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Regulatory changes in the banking industry

Navn:	Jon Stian Gulbrandsen Eide, Stian Hallum

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Espen Andersen

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Introduction

The banking sector in the European Union (EU) and in the European Economic Area (EEA) have experienced several changes in recent years: higher customer expectations, new regulations and deregulation, as well as new born-digital competitors are transforming banks playing field. As of mid 2017, there has been a dramatically increase of financial technology companies (fintechs) that are entering markets previously dominated by banks. These fintechs are challenging banks with flexible and personalized solutions toward the end consumers. Traditionally, banks have not been able to provide such flexible and personalized products and services due to strict regulations. In addition, large technology firms (bigtechs) and other non-banks have also started to offer payments solutions (for example, in the United States Facebook has made it possible to transfer money from their Messenger application, Apple have launched Apple pay, and in China Alibaba have launched Yue Bao which in short time became the world's largest money market funds), this is indicating that the traditional bank sector are being threatened by firm from several different industries.

Historically, entry barriers in the banking industry have been high. Barriers such as licensure laws, capital requirement, access to financing, regulatory compliance, and security issues have hindered new players from entering. As a consequence, banks have not had the same pressure as more consumer-centric industries (e.g. technology intensive industries, hotel industry, telecommunication industry) to innovate. In addition, before the 1990s cross-border expansions were subject to the authorization and subsequent control of the host country, as well as to capital requirement (Angelini & Cetorelli, 2003), hindering banks from branching across borders and hence limiting competition.

When the EU was founded in 1957 their goal was to build a "common market" for trade. To achieve this, the internal market had to have a close economic and monetary co-operations (EC, 2018a), which in 1991 led to the Treaty on European Union (the Maastricht Treaty). This involves the coordination of economic and fiscal policies, a common monetary policy and a common currency, the euro (EC, 2018d).

Motivated by establishing a single, competitive market for financial services, European countries have since the 1980s implemented several regulatory changes

affecting the banking industry. To increase cross-border competition in the EU the Second Banking Coordination Directive (89//646/EEC) went into force 1st of January 1993 defining the basic conditions for the provision of the so-called Single Banking Licence (EC, 1992). This directive was considered to be one of the most significant deregulation in European Banking in recent history (Angelini & Cetorelli, 2003). The directive enabled banks to branch freely into other EU countries and thereby created the world's largest banking market free of regulatory barriers (EC, 1992).

Since the 1990s, the EC have continuously worked to harmonize the payments services within its borders. The EU is aiming at creating a single euro payment area (SEPA) which lets citizens and businesses make cross-border payments as easily and safely as they would in their home countries, and cross-border payments are subject to the same charges as domestic payments (EC, 2018b). As electronic and non-cash payments started to increase in the 2000s, the EU sat up some common rules for payments with the adaptation of the first Payment Service Directive (PSD1, Directive 2007/64/EC) in 2007. This directive introduced a new category of payment service providers other than banks, called "payment services", with the aim of increasing competition around banks and increase consumers choice (EC, 2018b). This directive laid the groundwork for the aforementioned single euro payments area.

Today, banks are facing an even more significant deregulation than the Second Banking Consolidation Directive (SBCD) and the first Payment Service Directive. In 2015 the EU adopted a new directive on payment services: the revised Payment Service Directive (PSD2, Directive 2015/2366/EU) which went into force January 2016 and were applicable from 13th of January 2018 (some countries are behind on the implementation process). The new rules will enable banks customers, both consumers and business to use third-party providers (TPPs) to manage their finances, PSD2 prohibit surcharging, and enhance consumers' rights. Through this directive, the EC aims to improve innovation, reinforce consumer protection and improve the security of internet payments and account access within the EU and EEA. It introduces two new types of players to the financial landscape: Account Information Service Provider (AISP) and Payment Initiation Service Provider (PISP). PSD2 widens the scope of PSD1 by covering new services and players as well as by extending the scope of existing services (EC, 2018c).

Research Statement

When the EC adopted the SBCD, they attempted to improve competition in the banking sector, this was also an important objective in PSD1 and consequently in PSD2. In Angelini and Cetorelli (2003) article "The Effects of Regulatory Reform on Competition in the Banking Industry" they illustrated that European banks had been consolidated through a substantial decrease in number throughout Europe between 1987-1997. Which would, according to the structure-conduct-performance paradigm hypothesis result in negative effects on competition, especially since these consolidations took place within individual countries (they reported that few cross-border bank mergers had been observed in Europe) (Angelini & Cetorelli, 2003). Berger (2000) research on efficiency gains in the financial industry reported that the actual efficiency gains earned through integration were likely to be small compared to the potential, indicating that the consolidation observed in Europe in the 1990s could simply have been driven by the need to grow larger and consequently more difficult to acquire (Angelini & Cetorelli, 2003). Research conducted about the deregulation in the 1990s, indicated that competition among European banks had only improved modestly due to the deregulation (Angelini & Cetorelli, 2003).

