Banking in the Baltics – The Development of the Banking Systems of Estonia, Latvia and Lithuania since Independence

The Internationalization of Baltic Banking (1998-2002)[1]

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1 Introduction

The banking systems in the three Baltic states – Estonia, Latvia and Lithuania – have witnessed major progress in recent years. From the depths of the 1998 Russian crisis the Baltic banks have recovered quickly and continued to expand at a rapid pace. Banks in Estonia and Latvia in particular are catching up with some Central European transition countries, which at the outset of the reform period had more developed financial sectors, and may be on a trajectory to eventually attain the role of financial intermediation the banks in the present Member States of the European Union play. Despite the rapid growth, the Baltic banks have maintained and even improved asset quality while retaining high capital adequacy ratios. This study will try to recapitulate the latest history of the Baltic banks and to identify a few characteristics and factors behind their relative success. While currency boards and their support for a disinflation process have played a crucial role for the banking sector, this study focuses on the microeconomic level. The role of foreign capital, consolidation and regulation will be emphasized. The Baltic banking system is very strongly penetrated by foreign ownership and influenced by trends in neighboring Nordic countries. This study will also attempt to shed a light on some of the risks ahead.

There are important differences between the banking systems of the three Baltic nations. For example in Latvia, deposits from, and assets in, CIS countries play a very important role. In Lithuania the persistence of inefficient state-owned banks has hampered the development of the sector, while Estonia is already influenced by Nordic trends such as Internet banking. Nevertheless, most trends have become so similar in the three Baltic states, and ownership structures have converged to such an extent after 1998, that all three will be treated simultaneously. The analysis is presented in eight main sections. Section 2 deals with the impact on the financial system of the Asian and Russian crises and section 3 with the strong inflow of foreign direct investment (FDI) into the sector. Section 4 describes ensuing macroeconomic developments up to the present. Section 5 focuses on the evolution of banking regulation and supervision. The market structure and development is analyzed in detail in section 6, and section 7 projects the possible future evolution. Section 8 summarizes the study and gives some conclusions.

2 Under Trial: The Asian and Russian Crises 1997–1998

The Asian crisis of 1997–98 and the Russian crisis of 1998–99 were a severe test for the reform strategy of the Baltic states, their currency board (or quasi-currency board in the case of Latvia) arrangements and their high degree of openness. Overall, the Baltic economies withstood the test well, and in some areas, such as the financial sector, the result was arguably even beneficial, given that some inefficient structures were overhauled more rapidly.

1 *The developments from independence up to 1997 are dealt with in the study by Stephan Barisitz, "The Emergence of Market-Oriented Banking Systems in Estonia, Latvia and Lithuania (1988–1997)," which immediately precedes this study.* *I wish to thank Stephan Barisitz for his comments and support as well as representatives from Swedbank and SEB, who have provided me with valuable insights into their Baltic investments. I am also grateful for comments coming from Tuuli Koivu (Bank of Finland Institute for Economies in Transition, BOFIT), Peter Backé and Franz Schardax (both from the Foreign Research Division of the Oesterreichische Nationalbank).*

2 *Sveriges Riksbank.*

Initially, the Asian crisis (which started in July 1997 with the devaluation of the Thai baht) left the Baltic economies and financial systems fairly unaffected, but already in the autumn of that year, short-term capital, weary of risk in emerging markets, started to leave the Baltics states. In the second half of 1997 the Baltic equity markets lost more than half of their value.

Estonia was most affected by this process, with the Estonian TALSE index losing almost two thirds of its value in the year following its peak in August 1997. The inflow of portfolio investment to Estonia had sustained the boom both in terms of real estate prices, banks' assets and investment, and it contributed to a current account deficit of 12% of GDP in 1997. Concerns about the banking sectors' large holdings in domestic equities, more than 20% of banks' total assets, hastened the pace of consolidation of the banks in early 1998. As portfolio investments left Estonia, there was also a first wave of speculation against the Estonian currency board in October 1997, which, however, subsided when liquidity dried up as the automatic mechanism of the currency board operated. Nevertheless, this development led to higher short-term interest rates that affected financial institutions and households until interest rates fell again at the beginning of 1998. The strong asset growth in Estonian banks up to 1997 stagnated in 1998 (6% nominal growth), and profitability in the sector was reduced sharply.

However, the major real economic shock for the Baltic economies occurred with the Russian crisis of August 1998, when the ruble was devalued and the Russian state defaulted on its Soviet-era debt. This dealt a double blow – a collapse in trade, and losses in the Baltic financial system.

On the real side, Baltic exporters, who were dependent on Russian markets, were confronted with a very sharp deterioration in terms of trade as the ruble lost more than 70% of its value against both the U.S. dollar and the Deutsche mark from August 1998 to March 1999 (while imported Russian commodities were linked to the U.S. dollar). Trade could not be redirected in the short term, as exports to Russia and other CIS countries collapsed. Although Russia's share of the Baltic states' external trade had declined even before the crisis, it remained at 21%, 19% and 35% of exports respectively for Estonia, Latvia and Lithuania – enough to stifle growth even as the Russian crisis unfolded in 1998.[1]) The full effect of the crisis followed in 1999, when growth plummeted in Latvia and turned negative in Estonia and Lithuania, with unemployment rising rapidly. In Estonia and Latvia the budget surpluses also turned into sizeable deficits in 1999.

In parallel with the trade crisis, the financial sector suffered the consequences of the rapid increase in lending to enterprises depending on the Russian market or directly to Russian enterprises in the late 1990s.

In 1998–99 the Russian crisis hit the Estonian banks' customers, who were dependent on the Russian market. This sudden weakness also affected the share price of banks. Flaws in the management and risk controls of some of the larger banks were also revealed, but they had less of an impact as these banks were acquired or merged into better-managed banks during the year. However, the main Estonian banks were sufficiently capitalized to survive the 1997–99 down-

1 *OECD (2000), p. 54.*

turn, and during the latter half of 1998 the banking sector was actually strengthened as the crisis forced the pace of mergers.

In the end only four smaller, already rather weak, banks were seriously affected by the collapse in Estonian equity prices and the anemic Russian market. Three of the banks (Maapank, which had used deposits to buy heavily in the stock market, EVEA bank and ERA bank, both dependent on Russian eurobonds) were declared bankrupt by Eesti Pank, and the fourth (Forekspank, with about 6% of total banking assets) was taken over by Eesti Pank and merged with another medium-sized credit institution (Estonian Investment Bank) to create a new bank, Optiva.[1])

The situation was worse in Latvia, where banks for a long period of time had very strong ties to the Russian and CIS markets and exploited interest rate differentials between the Russian and Latvian markets. By 1998 more than 10% of Latvian banks' total assets were exposed to the Russian market, and more than one third of this exposure was to Russian high-yielding GKO bonds, as these assets had presented a tempting alternative to paltry returns on domestic assets.[2]) These Russian bonds, as well as many Russian corporate bonds, lost most of their value as the crisis unfolded. Consequently, Latvian banks' liquid assets were severely reduced. Uncertainty caused the interbank market to dry up. There was a large outflow of nonresident deposits (as Russian cash-strapped depositors scrambled for assets when the Russian banking system collapsed), and there were runs on some banks suspected of being overexposed to the Russian market. Latvijas Banka then injected liquidity into the market and closed three smaller banks (with the deposit guarantee system operational). Rigas Komercbanka, the country's fifth-largest bank, was subject to a bank run. It held 14% of its assets in Russia, and about 20% of its capital was owned by Russians. In 1998 Latvijas Banka installed administrators at Rigas Komercbanka, aided it with liquidity support and prohibited the withdrawal of term deposits ahead of maturity. Nevertheless, in 1999 the central bank was forced to declare Rigas Komercbanka insolvent and took over the bank with the ambition of rapid reprivatization. During the course of 1998, Latvian banks went from profitability to lossmaking, and capital adequacy ratios dropped, although nonperforming loans continued to fall, as many bad loans were related to earlier problems in the mid-1990s.

