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Co-operation between Competition Agencies and Regulators in the Financial Sector - Note by Norway

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1. Introduction

1. The financial crisis revealed the need for regulatory reform in the financial sector. New regulation has consequently been implemented across Europe in the years following the financial crisis. The objective of regulatory reform has partly been to ensure a stable financial system.

2. As a member of the European Economic Area (EEA), Norway and Norwegian financial institutions have been adapting to the reforms in the EU. The new regulation that has been implemented in Norway has thus mostly originated in the EU/EEA, but some of the regulation is a result of specific market conditions in Norway. In the period following the financial crisis, Norway has experienced a high growth rate in both private debt and house prices. Consequently, the Norwegian authorities have been concerned with the effect this may have on financial stability. Regulation specific for issuing mortgages has thus been implemented.

3. The Norwegian Competition Authority (NCA) acknowledge the need to implement stricter regulation in the financial sector to ensure financial stability. However, the NCA has expressed concern as to how certain parts of the legislation in the financial sector have been implemented. The NCA's attention has mainly been on the competitive impact of proposals from the regulators to improve or protect the stability of financial institutions. Specifically, the focus has mostly been on stricter capital[1] requirements for banks.

4. In its advocacy work, the NCA has focused on two areas. Firstly, to encourage the authorities to assess the competitive aspect and conduct in-depth analyses of competitive consequences when designing and implementing regulations in the financial sector. Secondly, to emphasize the importance of harmonized regulation in the EU/EEA. The aim of our advocacy efforts in this regard has been to ensure a level playing field in the financial sector.

2. Advocacy

5. The NCA has expressed its opinions about the implementation of regulation in different ways. First, the NCA has submitted responses in different consultation processes in 2013, 2014 and 2015. Second, the NCA published a market study on the Norwegian mortgage market in 2015. The topic of the market study was competition in the mortgage market in general, but it was also about regulation of banks. In addition, in 2016, the NCA authored a paper and an op-ed focusing on the possible impact of reduced

[1] Regulation in the financial sector following the financial crisis has meant increased capital requirements for banks. Capital consists mostly of equity.

competition on financial stability. These were published in the magazine Magma[2] and in Dagens Næringsliv[3], respectively.

6. There are other points of contact between the NCA and the regulators in the financial sector. The NCA has regular contact with the Financial Supervisory Authority of Norway (FSA) and other entities who are concerned with competition in the financial sector. In order to facilitate coordination between the NCA and the FSA, a collaboration agreement was entered into in 1996. The agreement stipulates that the NCA and the FSA will coordinate their proceedings in cases where the NCA and the FSA have overlapping interests, and keep each other informed on relevant cases. In accordance with the agreement, the NCA and the FSA have yearly meetings where current issues are discussed.

7. In addition, in 2014 the Ministry of Finance took the initiative to establish a forum for competition policy where the NCA, the FSA and the consumer authorities meet to discuss topics related to competition in the financial sector. The purpose of these meetings is cooperation and exchange of information between entities that have complementary and/or overlapping areas of responsibility. The meetings in the forum for competition policy are held biannually.

3. Consultations

8. Proposed legislation is usually sent on a public consultation process to obtain different stakeholder's views. In Norway, the Ministry of Finance is responsible for legislation concerning the financial markets, while the FSA usually develop the proposals on regulation in the financial markets.

9. The NCA has responded to four consultations concerning regulation in the financial sector in the period 2013 - 2015. In short, the proposed regulation has been about how to calculate capital requirements, which banks should be declared as systemically important financial institutions, and about the implementation of the CRR regulation and CRD IV directive on capital requirements in Norway.[4] The NCA also commented on the implementation of the Liquidity Coverage Requirement (LCR). In addition, the NCA has commented on proposed regulations on mortgages.

10. The NCA has in general been concerned with two recurring themes. Firstly, the NCA has encouraged the regulatory authority to evaluate the competitive effects of a proposed new regulation before implementation. As regulation may have an impact on competition, potential competitive effects of the regulation should thus be considered.

11. Secondly, the NCA has emphasized the importance of harmonized regulation across the EU/EEA. This is to ensure that banks operating in Norway will have an equal opportunity to compete. This is further presented in the section below.

[2] Magma is a membership magazine for members of Econa, a trade union for economists.