As mentioned in the introduction, several important regulations/deregulations have been implemented in the European banking sector since the 1990s. We intend therefore to further develop our understanding of how regulatory reforms have impacted the banking industry's competitive landscape between 1998 and 2018.

Research Question

"How does regulatory reforms and competitive pressure change the banking environment?"

The Banking Industry

To illustrate how the banking industry are structured and how it has performed we are using data from The European Banking Federation (EBF) which has been compiled from publicly available information released by the European Central Bank (ECB), European Commission (EC), Eurostat, The European Banking Authority (EBA), International Monetary Fund (IMF), national competent authorities and members of the European Banking Federation (EBF, 2017c).

Number of Credit Institutions

After the financial crisis in 2008, the number of credit institutions started to decline in 2009. It has been a reduction of 1.929 in total since 2008 (8525 in 2008 – 6596 in 2916), and from 2015 to 2016 the numbers decline with approximately six percent. When considering the segments: “branches of EEA-based credit institutions (outside the euro area)”, “branches of euro area-based credit institutions”, “branches of non-EEA based banks”, and “credit institutions legally incorporated in the reporting country”, the EBF shows that it is in the “credit institutions legally incorporated in the reporting country” that most of the consolidation take place, in this segment the stock has fallen by 26 percent since 2008.

Branches and Subsidiaries

In 2008, “bank branches” in the EU consisted of 237.702 units, in 2016 this number had decreased to 189.270 branches which equals a contraction of 20,4 percent. From 2015 to 2016 the decrease was approximately 4,6 percent.

Customers have increasingly adopted electronical payments as well as online and mobile banking, which has reduced the importance of widespread bank branch networks, which have allowed banks to reduce the numbers of physical location.

The overall number of “subsidiaries” of credit institutions within the EU have been declining for the nine consecutive years, from 503 in 2008 down to 343 in 2016. The number of subsidiaries of credit institutions outside EU have remained quite stable, in 2008 subsidiaries outside the EU were 286 compared to 2016 it had declined to 258. On the other hand, from 2015 to 2016 the drop were approximately 4.7 percent, the sharpest year-on-year fall since 2004.

Bank Staff

The lowest number recorded of employees in the banking sector, since the ECB began collecting data in 1997 was by the year end 2016. In 2016 number of employees in credit institutions consisted of 2,8 million. This is a drop of approximately 14 percent since 2008.

Bank Capital

The European banking sector have become more resilient and robust since the financial crisis as the recapitalisation effort that European banks have made is starting to pay off. EU banks show a solid capital position and have continued to strengthen their balance sheets (see table below).

Total (recorded in June every year)	**2011**	**2012**	**2013**	**2015**	**2016**
Core Equity Tier 1 Capital	5,3%	7,8%	9,0%	11,8%	12,8%
CET1 shortfall (€bn.) at 4.5%	29	9	15	0	0
CET1 shortfall (€bn.) at 7%	277	130	65	1	1
Tier 1 Capital	6,8%	8,1%	9,2%	12,3%	13,4%
Total Capital	8,1%	9,1%	10,9%	14,7%	16,1%
Tier 1 Capital shortfall (€bn.)	411	249	120	8	4
Total Capital shortfall (€bn.)	544	383	190	18	4
Leverage Ratio (3%)	2,8%	3,1%	3,1%	4,4%	4,7%
Leverage shortfall (€bn.)	N/A	N/A	64	9	3
Liquidity Coverage Ratio	71%	N/A	110%	128%	135%
LCR Shortfall (€bn.)	1.200	N/A	262	33	3
Net Stable Funding Ratio	89%	95%	N/A	105%	108%
NSFR shortfall (€bn.)	1.800	1.200	N/A	341	159

(Data and assumptions from EBA and EBF, EBF, 2017a)

Bank Profitability

The return on equity (ROE) was 3,5% in 2016, down from 4,3% in 2015. This is reflecting the low interest rate, which have become a challenge for banks. Banks ROE have fluctuated the last decade from 10,6% in 2007 and down to -1,5% in 2008. In 2009 and 2010 ROE grew to 1,4% and 3,8% respectively, before it fell down to -0,2% and further down to -0,9% in 2011 and 2012 respectively. ROE have since 2013 been fluctuated positively.