Lithuania's banks, despite a crisis in the real sector due to the collapse of the Russian market, suffered less directly from the Russian crisis, both because lending in the less dynamic state banks was less developed and because the more robust private banks were hardly involved in Russian assets – only 1.5% of total bank assets were directly in Russia. Nevertheless, asset growth and profitability was poor in 1998–99. Partly this was due to the final resolution of the earlier crisis in the state-owned banks, which in 1998 led to the definitive liquidation of the State Commercial Bank (an important provider of credit to large state-owned enterprises) and the transfer of some of its assets to Turto Bankas, the recovery bank. Some of the assets of the ailing Agricultural Bank (Lietuvos žemės ūkio bankas) were also transferred to Turto Bankas. In 1999 Litimpeks

1 *Eesti Pank (1998, 1999).*

2 *OECD (2000, p. 114–115), Latvijas Banka (1998).*

Table 1

The Baltic Banking Sectors: Chronology of Some Important Events (1998 to 2002)

	Estonia	Latvia	Lithuania
1998	– July: merger agreements signed between Hansapank and Eesti Hoiupank (largest and second-largest credit institutions) and between Eesti Ühispank and Tallinna Pank (third and fourth largest) – Central bank withdraws licenses or takes controlling stakes in some medium-sized and small banks – September: Föreningssparbanken (Swedbank, Sweden) acquires controlling stake (59%) in Hansapank for EEK 3.5 billion (USD 250 million). Supervision of consolidated banks' accounts enacted – October: deposit insurance law takes effect, deposit guarantee fund comes into operation – December: Skandinavska Enskilda Banken purchases significant minority stake in Ühispank (32%) for EEK 830 million (USD 60 million) – late 1998: central bank recapitalizes Forekspank (sixth-largest bank) and merges it with other credit institution, merged bank is renamed Optiva Pank	– October: deposit insurance scheme effective, deposit guarantee fund established – Fall 1998: following the Russian crisis, situation of a number of credit institutions overexposed to CIS countries, in particular of Rigas Komercbanka (fourth-largest bank), deteriorates – Late 1998: Skandinavska Enskilda Banken (Sweden) takes a 32% stake (subsequently raised to 44%) in Unibanka	– January: minimum capital requirement raised to EUR 5 million (corresponding to EU standards) – March: State Commercial Bank liquidated, transfer of bank's performing assets to the Savings Bank; transfer of Agricultural Bank's bad loans to Turto Bankas – Late 1998: Skandinavska Enskilda Banken purchases 42% of Vilniaus Bankas (second-biggest credit institution)
1999	– February: Eesti Ühispank is first CEE bank since Russian crisis to tap euro-denominated bond market – July: credit institutions law amended, strengthening Eesti Pank's authority in exercising supervisory functions	– Early 1999: supervision of banking groups on consolidated basis established – Early 1999: central bank suspends operations of Rigas Komercbanka, bank declared insolvent; subsequently, major creditors and Latvijas Banka work out rehabilitation plan – March: Latvijas Investiciju Banka (medium-sized bank) purchased by Merita Nordbanken (Nordea, Sweden) – March: government sells its controlling stake in Latvijas Krajbanka – October: Rigas Komercbanka reopens after successful recapitalization – End-year: minimum capital requirements raised to EUR 5 million (EU standards), triggering some mergers and exits	– August: Lietuvos Bankas again suspends most banking operations of Litimpeks Bank due to its illiquidity – September: central bank approves agreement of Vilniaus Bankas and Bankas Hermis (the two largest private banks) regarding a possible merger
2000	– June: central bank sells its 58% stake in Optiva Pank (third-largest bank) to Sampo Finance (Finland) for EEK 214 million (EUR 14 million); following this sale, authorities no longer retain any participations in banking sector	– May: 90% of Rigas Komercbanka sold to Norddeutsche Landesbank Girozentrale (Germany) – August: Skandinavska Enskilda Banken raises its stake in Unibanka (second-largest credit institution) to almost 100%, SEB acquires ownership of Unibanka's subsidiaries in Estonia and Lithuania, thereby creating the region's biggest financial group	– February: Vilniaus Bankas and Bankas Hermis merge; new institution named Vilniaus Bankas – December: government sells majority stake in Lithuanian Development Bank to Sampo Finance (Finland) for LTL 40 million (USD 10 million)
2001	– May: law on the establishment of unified Estonian Financial Supervision Agency for banking, insurance and securities enacted – June: amendments to bankruptcy law passed to bring legislation into line with EU norms	– July: Financial and Capital Markets Commission takes over unified supervision of brokerages, insurers, investment funds, private pension funds, credit institutions and other financial market actors	– May: 90% state shareholding in Lithuanian Savings Bank (LTB, second-largest credit institution) sold to Hansapank (Estonia) for USD 37.5 million – July: new, more effective bankruptcy and enterprise restructuring laws come into force
2002	– January: Estonian Financial Supervision Agency starts operations – February: integration of Helsinki and Tallinn stock exchanges accomplished	– April: amendment to law on credit institutions should increase compliance with Basel Core Principals	– February: litas repegged from U.S. dollar to euro (EUR 1 = LTL 3.4528) – March: authorities sell 76% stake in Agricultural Bank (third-largest credit institution) to Norddeutsche Landesbank Girozentrale for LTL 71 million (EUR 20.5 million)

Bank was also forced into bankruptcy. The weak overall performance of banks was also attributable to the consequences of a domestic fiscal crisis, as the budget deficit was spiraling to 8.5% of GDP in 1999. This led to a forced rapid consolidation of the state budget, with the government compelled to rely on a stand-by arrangement with the IMF. The austerity measures contributed to a severe recession in 1999 that in turn affected the banks' customers. Furthermore, uncertainty about Lithuania's commitment to the currency board led to a short period of speculation against the litas' link to the U.S. dollar. However, throughout the 1998–99 crisis, the two well-capitalized dynamic private banks Vilniaus Bankas and Hermis Bankas continued to expand assets, a process which was reinforced by foreign FDI.

3 Consolidation of the Banking Sector and Strong FDI

In the midst of the 1998 crisis the Baltic banking sector experienced an intensive regional consolidation phase which continued up until 2002 and created the present-day modern banking structures. Several factors facilitated and reinforced the acquisitions and mergers: failures and reduced bank share prices during the crises, privatization by the Estonian, Latvian and Lithuanian authorities of the last state-owned banks and finally strengthened regulation (which will be detailed in a subsequent section). This consolidation together with a parallel regional recovery has led to increasingly similar developments in all three Baltic markets. In general, developments appeared first in Estonia, where the reforms had advanced furthest, began in Latvia with a delay of one to two years, and then cropped up in Lithuania some two to three years later.