[3] Dagens Næringsliv is a Norwegian financial newspaper.

[4] The CRR regulation and the CRD IV directive give, among other things, detailed provisions on capital requirements.

4. The Basel I transitional floor

12. In the EU and EEA, national supervisors set capital requirements for domestically chartered banks, i.e. banks with head offices in the country and subsidiaries of banks with head offices in other EEA countries. Branches of foreign banks are not subject to regulation by the host country. Most foreign banks operating in Norway are Swedish and Danish banks. In Norway, some parts of the capital regulation have been interpreted differently than in Sweden and Denmark. Specifically, this concerns the distinctively Norwegian interpretation of the Basel I floor.

13. All banks must maintain a minimum ratio of total capital to risk weighed assets (RWA). After the introduction of Basel II in the EEA in 2007, banks were allowed to use internal risk models in order to calculate RWA, rather than using the standard weights of Basel I. This meant that banks could use their own risk weights to calculate RWA. The banks who used these internal risk models (IRB banks) were able to reduce their RWA considerably. In order to prevent banks from reducing their capital stock too much, a transitional floor for their capital was introduced. This is referred to as the "Basel I floor", or "the floor". The Basel I floor is that a banks' capital must not fall below 80 percent of what it would have been under Basel I.

14. The Basel I floor calculation in Norway differs from that in Sweden and Denmark. In Sweden and Denmark, the floor of 80 percent is applied to the absolute amount of capital the banks have, i.e. the numerator in the capital ratio.[5] In Norway, however, a bank's risk weighed assets cannot be lower than 80 percent of what they would have been under Basel I. This means that a Swedish or a Danish bank can adapt to the floor more easily than a Norwegian bank.[6] It is easier to achieve a higher capital ratio when the bank is able to lower RWA, i.e. the denominator in the capital ratio. A Norwegian bank thus has to hold more capital than a foreign bank to satisfy the 80 percent transitional floor.

15. The NCA has expressed concerns that the way the Basel I floor has been interpreted and implemented may have an adverse effect on competition between banks. First, because of the difference in regulation, Norwegian banks have to hold more capital than foreign banks who give loans to customers (both private and business customers) in Norway. This leads to a cost disadvantage for Norwegian banks, because equity (i.e. capital) is more expensive than debt.[7] Second, the distinctive Norwegian capital regulations cause Norwegian banks to appear less robust than foreign banks. This may contribute to higher funding costs for Norwegian banks in the international capital

[5] The capital ratio is calculated as total capital divided by risk weighed assets.

[6] The Swedish and Danish banks operating in Norway have satisfied the transitional floor. Note, however, that Swedish and Danish regulators have acknowledged regulation that causes a tightening of risk weights for banks operating in Norway. This regulation means that Swedish and Danish banks have to hold more capital, which reduces the differences between Norwegian, Swedish and Danish banks.

[7] According to the Miller-Modigliani (M-M) theorem, a firm's total cost of capital does not change when the share of equity (i.e. capital) and debt changes. Studies have shown, however, that the theorem does not hold and that the total cost of capital increases as the equity ratio increases. A study by Miles, Yang and Marceggiano (2013) suggest that the M-M effect is 45 – 75 percent, while a study by the European Central Bank (2011) suggest that the M-M effect is 41 – 73(78) percent.

markets. The NCA has thus advocated a policy for implementing the Basel I floor in a way that is more harmonized, thus with a less adverse effect on competition.

5. Regulation of mortgages

16. In 2015, following a period of a high growth rate in both private debt and house prices, the Ministry of Finance proposed to implement new regulation on bank's mortgage lending. Earlier regulation consisted of a set of guidelines that banks were recommended to follow. The proposal thus meant a more formalized set of rules for issuing mortgages.

17. The proposal included a range of specific rules on, among other things, thresholds for the loan-to-value ratio and the borrower's debt-to-income ratio. As an example, the loan-to-value ratio on a standard mortgage is 85 percent. The proposed regulation applied to new mortgages, including mortgages that are refinanced when a customer switches from one bank to another.

18. The NCA commented that a relatively large share of the mortgages that had previously been granted would not be approved under the new regulation. Hence, these mortgages could not be moved between banks after the implementation of the regulation. As an example, the NCA pointed out that 15 percent of all mortgages had a loan-to-value ratio over 85 percent. This amounted to over 200 000 households. A large number of the banks' customers would thus be locked in. This may be problematic because banks get an increased incentive to increase prices, e.g. the interest rates on mortgages. In addition, the NCA commented that this might cement the existing market structure.