Increased competition from fintechs

As shown above, the European banking sector has shown a positive growth from 2013, however, new regulations and disbursement of new technology are presenting challenges as well as opportunities for banks.

Regulations have led to increased capital and liquidity needs for banks. Regulations have also resulted in a rise in operational costs resulting from increased compliance and reporting. Profitability has been pressured with respect to cost of equity (COE), which has exceeded ROE since 2008 (EBF, 2017b), (see graph below).

Source: Bloomberg, Datastream, Consensus Economics, ECB Calculations. Retrieved from: ECB presentation from 7 July 2016 "Challenges for the European banking industry"
Note: Latest observations are for Q1 2016 (ROE) and Q2 2016 (COE)

EBF shows to a confidential survey to senior executives of European banks on what they believe are the biggest challenges facing EU banks, these are (1) capital requirements, (2) reporting requirements, and (3) liquidity requirements. In addition, 90 percent of banks are stating that digitalisation is a priority to increase their competitiveness (EBF, 2017b).

Important EU regulations

The European payment landscape shifted in January 1999 as the EU introduced the euro currency, and its cash implementation in 2002 with a goal of creating an economic and monetary union for all EU participants. The aim was to facilitate further harmonization within its border, and to create a standardized method of payments for a single market in the EU (EC, 2018a).

According to the EC, they are working to create an efficient an integrated market for payment services that guarantees; the same rules across the EU; clear information on payments; fast payments; consumer protection; and a wide choice of payment services in the EU (EC, 2018c).

Definition of payment services

The EU defines payment services as:

- allow people to deposit or withdraw cash on or from a payment account, as well as the operation of that account;
- execute payment transactions (e.g. standing orders, direct debits, etc.) both on payment accounts or by electronical means;
- issue and/or receive payment instructions;
- execute money remittance (transfers of money by foreign workers to persons in their home country

To achieve these, the EU has adopted two initiatives, the Payment Service Directive (PSD1) and the Revised Payment Service Directive (PSD2).

PSD1

Based on EU's aim at creating a single payment area Directive 2007/64/EC, commonly known as PSD1 was adopted by the EU in 2007, and fully implemented in 2009.

The directive provided the rules to regulate payment services to create a European single market for payments, with an aim at; making payments through EU easy, efficient and secure; open up for new entrants to facilitate increased competition; and setting the legal ground rules for PSD's requirements. The directive was incorporated into national law by 1. November 2009, and replaced all EU members national rules.

When looking at the results of this regulation in retrospect, the conclusion by the European commission was that several initiatives did not accomplish their goals

such as the aim at increasing collaboration between payment institutions and banks. This was argued with banks reluctance to share necessary information about their customers bank accounts to third parties. As to the payment services, the aim of increased competition did not achieve success where banks still controlled the majority of payment services which also hindered innovation. On the other hand, the positive effects of PSD1 was that cross-border payments became easier, more efficient and secure (EC, 2013).

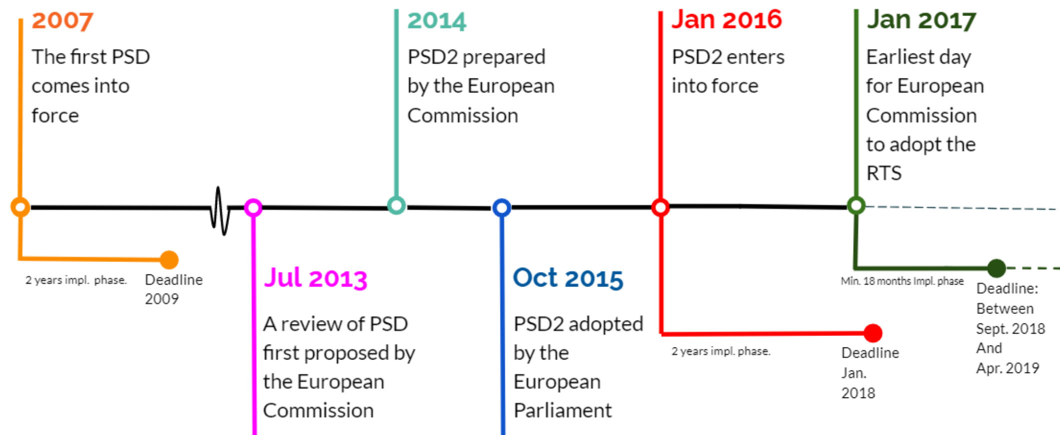
PDS2

The revised Payment Service Directive (PSD2, Directive 2015/2366/EU), proposed by the European Commission in July 2013 and agreed by co-legislator in 2015, is the latest in a series of laws adopted by the EU in order to provide for modern, efficient and cheap payment services and to enhance protection for European consumers and businesses.