The consolidation was driven very early on by foreign, mainly Swedish, participation. Foreign ownership had been important in the banking sector even prior to 1998, but then in the form of portfolio investment with a dispersed ownership structure. After 1998 strategic investments dominated, creating two rivaling regional banking groups: on the one hand the Hansapank group, majority-owned by Föreningssparbanken (Swedbank), on the other hand a pan-Baltic alliance of banks created by Swedish Skandinavska Enskilda Banken (SEB). In 2001 these two groups represented more than two thirds of the banking sector in the Baltic region in terms of assets.[1])

The regional consolidation in Estonia was initiated by Hansapank. At the end of the 1990s Hansapank had established a strong private client and corporate business in Estonia and set out to acquire branch networks in the neighboring countries. In 1996 Hansapank had already acquired Latvia's sixth-largest bank, Deutsche Lettische Bank, and renamed it Hansabanka. The next step followed in July 1998, when Hansapank, then already Estonia's largest bank, merged with the third-biggest bank, the Estonian Savings Bank (Eesti Hoiupank), in the wake of the Asian crisis and the stock market crash in Tallinn (the Savings Bank had earlier acquired the Latvian Tavijas Zemes Banka). A few months later Föreningssparbanken (Swedbank), in competition with its Swedish rival SEB, acquired through the stock market a strategic share of 59% in the new, larger Hansapank, which then already represented about half of the Estonian banking sector.

1 Hansabank (2002), Vilniaus Bankas/SEB (2002).

After losing the "battle" over Hansapank, the SEB group instead took minority stakes in runners-up in all three Baltic countries at the end of 1998: in the second-largest Lithuanian Bank, Vilniaus Bankas, the second-largest Latvian bank, Unibanka, and the second-largest Estonian bank, Union Bank of Estonia (Eesti Ühispank).[1]) These three banks – Vilniaus Bankas, Unibanka and Ühispank – already had a trilateral regional cooperation agreement.

After this period of mergers and acquisitions, the Baltic states had, in the space of a single year, ended up with two dominating rival Baltic banking groups, both backed by strong Swedish owners.

The Hansapank group started a Lithuanian subsidiary, Hansabankas, and expanded its Latvian Hansabanka rapidly, which in April 2000 also acquired Ventspils UBB, a smaller Latvian bank. In May 2001 Hansapank then made up for its relatively smaller size on the Lithuanian market by acquiring 99% of the privatized Lithuanian Savings Bank (LTB), the country's second-largest bank after Vilniaus, and merged it with its local subsidiary into Hansa-LTB. In the process, the former LTB was radically streamlined, with more than half the retail outlets closed and staff reduced by more than 25%. With LTB, Hansapank had gained a strong presence in all three countries. In 2001 Hansapank controlled about a fourth of the entire Baltic banking sector in terms of assets (table 1).

Meanwhile, SEB expanded its stakes in the three banks it had purchased to nearly 100% and became directly involved in the management of its Baltic operations. Vilniaus Bankas in 2000 merged with the third-largest Lithuanian bank, Hermis Bankas (which had previously bought the smaller Industry Bank), thus creating the largest group in the country. In 2001 SEB's Baltic holdings together controlled about a third of the Baltic banking sector in terms of assets (table 1).

Together, the two banking groups in March 2002 controlled 84% of the Estonian loan market, 46% of the respective Latvian market and 63% of the Lithuanian market (charts 1 through 4).[2]) This dual domination could have ended when SEB and Swedbank discussed a merger during 2001 that could have forced either of them to divest their Baltic holdings, but the deal was subsequently called off after the European Commission voiced concerns relating to competition in the Nordic market.

Furthermore, the Finnish Sampo group acquired Optiva Bank in Estonia (the result of the merger of the Estonian Investment Bank and Forekspank) and also the Lithuanian Development Bank. The Nordic group Nordea established operations in all three Baltic countries. The German Norddeutsche Landesbank Girozentrale (Nord/LB) meanwhile acquired 76% of Lithuania's third-largest bank, the Agricultural Bank (Lietuvos žemės ūkio bankas) and 90% of Rigas Komercbanka, then in the process of being restructured after the crisis but still one of Latvia's larger banks (now called Pirma Banka). Sampo, Nordea and Nord/LB are thus at present the main Baltic rivals of Swedbank and SEB.

In total, foreign capital in the middle of 2002 thus controlled over 80% of the aggregated Baltic banking sector in terms of assets, and foreign ownership exceeded 90% in Estonia, 85% in Lithuania and 70% in Latvia.

1 *Ühispank had just before acquired another large Estonian bank, Tallinna Pank (which in turn had bought the Latvian Saules Bank).*

2 *Hansabank (2002), Vilniaus Bankas/SEB (2002).*

In November 2002, this left only one major Baltic bank which still is locally owned, Latvia's Parex banka, itself the result of a merger of several Latvian banks. Parex banka has signaled that it, too, is prepared to find a strategic European partner. Latvia remains the least consolidated of the banking markets. In 2002 it had 22 licensed banks and one branch of a foreign bank, more banks than the two other Baltic countries together. Half of these, however, are small niche banks dealing essentially with nonresident transactions.

Up until 2001 Lithuania was the only Baltic country where the state remained an important player in the banking market. As mentioned earlier, the two dominant state-owned banks, LTB and the Agricultural Bank, were privatized as late as 2001–02 (after several earlier attempts had failed or had been delayed), and both were then considered overstaffed and more inefficient than Vilniaus Bankas, the privately owned competitor. In Estonia only one small bank (Optiva Bank) remained in state hands before being divested in July 2000. In Latvia state ownership amounted to only 3.7% of the sector in 2001.[1])

The combination of consolidation and foreign ownership had at least four major effects on the Baltic banking system:

– The acquisition by the foreign, in particular Swedish, banking groups gave the Baltic banks a sizeable capital injection at an important juncture – although this capital would later be superseded in most banks by a rapid growth of deposits.
– The trust among customers, which had already been increasing in the most dynamic and transparent banks, improved further when foreign capital was perceived as backing and guaranteeing the banks.
– Know-how was transferred from foreign banks, mainly in risk management, which had been improved in particular in Sweden after 1992 as a consequence of the major banking crisis in the early 1990s. Most notably the Swedish owners set up risk assessment committees and screening procedures modeled on those in Sweden.
– There was a shift from investment banking to more conventional banking, and an increased focus on medium and small enterprises and private clients, notably on mortgage loans, an evolution which will be detailed in section 6.

Table 2

Major Baltic Banks in June 2001

	Equity	Market share of total Baltic states			Net profit
		Assets	Deposits	Customer loans	
		%			
Hansapank (Estonia)	284	18	16	14	22.9
Vilniaus Bankas (Lithuania)	153	10	12	12	9.1
Parex banka (Latvia)	82	8	10	8	8.6
Ühispank (Estonia)	110	8	8	11	4.7
Lithuanian Savings Bank (LTB)	59	7	10	4	3.4
Unibanka (Latvia)	79	7	6	12	8.4
Hansabanka (Latvia)	62	6	7	6	4.2
Lithuanian Agricultural Bank	35	4	4	5	3.0
Total	1,188				85.3
Vilniaus Bankas, Ühispank, Unibanka	342.3	25	25	34	22.1
Hansapank, Hansabanka, Hansabankas, LTB	415.1	32	33	25	30.5

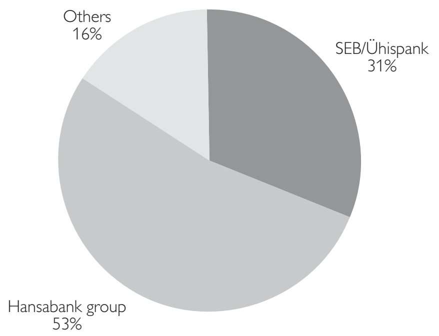
Source: SEB, Vilniaus Bankas, Lietuvos Bankas, Eesti Pank, Association of Commercial Banks of Latvia, banks' financial statements.

