

Baltic Banking is Modern and Concentrated

by Mart Sörg

The introduction of a market economy in the Baltic States during the last two decades took place simultaneously with structural and legal reforms. Development of the financial sector has been one of the more difficult areas of reform, since at the start of transition economy there were no relevant benchmarks for the market economy financial institutions and markets.

Reforms in the Baltic banking sectors started in 1988, three years before the restoration of political independence. Baltic countries preferred to introduce commercial banking. They had one more aim in reconstructing their banking systems – to restore financial independence from Moscow. As a consequence, Baltic Republics became pioneers in reforming the banking system in the former USSR. After the hyperinflation of 1991, which had reduced the real value of the obligatory initial capital of commercial banks by several times, a boom in establishing a new type of bank was observed. The first stage of development of new banking ended in banking crises: in Estonia 1992-1994, in Latvia 1995-1996 and in Lithuania 1995-1996. The banking crises in the Baltics were imminent, because the reorganisation of banking coincided with a time of reforms in the monetary and economic systems as well as with deep economic crises. In addition, the risk management systems of the new banks did not conform to the real needs. The crises resulted in the bankruptcy and mergers of banks, and the arrival of foreign banks as strategic investors for Baltic banks. The crises cleared the Baltic banking sectors from weaker links and presented both the central banks and the managements of operating banks with directions for improving the banking regulation and management practices.

As can be seen in Table 1, according to EBRD calculations, the banking sector reform in Estonia is practically finished, but the index of reform of non-bank financial institutions is lower – 3.3. Compared with Estonia, the success of reforms in other Baltic States is slightly smaller, which motivated the Hansapank Group to expand from Estonia to Latvia's and Lithuania's market and to improve the financial sector performance in these countries. The concentration of banks is very high in the Baltics. In the Baltics we have 43 operating banks for a population of ca 7 mln. For example, in Finland 5 mln inhabitants are serviced by almost 350 banks. Banking sector concentration is the highest in Estonia, where Hansapank's market share, by assets, is over 50%, and the share of the next biggest bank, Eesti Ühispank, is approximately 30%. A third of the Baltics' banking market, by assets, is in the hands of Swedish-origin SEB (Eesti Ühispank, Latvian Unibanka and Vilniaus Bankas) another third is in the hands of Swedbank via the Hansapank Group. Domestic banks and other foreign bank branches (from Finland, Germany and others) provide considerable competition for the two leading bank groups in several fields of activity.

Table 1. Banking sector indicators in 2004

	Estonia	Latvia	Lithuania
EBRD index of banking sector reform (1 min, 4 max)	4.0	3.7	3.0
EBRD index of reform non-bank financial institutions	3.3	3.0	3.0
Number of banks	7	23	13
Total assets (% of GDP)	76	84	33
Market share of the 5 largest banks (%)	98	63	82
Foreign-owned bank assets in (%)	97	47	91
Non-performing loans of total assets (%)	0,8	1,8	na
Return on equity, ROE (%)	23	21.4	13

Source: EBRD Transition report 2004, Part 3; ONB WP 96, 2005, p.5., Eesti Pank

The assets of the Baltic banks have grown much faster than GDP in the Baltic States. One reason for this is the enormous potential for growth. Banking assets in the Baltics stand at

levels well below 100% per GDP – far from the level achieved in the Eurozone, where it was more than 260% in 2003. Despite the decrease, the interest rates and interest margins of Baltic banks are continuously highly profitable. High profit and expanding ambitions require developments in the banks' management systems and the introduction of new products and services.

For the aforementioned reasons the payment environment in the Baltics is mostly electronic, and instead of less efficient payment instruments, Internet banking and debit orders are widely used. The speed of development of electronic banking has high growth rates. For instance, the number of bank cards issued in Estonia has reached one card per inhabitant. The number of points of sale (POS) accepting card payments has also increased 3.4 times during last five years.

From Table 2 we may see that the number of card payments per capita in Estonia is several times higher than in other new EU members, former socialist economy countries (except Slovenia). Good automated teller machines (ATM) and points of sale (POS) network is the basis of this success. The development of electronic banking in Latvia and Lithuania is also quickly going up.

Table 2. Use of cash and payment cards in 2003

	Cash in circulation/ GDP	Number of card payments, per capita	Number of payment cards, per capita	Number of ATMs and POS terminals, per 1 mln inhabitants
Czech Republic	9.20	5.50	0.62	3.268
Estonia	6.10	35.20	0.88	7.260
Hungary	7.30	7.00	0.66	2.702
Latvia	10.20	10.20	0.77	4.789
Lithuania	8.30	7.30	0.62	3.475
Poland	6.20	4.07	0.39	2.389
Slovakia	8.00	5.60	0.56	2.852
Slovenia	2.70	49.00	1.70	16.674

Source: European Central Bank. Blue Book. February 2005.

Foreign businessmen and visitors to the Baltics have expressed the opinion that our banks are operating in accordance with modern market economy patterns in every respect. The above-presented indicators demonstrate the same fact: Baltic banks have achieved the level of trustworthiness, novelty of products, and standards characteristic of banks of the developed countries. Accession to the EU a year ago gave us hope that the extremely high concentration in the Baltic banking sector will decrease in the future, as it is likely that several big European banks will try to enter our prosperous emerging market. The first signs thereof are applications to our Financial Supervision Authorities to establish representative offices in the Baltics and the boost of share prices in the Baltic Stock exchanges. For instance, in Vilnius the Stock Exchange share price of Ukio Bankas rose by the middle of August more than double compared with the last two months. And in August 23rd this year Svenska Handelsbanken, which has one of the highest ratings in Europe and is operating in 18 European countries, informed the market that they have a strategy to establish a branch-office in Tallinn in first half of 2006. Planned head of the Tallinn Office, Harri Tuohimaa, already is preparing the branch activities in temporary rented rooms in Tallinn.

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