The aim of PSD2 is to provide the legal foundation for further development of a better integrated internal market for electronical payments within the EU, setting comprehensive rules for payment services with the goal of making international payments (within the EU) as easy, efficient and secure as payments within a single country, and to provide the necessary legal platform for SEPA (EU, 2012). The directive also aims at opening up the EU payment market to third party providers (TPPs), aiming on expanding the competitive environment, create new innovative solutions and enhance collaboration between banks and non-banks.

In a press release on January 12, 2018 from the European Commission Valdis Dombrovskis (Vice-President responsible for Financial Stability, Financial Services and Capital Market Union) said: “This legislation is another step towards a digital single market in the EU. It will promote the development of innovative online and mobile payments, which will benefit the economy and growth. With PSD2 becoming applicable, we are banning surcharges for consumer debit and credit card payments. This could save more than €550 million per year for EU consumers. Consumers will also be better protected when they make payments” (EC, 2018c).

Below is the timeline regarding PSD1 and PSD2:



(Source: Every, 2017)

Initial Literature Review

In the first section of our literature review we have used Hoskisson, Hitt, Wan, and Yiu (1999) paper "Theory and research in strategic management: Swing of a pendulum" as main source for getting an overview over the evolution and development of strategic management research.

Strategic management research

Several different perspectives in strategic management research have been developed and researched in the search of explaining the survival and success of a firm. These perspectives have dramatically changed our interpretation of firm success over the years. The early work by Chandler (1962), Ansoff (1965), and Learned, Christensen, Andrews, and Guth (1965/1969), laid the foundation of what is today a comprehensive body of research within the strategic management field. In the 1960s, the aforementioned authors built their research on classical management theories introduced; Barnard (1938), Selznick (1957), and Penrose (1959), among others (Hoskisson et al., 1999). According to Chandler (1962) strategy is "the determination of the basic long-term goals and objectives of an enterprise, and the adaptation of courses and action and the allocation of resources necessary for carrying out the goals" (Chandler, 1962). Chandler (1962) further defined structure as "the design of organization through which the enterprise is administered" (Chandler, 1962). According to Hoskisson et al. (1999) changes in strategy can therefore be interpreted as responses to opportunities or needs created by changes in the external environment (e.g. technological innovation). In this time-

period, the focus was on the internal competitive resources and aimed at identifying firms' "best practices" that contribute to firm success (Ansoff, 1965; Learned et al., 1965/1969).

In the 1970s and 1980s the strategic management research shifted direction from the firms' internal factors toward the firms' external factors. Research that previously were dominated by inductive, case studies on a single firm or industry, had now turned towards deductive, large-scale statistical analysis seeking to validate scientific hypotheses (Hoskisson et al., 1999). The shift had been influenced by industrial organizations (IO) economics, where (Bain, 1956, 1968) introduced the structure-conduct-performance (S-C-P) paradigm. Bain (1968) was concerned with "the environmental settings within which enterprises operate and how they behave in these settings as producers, sellers, and buyers" (Bain, 1968). This turned the internal of view of the firm into an external approach, where the primary unit of analysis was the industry or competing groups of firms. As summarized by Porter (1981) the S-C-P paradigm can be explained as " that a firm's performance is primarily a function of the industry environment in which it competes; and because structure determines conduct (or conduct is simply a reflection of the industry environment), which in turn determines performance, conduct can be ignored and performance can, therefore, be explained by structure.

Industrial Economics Research

Michael Porter employed IO economics logic to utilize a structural analysis approach (M E Porter, 1980), to understand the structure of an industry. Porter focused on competition outside the firm's immediate and existing rivals. To specifying the various aspects of an industry structure, Porter developed his famous "Five Forces Model" (M E Porter, 1980), this is a useful analytical tool to assess an industry's attractiveness and facilitates competitor analysis. According to M E Porter (1980); Porter (1985, 1996), the ability for a firm to gain competitive advantage rests mainly on how well it positions and differentiates itself in an industry to make profit.