1 *The ownership was in Latvijas Hipotēku un zemes banka (Mortage and Land Bank), and a 32% stake in Latvijas Krajbanka. IMF (2002c), Lepik and Törs (2002), Zubkova et al. (2002).*

Chart 1

Market Share: Loans Estonia,

Baltic Banking Groups, March 2002

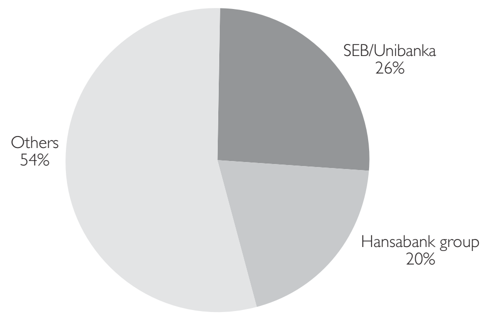


Source: Henszpank group.

Chart 2

Market Share: Loans Latvia,

Baltic Banking Groups, March 2002

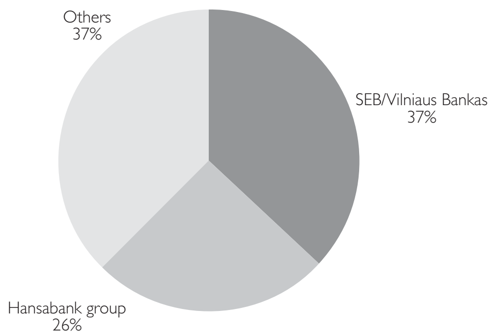


Source: Henszpank group.

Chart 3

Market Share: Loans Lithuania,

Baltic Banking Groups, March 2002

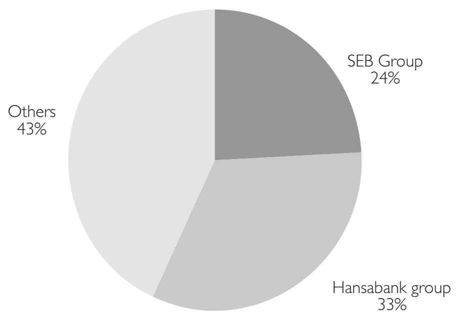


Source: Henszpank group.

Chart 4

Market Share: Deposits,

Baltic Banking Groups, March 2002



Source: Henszpank group.

4 Recovery in the Banking Sector Supported by a Macroeconomic Rebound

The 1998–99 crises were followed by a strong macroeconomic recovery in all three Baltic states, which was supported by buoyant international demand. This created a favorable environment for the development of the consolidated banking sectors. Economic growth even continued through the international downturn of 2001–02. In part this was due to the continued relocation of production facilities to the Baltics by European companies which wanted to take advantage of the low labor costs, improvements in productivity and a more stable institutional environment ahead of an increasingly certain EU accession. The extreme openness of the Baltic economies, which had worked against them during the Russian crisis, helped them recover through a reorientation of trade to the EU, which in 2002 was the main trading partner of all three countries. But in part the recovery was also the result of the revival of old ties to Russia and CIS countries as Russia and the entire CIS region recovered strongly from the 1998 crisis on the back of rising oil prices and an industrial rebound. In 2001 Latvia registered Europe's highest GDP growth rate (7.6%), followed by Lithuania (5.9%) and Estonia (5.0%). Unemployment remained high throughout the Baltics, and only in Latvia was it reduced marginally. The budgetary situation improved rapidly in all three states, and public sector debt accumulation never became a threat to the currency board arrangements. In February 2002 the Lithuanian currency board repegged from the dollar to the euro at the then prevailing exchange rate, without serious concerns from the public despite large dollar deposits. Latvia also announced in 2001 that the lats would be repegged to the euro following accession to the EU.

FDI inflows remained strong throughout the Asian and Russian crises and continued afterwards. But as portfolio investment fell and was increasingly replaced by internal savings intermediated by the banking systems, and as export earnings increased rapidly, the current account deficits narrowed in the Baltics in 1998–2001, in particular in Lithuania. Current account deficit levels remained high, however (in 2001 9.7%, 2.2% and 6.1% respectively for Latvia, Lithuania and Estonia), even for small emerging market economies, although they were still largely covered by FDI inflows.[1])

An important factor supporting the banking sector was the disinflation process after 1998, with inflation falling in 1997–2001 from 10.6% to 5.7% in Estonia, 8.4% to 2.5% in Latvia and 8.9% to 1.2% in Lithuania. Given that monetary policy is governed by currency boards in Estonia and Lithuania, this was not due to a tightening of monetary policy, but to the workings of the currency boards themselves and price deregulation. Inflation rates decreased as the Baltic currencies became less undervalued, with less need for real appreciation.

Nominal interest rates diminished in line with inflation and fell even further as real interest rates decreased and worries related to the Asian and Russian crises receded. The prospect of EU accession and even euro introduction further narrowed interest spreads towards the euro area. It is now considered possible that all three Baltic states may join the euro area just three years after EU accession in 2004.

5 The Role of Regulation and Supervision from 1998

Another factor supporting the consolidation and expansion of the Baltic banking sectors has been the reinforcement of regulations through a continued tightening of the framework and improved competence of the regulatory authorities. This narrowed the scope for banks with a deliberately high risk profile and induced weaker banks, which were less likely to fulfill requirements during the 1998–99 crises, to merge with more stable banks.

As mentioned earlier, the direct aftermath of the Russian crisis was marked by closures of a number of smaller banks in the Baltic states, sending an implicit signal to other banks to consolidate. While in Estonia the banks that lost their licenses and were liquidated were fairly small, in Latvia and Lithuania there were, as noted earlier, large forced reconstructions of banks by the authorities. Some of the smallest and least viable banks were also closed when authorities increased minimum capital requirements in 1998 from EUR 2 million to EUR 5 million in Latvia and from EEK 15 million to EEK 35 million (this

1 *European Commission (2002).*

corresponds to EUR 1 million to EUR 2.2 million; later this threshold was raised to EUR 5 million, see table 2.) in Estonia.[1])

The closures of banks were facilitated by the introduction of deposit guarantee schemes in Estonia and Latvia in 1998 and in Lithuania already in 1997 (with an expansion in 2001). These schemes are particularly important in the context of currency boards, where no proper lender of last resort exists. The guarantees were set fairly high at 90% of deposits up to EEK 40,000 (EUR 2,556) and LVL 3,000 (about EUR 5,025) in Estonia and Latvia respectively, and up to 70% of LTL 45,000 (EUR 13,032) in Lithuania, with the aim of reaching the EU minimum level of EUR 20,000 by 2007 for Estonia and Latvia and 2008 for Lithuania.[1]) The Estonian scheme proved effective, as depositors in failed banks were compensated in 1999 with borrowed money (backed by a state guarantee) which then was repaid as the guarantee scheme accumulated funds (earlier compensations directly out of the state budget had come at a cost of more than 0.5% of GDP). However, as the minimum guarantee is being raised to the EU level of EUR 20,000 (more than three average yearly salaries in all three countries), complaints have been voiced that contributions to the schemes will pose too heavy a burden on bank profitability. In Lithuania the deposit scheme in 2001 represented an annual cost of a full 0.45% of deposits.[1])

Minimum capital adequacy requirements have generally remained high in the Baltic states, 10% in all three countries at end-2002, and above or at that level throughout the period 1998–2002 (table 2). Partly this is an extra precaution, given that the Estonian and Lithuanian currency boards lack a lender-of-last-resort function (with similar conditions for Latvia) and thus need to ensure sufficient liquidity. The Baltic banks have in any case remained very well capitalized with a substantial margin to the requirements. In Estonia, for example, banks are estimated to have liquid assets covering 80% of liabilities.

Moreover, the foreign ownership of the major banks by much larger Nordic groups is often referred to as an implicit guarantee of capital supply to the Baltic banks, and even to a certain degree as a substitute for a lender of last resort, as long as the Baltic holdings represent a very small part of the Nordic groups' consolidated balance sheets.