19. When the regulations was implemented, it was with a clause that makes it possible to move existing mortgages between banks. This alleviated the problem of locked-in customers.

6. Market study on the Norwegian mortgage market

20. In 2015, the NCA published a market study on the Norwegian mortgage market. The background for initiating the market study was observed increases in profitability and margins in the Norwegian mortgage market in previous years. The developments in the banks' profitability and margins were intensively debated in the media. As the banks prepared to increase the interest rates on mortgages in 2013, they made several announcement in the media. Their main message was that increased mortgage rates was a necessity to comply with stricter capital requirements. In addition, regulatory reforms that led to tightened capital requirements for Norwegian banks had been criticized by the industry and the NCA because they created competition on unequal terms for banks operating in Norway.

21. A substantial proportion of the Norwegian population are homeowners. Home purchases are usually funded by mortgage loans. Thus, proper functioning of mortgage markets is of great importance for consumers. Given the importance of the sector for consumers and the recent developments, the NCA conducted a sector study of the competition in the Norwegian mortgage market. The aim of the study was to identify potential restrictions to competition. Based on the findings, the NCA proposed various measures to promote competition in the sector targeted at both the government and the industry.

22. The study was mainly based on information gathered from a sample of banks operating in the Norwegian mortgage market. The findings showed a significant increase in average margins in the mortgage market from 2012 and onwards. In addition, following the financial crisis, there was a reduction in the variance of mortgage rates offered by various banks. Equal prices and high margins may indicate collusive pricing behaviour.

23. The NCA concluded that the market conditions in the mortgage market facilitated coordination on prices. There are entry and expansion barriers in the market that limit the ability of potential players and smaller banks to challenge the major banks' pricing behavior. The main expansion barrier is low consumer mobility. The NCA found that there are both search and switching costs in the market that may contribute to the low consumer mobility. Search and switching costs have lock-in effects on consumer behavior that in general have negative effects on competition. Consumers locked to one supplier are less price sensitive. This allows banks to set higher mortgage rates without losing a significant proportion of their customers to their competitors.

24. A review of the possible impact of regulation on competition was also an important part of the report. The NCA found that the increase in margins and the reduction in the variance of mortgage rates coincided with the introduction of regulations that tightened capital requirements for Norwegian banks. To strengthen their capital under stricter capital regulation, the banks mainly used retained earnings that largely stemmed from a rise in margins in the mortgage market. The NCA thus found that the introduction of stricter capital regulation may have facilitated a collusive outcome in the market by making it easier for banks to find a common focal point for their prices. The NCA argued that it is important to take into account competitive implications of new regulation.

25. The NCA found that the stricter capital regulations may have had adverse effects on competition among banks. The capital requirements increased relatively much during a fairly short period. In addition, the NCA pointed out that the regulation is not fully harmonized with the capital regulations in the European Union. Given that home country authorities regulate branches of foreign banks, this creates competition on unequal terms for banks operating in Norway. The capital requirements are essentially higher for Norwegian banks than for branches of foreign banks operating in Norway. In addition, the distinctive Norwegian capital regulations can cause Norwegian banks to appear less robust than foreign banks. Each of these factors contributes, all else equal, to higher funding costs for Norwegian banks.

26. In the market study, the NCA advocated a policy for implementing the Basel I floor in a way that is more harmonized, and consequently with a less adverse effect on competition.

27. Furthermore, the NCA emphasized that the competitive consequences of new regulation should be assessed when new regulation is designed and implemented.