Strategic groups

The strategic groups analysis approach have been used by scholars studying a broad variety of industries and "is a method of segmenting or classifying different groups of competitors within an industry on the basis of strategic dimensions such as

geographical spread or degree of product diversity" (Letto-Gillies, 1996, p. 189). Firms often have similar characteristics, where these can be identified by e.g. strategy or resources (Hatten & Hatten, 1987), and can further with emphasis on this be places into different strategic groups (Hunt, 1972; Michael E. Porter, 1980).

The concept of strategic groups is closely linked to mobility barriers (Caves & Porter, 1977). Mobility barriers are explained as barriers hindering firms in one strategic group from entry by members of another group through means such as scale economies, product differentiation, or distribution network. Mobility barriers represent crucial factors, in addition to industry-wide factors, in accounting for intra-industry differences in firm performance (Caves & Porter, 1977; Porter, 1979) in this regard, industry is no longer viewed as a homogeneous unit to the extent that the concept of strategic groups exposes the "structure within industries" (Porter, 1979).

Porter (1980) identified cost leadership, differentiation and focus as three generic strategies for competitiveness:

Cost leadership – refers to firm's strategy where reduction of prices in the sense of e.g. "stripping" the product of its excessive features and technological enhancements, enabling firms to outperform their more high-end competitors on price. In this sense, firms could cover the market where just the core of the product is needed. Linking this to the banking industry, we have seen an emergence of pure internet banks such as S'banken (Skandiabanken) in Norway among others, where scholars and consulting firms have discussed whether this is a part of a disruptive path for the banking industry as we see it today.

Differentiation strategy – refers to firm's that segments themselves outside the "normality" per se, of a given service or product, where e.g. uniqueness in product specifications attract customers with higher willingness to pay than the more price sensitive ones attracted to the cost leadership strategy. In comparison to the cost leadership strategy where customers are more price sensitive and much more mobile in their firm preferences, these customers have tendencies of stronger loyalty due to their certain preferences and quality specifications.

The focus strategy – refers to firms who specialize themselves towards a more concrete segment within e.g. a certain geography, compared to the two others who

strives to cover the whole market. In the banking industry, this segment can be compared to local banks which focus more on customer relations and local knowledge, which further enables them to profit from higher fees than the industries normal.

Although the methodology on how to identify strategic groups and the overall theory has been criticized (Barney & Hoskisson, 1990; Cool & Dierickx, 1993; Hatten & Hatten, 1987; Ketchen & Shook, 1996), empirical research on the subject have covered several industries, and related to this thesis insurance (Fiegenbaum & Thomas, 1990), and banking (Amel & Rhoades, 1988; Mehra, 1996), with interesting results. McGee and Thomas emphasize that researchers on this subject must obtain a thorough understanding of the industry to be capable of identifying groups correctly. Thus, the validity of the results has been argued back and forth by scholars on the background of their variety of samples, statistical test and variables used to identify and measure groups.

The overall goal within both the strategic group and industrial organization literature has been to explicate on groups and firms performance and profitability differences in industries (McGee & Thomas, 1986). Although the perception of strategic groups and what they actually are, is for each individual to judge (McGee & Thomas, 1986), the difference in variables and measuring choice could give completely different results.

In the late 1980's and early 1990's there was several studies on strategic groups with variations on primary data used. Reger and Huff (1993) presented an overview over the industry and data used in the most acknowledged papers at that time, where archival was a clear dominator, whereas survey questionnaire validated with archival, conceptual, interviews and multiple case studies was used as main data source in a fraction of the papers.

Within the banking industry, strategic groups have obtained great attention, where the method of group identification and performance measures has had the same spread as other industries. The method of using size (their market share), suggested by Porter to be used as a proxy for group membership, as a key variable , which has been one of the more conventional methods of grouping banks, is argued by some

scholars to be a poor standalone measure (Brown & Glennon, 2000). In Brown and Glennon's (2000) paper on commercial banks and their usage of same production technology and cost structure portfolio composition, bank portfolio composition was used, and argued to be a more thorough measure than size. Due to banks diversity of asset types, they conducted a cluster analysis, using a minimum distance criterion, where agricultural loans, securities, real estate loans, C & I loan, consumer loans, core deposit, purchase deposit, off-balance deposit, off-balance sheet, loans sold and brokered deposit was used as series to identify the clusters. The usage of cluster analysis could be argued to be a more comprehensive method since more than one variable can be used, and has been applied by several researchers within the banking industry (Amel & Rhoades, 1988; Prior & Surroca, 2006). On that respect, the results in the majority of papers on analyzing the banking industry identified differences of significance in profitability between groups (Koller, 2001; Mehra, 1996, p. 67).