Actual supervision in the Baltic states, both off-site and on-site, has reached international standards during the period 1998–2000. According to the Report on the Observance of Standards and Codes for Estonia (IMF, 2002e) and the Financial System Stability Assessment for Lithuania and Latvia in 2001 (IMF, 2002b, 2002c), the quality of supervision is on a par with that of the most developed markets. According to Latvijas Banka, on-site bank inspections in Latvia are more frequent than in EU countries. Noncompliance with capital adequacy requirements gives the central bank extensive power to intervene in the banks' operations in all three Baltic states, with the right of appointing administrators. The application of IAS (International Accounting Standards) is compulsory in all three Baltic states. All major credit institutions are audited by internationally recognized auditing firms. Most have very transparent investor relations policies, with extensive information available on Internet sites.

1 *Lepik and Törs (2002), Zubkova et al. (2002), Gabaravicius and Kuodis (2002).*

To ensure that the source of foreign deposits is not money laundering, particular legislation has been passed in Estonia, Lithuania and Latvia; in the latter, it has involved the creation of a special anti-money laundering board.

The German model of a single, unified financial supervision authority was adopted by Latvia in 2001 and Estonia in 2002, both agencies being independent but affiliated with the respective central bank. This model is expected to facilitate making an overall assessment of diversified financial groups, an apparent problem during the 1998 crisis. Lithuania, on the other hand, has kept supervision divided between the Bank of Lithuania, the Securities Commission and the State Insurance Supervisory Authority.

A major concern ahead is the rapid growth of leasing companies (which will be detailed in section 6). Here the requirements for disclosure and the powers of supervision of the authorities are more modest by law. Leasing firms have been venturing into more risky assets.

In all three Baltic states there has also been a general improvement in the microeconomic framework, with commercial codes, bankruptcy procedures, rules for collateralization, accounting and auditing rules being fully implemented. Privatization of the last major remaining state-owned enterprises was also completed during the 1998–2001 period.[1]) Nevertheless, much remains to be done, particularly in the field of legal infrastructure, where the timely enforcement of contracts, the prevention of corruption and improved audits of firms, which often are dubious, are imperative. In this development Estonia appears to be somewhat ahead and Lithuania somewhat lagging.

Table 3

Prudential Regulations and Deposit Protection in the Baltics as of Mid-2002

Type	Requirement		
	Estonia	Latvia	Lithuania
Minimum capital requirement	EUR 5 million	EUR 5 million	EUR 5 million
Minimum capital adequacy	10% of risk-weighted assets	10% of risk-weighted assets	10% of risk-weighted assets
Maximum lending to a single borrower	25% of bank's capital	25% of bank's capital	25% of bank's capital
Maximum foreign exchange exposure (overall open position)	30% of bank's capital	20% of bank's capital	25% of bank's capital
Deposit protection (guarantee)	EEK 40,000 (EUR 2,556), will be increased to match ECB requirements of EUR 20,000 (EEK 313,000) by 2007	LVL 3,000 (about EUR 5,025), will be increased to match ECB requirements of EUR 20,000 (LVL 13,000) by 2007	LTL 45,000 (EUR 13,032) (100% at LTL 10,000) ECB requirements of EUR 20,000 to be reached by 2008
IAS: year of introduction	1995	1995	1997

Source: Eesti Pank, Latvijas Banka and Lietuvos Bankas, November 2002.

1 *For further details see the 2000 and 2001 preaccession economic programs of Estonia, Latvia and Lithuania.*

6 Evolution of the Baltic Banking Markets

6.1 Market Structure

Overall, the banks have remained the major suppliers of capital to the Baltic financial system, with a marginal role for the stock markets, despite a recovery since the lows of 1998 and some development in the corporate bond market. All three Baltic countries appear to be following a continental European model of universal banking, given the absence of a compulsory separation between the banking and securities businesses. Since the mid-1990s, the banks have remained major players in the leasing, pension fund, insurance and securities businesses. However, an increasing number of Baltic enterprises, in particular the larger ones, are being funded directly on major European financial markets. In all three Baltic states the main means of financing the real economy remains retained earnings, FDI or capital raised from European financial markets. One reason for this might be the large asymmetries in information in an emerging market environment, which makes this form of intrafirm capital less costly for Baltic enterprises than raising the capital directly from the banking sector.

Although banks dominate the financial landscape, the region still remains underbanked. According to IMF statistics, the ratio of domestic credit to GDP was only about 50% in Estonia, 38% in Latvia and 18% in Lithuania in early 2002, as compared to the euro area average of about 160% (chart 6). Total assets to GDP were 72% in Estonia, 73% in Latvia and 32% in Lithuania in 2001 as compared to 256% in the euro area. These levels are also below those of countries like Greece and Spain before their accession to the EU, or even of some large central European accession countries.[1]) However, as the ratio of assets to GDP is increasing more rapidly in Estonia and Latvia than in the central European accession countries (where the overall quality of assets appears to be worse than in Estonia and Latvia), these two Baltic states could well catch up with the leading central European countries in the field of banking in the next few years.[2]) Monetization (the ratio of M2 to GDP) is also increasing rapidly from low levels.

The market in each country has been very forcibly driven by the two main banks linked up with the Swedish investors. The tendency in the leading consolidated groups has been to move from a more narrow investment banking perspective to reach out to the growing medium-sized companies, often subcontractors to Western markets.

Unlike in many other emerging markets, lending to the public sector has comprised a very modest part of assets due to the nature of the currency board arrangements and budget consolidation in all three Baltic states.

6.2 Sources of Earnings

The most marked feature is the very rapid general growth in lending from 1999 to 2002 with 10% to 30% annual increases (chart 7) in Estonia and Latvia, albeit from a low base. In Lithuania asset growth stagnated from 1999 to 2000 during the ownership changes in the banking sector and recovered only mildly later

1 *Thimann (2002).*

2 *In the Czech Republic assets as a share of GDP are even decreasing. Chart 6 clearly shows the contrast to Estonia and Latvia.*

(about 10% growth). In part this can be attributed to differences in corporate culture, Lithuanian enterprises strongly preferring to finance activities on retained earnings, but in part it may also be due to a less developed banking system, with former state-owned banks hesitant to extend credit during an intensive restructuring phase. While the leading privately owned banks in Lithuania have expanded, the credit institutions which until recently were state owned have stagnated.

The overall impetus behind the strong growth of credit in Estonia and Latvia, and signs of a similar takeoff in Lithuania, correspond to the combination of a structurally underbanked market, strong growth with emerging investment opportunities and a rapid decrease in real interest rates in all three countries, which are now among the lowest in the accession countries.

In all three Baltic states new lending is almost exclusively directed towards the private sector. In Estonia the exposure of banks and their leasing subsidiaries to the real sector has increased from 25% to 40% of GDP from 1998 to late 2001.[1])

Lending to businesses remains more short-term than in developed European markets, the enterprises preferring to borrow for two- to three-year periods and rolling over the loan thereafter. A sizeable part of the lending is still directed towards supporting customer liquidity. Average maturities have increased, however, in particular in Latvia and Estonia.