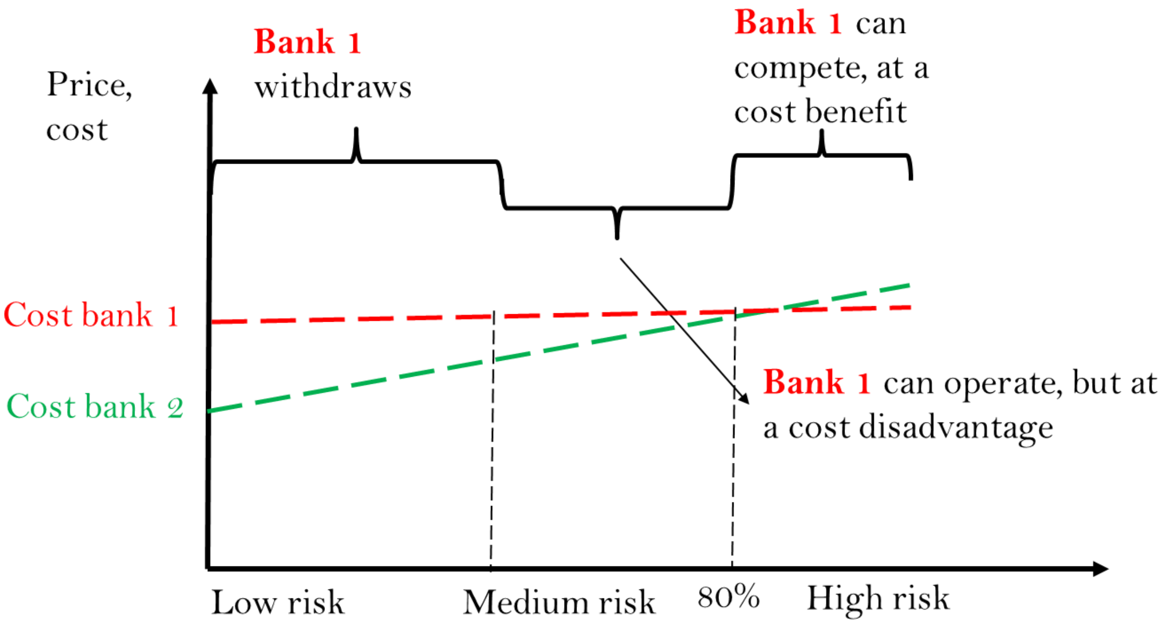
7. Competition and financial stability

28. The purpose of regulation in the financial sector is to improve financial stability. In 2016, the NCA authored a short paper that was published in Magma. In the article, the NCA argued that the distinctively Norwegian regulation could lead to reduced competition, and that this may counteract financial stability.

29. As presented above, the transitional floor leads to Norwegian banks having to hold more capital than foreign banks. This leads to a cost disadvantage for the Norwegian bank relative to the foreign bank.

30. The capital requirements take into account the riskiness of the banks' assets, and risk weighting implies higher capital requirements for riskier exposures. Hence, the size of the risk weights depend on the degree of risk associated with their loan exposures. The Basel I floor has the effect that Norwegian banks has to hold the same amount of capital regardless of how risky the underlying asset is. A foreign bank is able to hold less capital for less risky assets, and so on. This has an impact on costs and pricing. In order to illustrate the differences between Norwegian and foreign banks, the NCA constructed and example in which two banks are compared. . Bank 1 is a Norwegian bank that does not hold enough capital to satisfy the Basel I floor.[8] Bank 2 is a branch of a foreign bank. It is assumed that the banks would have the same costs if not for the distinctively Norwegian Basel I floor. This is illustrated by the green line in the figure. In this case, the Norwegian bank is required to hold more capital for low and medium risk assets. The Norwegian bank thus has a cost disadvantage in these segments, as illustrated by the red line in the figure. In the segments for high risk however, the Norwegian bank has a cost benefit. The figure illustrates the situation for banks' lending to businesses.[9]

Figure 1. Costs for Bank 1 and Bank 2, for low, medium and high risk



31. As illustrated by the figure, the cost disadvantage for the Norwegian bank in the low risk segment is large enough to make the bank withdraw from this segment. The Norwegian bank can still operate in the medium risk segment, but it will still have a cost

[8] All Norwegian IRB banks still has to increase their capital ratio to satisfy the Basel I floor.

[9] Under the Basel I regulation the risk weight for business loans was 100 percent. Given that the Norwegian bank does not satisfy the Basel I floor, the marginal risk weight for business loans is 80 percent.

disadvantage. In this situation, it is possible for the foreign bank to strategically adjust its pricing, and set its price just below the Norwegian bank. The foreign bank is then able to capture the entire medium risk segment. In the high risk segment the situation is reversed, and the Norwegian bank has a cost benefit.