Further literature review

In our initial literature review we considered strategic groups to be a key aspect to look at the performance of an industry. As these types of research often surfaced during our literature search. In the last days of our preliminary review we have seen that there are several different methods to determine the performance of an industry. And we therefore need to gain a more comprehensive understanding of previous studies in this field. As a consequence, our methodology part is not yet complete due to sudden changes, but are leaning towards the approach used by Angelini and Cetorelli (2003) at this particular time, as this research looked at the same factors that we are considering; regulatory changes and competition in the banking environment.

Methodology

Our study aims at identifying possible competitive environmental changes in the Scandinavian banking industry within the timespan 1998-2018. To do so, we will conduct a longitudinal quantitative study based on the one applied by Angelini and Cetorelli (2003) in the Italian banking industry. This approach "is based on the econometric estimation of the parameters of a firm's behavior equation" (Angelini & Cetorelli, 2003, p. 667), and we will estimate marginal costs, Lerner Indexes, and R&D investments.

Lerner Index:

- The Learner Index can be written as (P-MC)/P, where P = market price and MC = marginal cost set by a bank/firm. The index can range from 0-1, where a firm with L=0 implies that the firm has zero market power.

Research and development investment (R&D):

- We will also estimate the changes in R&D investments done by banks in Scandinavia in an attempt to analyse the changes in relation to the change in the competitive environment.

In a perfect competitive market, the marginal cost is equal to price, which implies a Learner Index of 0. By computing the industries Learner Indexes, we can measure the general competitive environment in different regions across Scandinavia. We will compute and analyze this for all years (1998-2018), and analyze the trends in relation to regulatory changes.

We will further use these estimates in our statistical analysis to analyze possible trends in relation to regulatory changes.

In Angelina and Cetorelli's they detected a steady period from 1984, whereas significant changes were detected from 1992. This was the year of the Second Banking Coordination Directive implementation mentioned in the introduction. On that mark, the PSD1 and PSD2 regulations will be included as phenomenon's in our hypothesis as to the impact these regulations have had on the competitive environment in the banking industry. After our statistical analysis have been conducted, we will test our hypothesis which will be compiled in the starting face of our thesis.

As to the classification of the banks we are using in our study, we will separate them into investment and retail banks. We will further distinguish banks within different clusters based on their geographical location in order to comprise them into national banks, regional banks and cross border banks (operating in two or more Scandinavian countries).

Secondary data

We will foremost use secondary data in order to conduct our study. The collection of data will be done through databases found on www.finansnorge.no, www.thebanker.com, and other related databases in Sweden, Denmark and Finland. Much of the data needed is also made available in the bank's quarterly and yearly financial statements.

Research Approach

1. Develop a thorough understanding of the banking industry in Scandinavia and its underlying mechanisms, and get a good overview over all its players
2. Compile hypothesis
3. Gather the relevant data needed to conduct statistical analysis
4. Understand their business models, both similarities and differences
5. Develop the statistical models to conduct our study
6. Use the statistical models to test our hypothesis
7. Understand, examine and conclude on our results

Limitations

Our limitations in conducting this study is first and foremost our lack of knowledge about the banking industry. None of us have had any hands-on experiences in the banking industry, as we have never worked within banking. We will therefore be dependent on previous literature as well as seminars and interviews with bankers to gain enough understanding about the industry. Another limitation is our knowledge about statistical analysis. We have during these five years at BI Business School acquired some knowledge about statistical analysis through courses at such as multivariate statistics, but we will be dependent on extensive personal development within the field and some help from more experienced persons to provide a reliable statistical analysis. A significant limitation/challenge in our research will also be our ability to link changes in the banking environment solely to changes in regulations and competitive pressures. An extension of our analysis may therefore be needed, with more variables and taken into account.

Progression Plan

Month	
January	Hand in preliminary 15th of January Develop a thorough understanding of the Scandinavian banking industry, business models, similarities and differences. Understand and develop method Collect data
February	Receive feedback on preliminary Further development of theoretical framework/Industry analysis/method Assess feedback and make necessary changes
March	Assess theoretical framework and make necessary changes Start analyzing data
April	Analyze data Write thesis
May	Write thesis First draft finished Revision of first draft
June	Revision and improvements
August	Finalizing thesis
September	Hand in thesis 1st of September

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