A majority of the lending (and of the deposits of the business sector) is held in foreign currency or indexed against the euro or the U.S. dollar. The share of borrowing in foreign currency has actually increased somewhat, in line with the internationalization of Baltic businesses. The currency boards have remained in place for a decade in Estonia, and almost as long in Lithuania, while the Latvian lats has remained stable for a decade. Many enterprises have therefore preferred not to use the national currency, given that a large number of loans is used for trading transactions denominated in foreign currency and, most importantly, given that interest rates in euro and dollars are still somewhat below those in Estonian kroon, Latvian lats and Lithuanian litas. Part of this difference in interest rates can be attributed to the greater depth and efficiency of the euro and dollar markets, but in addition, many enterprises appear to consider the actual exchange rate risk (i.e. the risk of dissolution of the currency boards and the discontinuation of the Latvian peg to the SDR) less than what is actually priced into the market. In Estonia most of the foreign currency-denominated assets are in euro – given that the currency board, as mentioned, was denominated in Deutsche mark and subsequently in euro (loans were previously in Deutsche mark). But in Lithuania most foreign currency-denominated loans are in dollars (80% in 2001), partly due to the fact that Lithuania's currency board was dollar-denominated until February 2002, when it was repegged to the euro, partly due to the fact that a large part of the country's trade is dollar-denominated – in particular the remaining trade and transit trade with Russia.[2]) Since the repegging of the litas, the share of euro-denominated loans in total loans has increased in Lithuania.

1 *Lepik and Törs (2002).*

2 *IMF (2001b).*

There has been a further reorientation from the Russian market towards domestic customers. Only in Latvia did assets from Russia and the CIS still represent a portion equal to that of domestic loans in 2001. This reflects stronger economic links with Russia, notably through the large Russian-speaking minority in Latvia which has maintained contacts with, and knowledge about, the Russian commodities business. Most of these assets are concentrated within the locally owned Parex banka and a few smaller banks. In Estonia and Lithuania, the share of Russian and CIS assets still represented about 15% of the total in 2002.

There is also a reorientation from loans for trading purposes, which were important in the 1990s, towards credits to industrial companies, as commercial needs are increasingly catered to within Baltic enterprises that have become owned by foreign groups.

Credit assessments of firms are often different from those in more developed markets. Audits are often doubtful, and only a minority of customers follow IAS (as opposed to banks themselves, where IAS is compulsory). Nevertheless, both leading banking groups (Swedbank and SEB) have implemented strict risk management procedures modeled on those applied in Nordic countries.

The most rapidly growing field of lending of the banks in all three Baltic states is that of the leasing subsidiaries of the banks, which are particularly successful in business with smaller and medium-sized companies. This appears to reflect remaining concerns about being able to seize collateral within reasonable time periods, despite improved rules and legislation on the collateralization of loans and bankruptcy laws compatible with EU standards. Although the appropriate laws are in place, court procedures remain cumbersome and time-consuming, with risks of asset-stripping and depreciation of collateral. It can also be a consequence of the banking system reaching out to new and smaller clients where the banks have less information and leasing in effect is akin to a sort of screening. With its clear-cut ownership rules, leasing furthermore allows for assertive marketing even to riskier and smaller clients. This evolution, with aggressive and high-risk leasing companies taking up a greater part of the banks' balance sheets while these companies themselves are not subject to the same detailed regulation and supervision, is cause for some concern to the supervisory authorities. Real estate is a common leasing property (unlike in the Nordic and other European markets), as are company cars. In Estonia, where leasing is furthest developed, it comprised about a third of banking assets in 2001.

In general, total lending to finance commercial real estate projects grew strongly up to 2001, but has been somewhat more muted since then in Estonia and Latvia. This is both the consequence of the cooling of the property market, with the demand for office space falling off, and the result of a change of attitude on the part of banks, which tried to reduce their exposure to the commercial real estate market against the background of the unpleasant experience of their Swedish bank owners, who were severely hit by the real estate bubble in the early 1990s.

But the expansion of mortgage lending has accelerated after a slow start and expanded at a rate of about 100% in Estonia and Latvia in 2001–02. It now represents more than 30% of total domestic assets in Estonia and more than 15% in Latvia. Lower interest rates have been the driving force, and in Lithuania also government subsidization of mortgage loans. Nevertheless, retail lending remains limited, in particular in Latvia and Lithuania. Only some 5% to 10% of households take out mortgages in the Baltic states as opposed to more than 80% of households in Scandinavian countries. Growth in the retail sector, and in particular mortgage lending, is expected to continue and to be reinforced in the next few years.

The quality of loan portfolios has improved markedly since 1998, in particular in Estonia and Latvia. Nonperforming loans (NPLs) have reportedly fallen from 1997 to 2001 from 3% of total loans (almost 5% in the months following the Russian crisis) to below 2% in Estonia, from 10% to 4% in Latvia and from 22% to 9% in Lithuania.[1]) Although the figure for Lithuania is high, the distribution of NPLs remains very uneven, with some banks bearing most NPLs, while the leading bank groups have reduced their NPLs very substantially.

6.3 Deposit Growth

The growth in assets has been strongly supported by rapid deposit growth, which, after dropping sharply in the months before and after the Russian crisis in the fall of 1998 and the beginning of 1999, has outpaced loan growth, with growth rates coming to around and above 30%.[2]) But although more than two thirds of Estonians, Latvians and Lithuanians hold bank accounts, the levels of deposits are still relatively low. Deposits amounted to about 40% of GDP in Estonia, about 30% in Latvia and to 25% in Lithuania at the beginning of 2002 (chart 8). This compares to about 85% of GDP in the EU.

The Baltic countries, and most noticeably Latvia, have profited from an influx of foreign deposits. The profile of the foreign funds indicates that they mainly serve as a means of cross-border transfers. International corporations operating in the Baltic states represent a large and growing part of nonresident depositors. In Latvia in particular nonresident deposits are also the result of Russian and other CIS depositors wishing to take advantage of reliable financial institutions and regulations. In fact, nonresident deposits have kept pace with the rapid growth of domestic deposits.

The IMF, in its 2001 Financial Stability Assessment Report on Latvia, raised the issue whether nonresident deposits could be linked to the laundering of money from CIS countries, with the risk of a loss of confidence in Latvia's financial system even if these assets (mostly concentrated within smaller niche banks) appear to be adequately matched in the books by liquid Western assets. Latvia has created an anti-money laundering board to which banks are required to report suspicious transactions, but the country in 2001 was still subject to some criticism by the FATF (the Financial Action Task Force, the OECD money laundering watchdog) and the European Committee on Crime Problems.[3])

The special character of Latvian deposits is also reflected in the large portion of savings and foreign currency accounts. In Estonia and Lithuania demand deposits remain much more important than time or savings deposits, while both

1 *IMF (2002b, 2002c), Eesti Pank (1999, 2000, 2001), Latvijas Banka (1999, 2000, 2001), Lietuvos Bankas (1999, 2000, 2001).*

2 *The excess went into domestic bonds (for Estonia in 2002), foreign liquid assets and liquidity.*

3 *IMF (2002c).*

are equally important in Latvia. Foreign currency deposits are important in both Latvia and Lithuania, but less so in Estonia.

Most foreign currency-denominated deposits are kept in euro or U.S. dollars, the dollar being particularly important in Latvia, where nonresident (CIS) customers have preferred to keep deposits in foreign currency despite the lower interest rates than on deposits in lats. Savings in Lithuania have also to a surprisingly large extent remained in U.S. dollars, despite the repegging of the litas from the dollar to the euro.

Foreign institutional borrowing by Baltic banks also played an important role from 1997 to 1999, but as domestic deposits have increased, and for many banks have outpaced the growth in lending, the reliance on foreign borrowing and capital injections has diminished. In the process, interest rates on liabilities have become more favorable whereas most deposits remain remunerated at very low rates.[1]) There have been no runs on banks or rapid swings in deposit demand since 1998, an element of stability reinforced by the introduction of the deposit guarantees.

