for close supervisory monitoring of DnB NOR's activities, not least regarding choice of risk profile and systems for managing risk. Such monitoring will also assist the authorities in dealing more quickly and more efficiently with serious problems, should they arise.

In crisis situations, the proposed financial group may pose greater challenges to the authorities due to its size and complexity. The banking crisis demonstrated that the authorities were capable of dealing with a crisis involving a larger portion of the Norwegian banking system than DnB NOR will constitute. However, the fact that the central government is a major shareholder may be a complicating factor in the handling of a crisis in the merged bank.

The merger will justify a broad review of the system of guarantee funds. Nevertheless, a changeover to a single fund should be implemented.

Norges Bank expects that competition in most markets for banking services will continue to be satisfactory after the merger. Reduced competition is likely to have the most significant impact on small and medium-sized enterprises in outlying regions, where intimate knowledge of the individual company may be essential and where customer relationships limit moving from one bank to another. Therefore, the savings banks' future commitment to this market will be crucial.

Norges Bank cannot see that financial stability considerations are a decisive impediment to the merger desired by the two banks.

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