32. According to this argument, the effect of the distinctively Norwegian transitional rule is a shift in market shares. In the low and medium risk segments, we expect that foreign banks will take a larger share of the market, while in the high risk segment it is expected that the Norwegian banks can gain a larger market share. The NCA has observed that this is in line with the observed development in the Norwegian bank market, where foreign banks have gained a larger share of the market. Some Norwegian banks also signalled that they would exit or scale down on lending to businesses.

33. In the short run, these effects have a negative impact on the market. The shift in market share in favour of foreign banks leads to higher costs for the banks customers, because of the foreign banks' ability to adapt strategically to the situation. This effect is weaker, however, if the foreign banks exert strong competitive pressure on each other.

34. The purpose of the regulation is not to ensure positive gains in the short run. The purpose of the regulation is to make banks more solid and thus ensure a stable financial system in the long run. In the NCA's opinion, it is not obvious that this will happen, however. First, Norwegian banks will account for a relatively smaller share of loans in the low and medium risk segments. Norwegian banks will thus end up with more risky assets, on average. Second, it is not certain that there will be a decrease in total lending, since the foreign banks can replace the Norwegian bank's lending. Third, a shift in market shares due to banks competing on unequal terms can lead to a misallocation of loans. It is not necessarily the most efficient bank with the best risk assessment that gains the largest market share. This can lead to poorer risk assessments of borrowers, which again can be problematic for financial stability.

35. It is also relevant to look at the behaviour of foreign banks operating in the Norwegian market. During the financial crisis foreign banks retreated from the market to a greater extent than Norwegian banks. Following the financial crisis, foreign banks had a higher growth rate than Norwegian banks. This might be an indication that foreign banks benefit from the difference in regulation. If the distinctively Norwegian regulation leads to procyclical lending from foreign banks, foreign banks may retreat from the market in a crisis.

36. As mentioned, foreign banks had a higher lending rate than Norwegian banks. Lending from foreign banks is also more volatile. A review of literature on bank ownership and lending may provide an explanation of the volatility of foreign banks' lending.[10] The volatility of foreign banks' lending can be explained by their ability to allocate capital within the banking concern. Studies have shown that a crisis in the bank's home country led to reduced lending in other countries. Hence can foreign banks' lending be cyclical. In addition, an economic crisis in the home country can then spread to other countries. In the opposite case, when there is a crisis in the host country, foreign banks can have a positive effect on the lending supply.

37. In 2016, Nordea applied to the Norwegian government to change its legal structure and merge with its Swedish parent company, and thus become a foreign bank.

[10] Turtveit (2017) *Branches of foreign banks and credit supply*, Economic commentaries No. 3/2017, Norges Bank.

Nordea is one of the largest banks in Norway, and is defined as a systemically important financial institution. The change of Nordea's legal structure was approved, and in January 2017 Nordea became a branch of a foreign bank. This means that 36 percent of all business loans in Norway are issued by foreign banks.

38. The discussion of competition between Norwegian and foreign banks was the subject in a newspaper op-ed authored by the NCA. The newspaper article was written when Nordea's application to merge with its Swedish parent company was pending. The NCA emphasized that the stricter Norwegian regulation may cause Norwegian banks to move abroad, and that a branchification of Nordea would lead to an increase in foreign bank's market share.

39. The NCA has argued that regulation that favours some banks may counteract financial stability. This is the opposite of the intended effects of the regulation. Observations of the Norwegian market may indicate that branches of foreign banks have benefitted from the more favourable regulation.

8. Concluding remarks

40. It is important to ensure financial stability through more solid banks. The NCA and the regulators in the financial sector have a continuous dialogue concerning the impact of regulation on competition. In this process and in its advocacy work, the NCA has been concerned with how the implementation of regulation in the Norwegian market has influenced competition.

41. In general, the NCA's advocacy efforts in this field have pursued two major goals: Firstly, to encourage the authorities to assess the competitive aspect and conduct in-depth analyses of competitive consequences when designing and implementing regulations in the financial sector. Secondly, to emphasize the importance of harmonized regulation with the EU/EEA. As of today, the NCA consider that these concerns have not been remedied to a full extent.

42. A more successful advocacy effort regards the regulations in the mortgage market. Here, the NCA commented that some customers would be locked in because they had been granted a mortgage under less strict rules. The regulation was eventually implemented with a clause that make it possible to move existing mortgages between banks. This alleviated the problem of locked-in customers.