Thus the banking system has apparently been increasingly successful in the mobilization of domestic savings and in reducing cash holdings in favor of deposits. An important factor in the reduction of cash holdings has been the implementation of IT technology throughout the network of the SEB affiliates and the Hansapank group, increasing the convenience for customers. Together, both bank groups had more than 800 ATMs in the Baltics in 2001. In Estonia over 90% of cash withdrawals were conducted through ATMs and over 90% of bank transactions were carried out electronically in 2001.[2]) In Estonia and Latvia the Swedish and Finnish telephone and Internet banking trend has also had a clear influence. Altogether at the end of 2001 there were over 700,000 Internet banking customers in the Baltics, mostly in Estonia. This marks a higher density of Internet banking than in many EU countries, although transactions remain small.[3]) The necessary investments have been facilitated by the support of the Swedish owners, who had already implemented similar systems for Swedish customers. A third of Estonian households use Internet banking, according to a 2001 survey by Eesti Pank.[4]) Nevertheless, according to the same survey, cash remained the preferred method of payment even in Estonia, considered the most advanced of the three Baltic markets.

6.4 Capitalization and Profitability

The Baltic banks have become well capitalized, in excess of the high capital adequacy ratios imposed by the authorities. In 2001 all the major Baltic banks had capital adequacy ratios as defined by the BIS far in excess of 10%, most of them around 15% (table 3). This was in fact a decline from even higher levels in earlier years.

Profits and returns on capital of the Baltic banks nosedived during the Russian crisis but have recovered since the end of 1999, albeit to more modest

1 *Zubkova et al. (2002).*
2 *Kaasik (2001), Eesti Pank (2000b).*
3 *Hansabank (2002), Vilniaus Bankas/SEB (2002).*
4 *Kaasik (2001).*

levels than before the crisis (table 3). Profitability remained better in Estonia and Latvia than in Lithuania until the beginning of 2002. Competition has intensified, apparently despite the dominating role of just two main banking groups. After a rebound in 2000, following the recovery from the Russian crisis, interest rate margins have declined in all three Baltic markets, although they remain high (in particular in Lithuania) compared to those in EU countries and higher than in certain other accession countries, e.g. Hungary.

Profits have been further hit by the global downturn in 2001 and 2002. On the other hand, the economies of scale achieved through the consolidation of the banks, the reduction of staff (despite the rapidly growing customer base) and improved efficiency through information technologies have adjusted costs and increased profitability. Operating expenses to assets are now on a par with the EU average for the best-performing Baltic banks, albeit below that of Nordic banks (somewhat lower, though, for Lithuanian banks compared to Estonian and Latvian banks). This has contributed to keeping up profitability despite reduced margins (table 3). Profitability has even increased markedly for several of the major banks. However, net interest revenue still represents some 65% to 70% of operating profits, with a very small contribution from fees. As margins are bound to come down towards European levels, fee incomes will have to improve to maintain profitability.

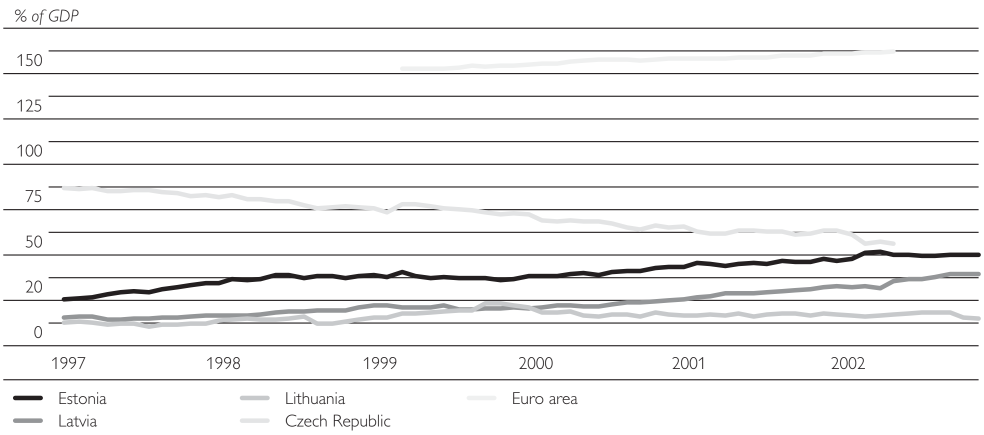
Asset management is considered an important future source of income for the Baltic banks. All three Baltic nations have introduced new multi-pillar pension schemes with an important privately managed fully funded pillar. This has contributed to a rapid development of pension funds and life insurance companies, supported by favorable tax rules.

Chart 5

Domestic Credit in Estonia, Latvia and Lithuania

Compared to the Czech Republic and the Euro Area 1997–2002

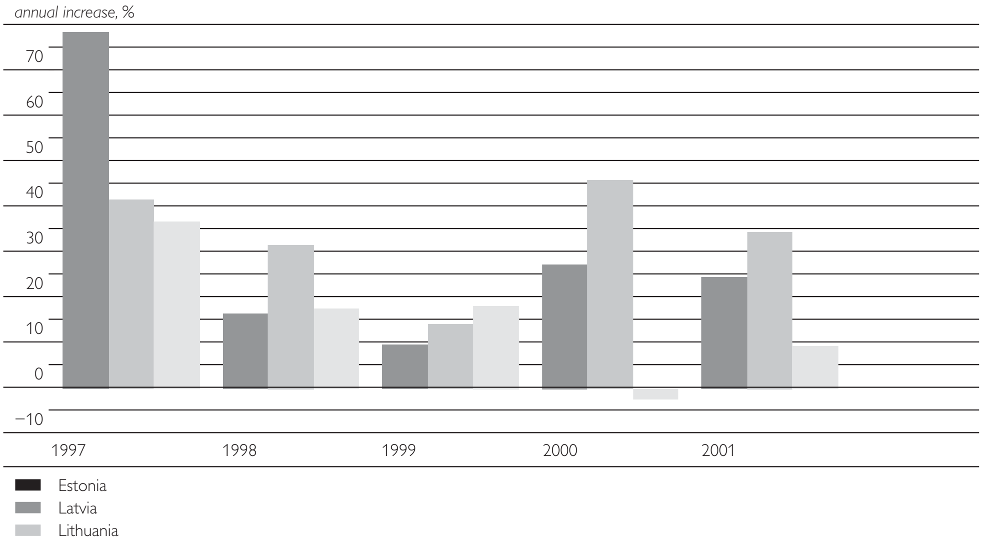
Domestic credit as a percentage of GDP



Source: IMF, IFS 1997–2002.

Chart 6

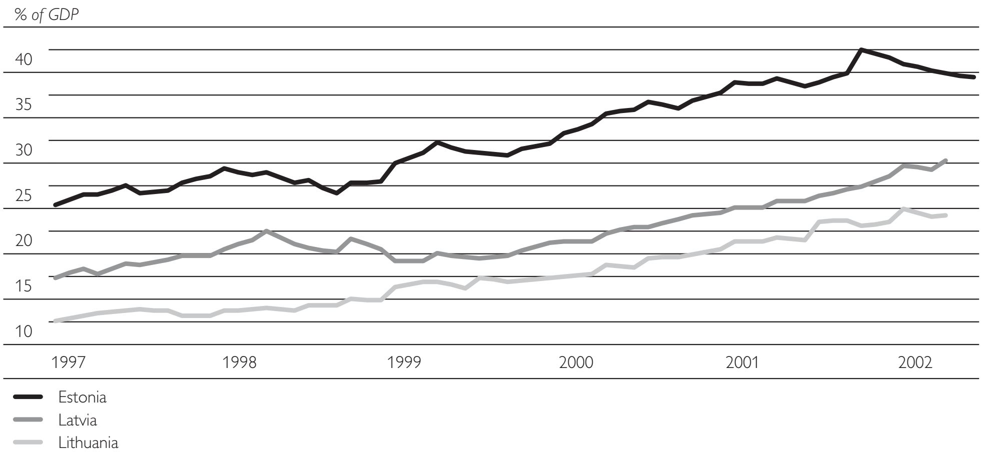
Domestic Credit Growth in Estonia, Latvia and Lithuania 1997–2002



Source: IMF, IFS 1997–2002.

Chart 7

Deposits in Estonia, Latvia and Lithuania 1997–2002



Source: IMF, IFS 1997–2002.

Table 4

Key Indicators/Ratios of Major Baltic Banks Mid-2001

	Net profit	Capital adequacy	ROAA	ROAE	Cost/ income	Interest margin
	USD million				%	
Hansapank[1])	97.30	14.40	3.18	27.53	51.6	4.57
Vilniaus Bankas	16.73	16.23	1.65	14.42	69.0	4.87
Ühispank	9.70	11.83	1.39	11.25	68.6	3.75
Unibanka	14.14	11.70	2.4	24.3	57.6	4.0

Source: Vilniaus Bankas, Lietuvos Bankas, Eesti Pank, Association of Commercial Banks of Latvia, banks' financial statements.
[1]) Group figures.

7 Prospects Ahead of EU and Euro Area Accession: Opportunities and Risks

In the coming years increased direct competition from the larger European banks is expected – in particular given that the Baltic states could enter the Eurosystem as soon as 2007–08. As mentioned earlier, both Swedish-Finnish Nordea and the Finnish Sampo group as well as German banks are already challenging Swedish Swedbank and SEB groups in all three Baltic states, and the market shares of both assets and deposits of these branches of EU banks are growing rapidly. Although still very much larger than their Baltic counterparts, SEB and Swedbank remain small banks in a European perspective. As competition intensifies, the high profit margins of the two leading bank groups in the Baltics are bound to erode.

However, if the Baltic markets are going to follow a pattern somewhat similar to that in smaller European markets, such as the neighboring Nordic markets, it is unlikely that the two groups dominating the market today will eventually yield a large market share to new entrants. Larger local corporations, which are already tapping the European financial markets and soliciting large European banks, are likely to be targeted by new entrants. However, these new entrants will probably face problems competing with already established universal banks with extensive branch networks, such as the Hansapank group and the SEB constellation of banks. The competition will rather reinforce the segmentation between several banks catering to the small number of large Baltic corporations (given the already small size of the market) and a few universal banks oriented towards the large number of small and medium-sized companies.

Nevertheless, as competition continues to intensify, interest margins are bound to decline, thus forcing the two dominating groups to increasingly rely on fees and finding other sources of income, developing new services, notably asset management (pension funds). In any case, the Baltic banking sector is likely to continue to grow very much faster than GDP for many years to come – given the still low level of banking relative to the economy. In particular this is the case for Lithuania, which is still very underbanked and where a long period of bank restructuring and privatization could well bear fruit in the next few years in the form of rapid growth and some catching-up with its Baltic neighbors.

But the rapid expansion is probably not risk-free, despite the supervision both from Nordic parent banks and from increasingly experienced national supervisory authorities. This goes for the somewhat unchecked development of leasing, in particular real estate leasing, with the leasing subsidiaries becoming an increasingly important part of the banks' balance sheets. It is also worth noting that most of the leasing up to now has not concerned machinery and equipment, but company cars and real estate.

Another issue is the rapid growth of mortgage lending. Although the development of retail and mortgage lending is part of a sound convergence with the normal European banking pattern, and Baltic households are still net savers, it may be that the routines and experience in risk management for this type of lending are not yet fully developed.

On the deposit side there are some signs that the Baltic banks may be able to skip some stages of market development – never developing a branch network as extensive as that in Western European countries and instead relying more on cards, and telephone and Internet banking.

In Latvia the section of the banking sector catering to the Russian and CIS market, which represents some 18 or 19 banks, is expected to go through a phase of consolidation. Whereas neither local nor international experts have many doubts about the reliability of capital adequacy figures and IAS compliance for the leading banking groups (with the exception perhaps of the recently integrated Lithuanian banks in these groups), there are still some question marks as to the smaller niche banks, in particular in Latvia. The nonresident deposits of these niche banks appear to be matched by liquid assets in OECD countries, that is the banks use deposits to invest in liquid OECD assets. It is an open question what will happen to nonresident deposits, as they will be increasingly exposed to scrutiny upon the countries' accession to the EU. As Latvia repegs from the SDR to the euro upon accession to the EU, presumably in mid-2004, it will be faced with a mismatch between dollar deposits and loans and the euro-pegged currency, like Lithuania was. However, in Lithuania this appears not to have posed any major problems so far.

In terms of regulation, the sector will face restrictions for lending and deposits, as the Baltic states envisage EU entry in 2004 and then EMU membership, possibly as soon as 2007. Reserve requirements are bound to be lowered to conform to ECB standards, thus relaxing some demands for safety margins, but also risking creating a short-term monetary stimulus. At the same time the ECB requirements for setting deposit insurance at EUR 20,000 will present additional costs.

Supervisory authorities both in the Baltic states and in the Nordic countries are increasingly going to be faced with a "too small to fail" issue. With the foreign ownership of these banks very large, their parent banks (mainly in Sweden) are considered to have an implicit responsibility for the Baltic banking system. However, the Baltic banks are so small compared to the parent banks' consolidated balance sheets that they do not pose any threat to financial stability in the country of the parent banks, in this case mainly Sweden. Thus the supervisory authorities in the country of the parent banks have no particular (national) incentive to assume responsibility for supervising the systemic risks in the Baltic countries, despite the fact that the parent banks are expected to shoulder responsibility for an eventual systemic crisis. This emphasizes the important responsibility of the still rather young supervisory authorities in the Baltic states to scrutinize systemic risks despite the responsibility of the foreign owners and, in particular, to keep track of the financial strength of parent banks. At the present levels of growth, the Baltic banks might also represent a much more significant part of parent banks' assets within a decade. Coordination of supervision with the Swedish authorities has also been reinforced, in particular in Latvia and Estonia.

8 Summary and Conclusions

The impact of the Asian and Russian crises and the inflow of FDI to the banking sector in 1998 marked a turning point for the Baltic financial systems, forcing a restructuring of the banking sector that would produce rapid growth and an improved quality of asset portfolios in the following years. The role of stock markets declined, as reflected by the collapse of the Tallinn exchange in the wake of the Asian crisis, while that of universal banks increased to the point at which they dominate financial intermediation.

The Russian crisis led to short recessions in all three states, some minor bank failures and above all mergers between banks. From 1998 foreign investors shifted from holding passive portfolio stakes in the Baltic banks to taking strategic positions. This led to the creation of two major banking groups, both owned by Swedish banks, which gradually increased their stakes in the purchased banks' capital. Both of these groups acquired smaller banks in all three Baltic states from 1998 to 2002 until they dominated the market with about two thirds of assets and more than half of deposits. As Lithuania and Estonia have privatized their last remaining large state-owned banks into foreign hands, Swedish, Finnish and German banks now own most of the Baltic banking sector. While the Estonian and Lithuanian banking sectors became truly consolidated, Latvia remained the exception, with a number of smaller niche banks oriented towards the Russian and CIS market, attracting in particular nonresident deposits. Except for the initial capital injection, the foreign participation also reinforced trust in the banking system and improved risk management practices.

As a consequence of both the purging effect of the banking crises and foreign know-how, the Baltic banking sector has increasingly played the typical role of a financial intermediator. Already in the aftermath of the Russian crisis, Estonia and Latvia experienced very rapid asset and deposit growth, while Lithuania has lagged somewhat behind. In particular, there has been a reorientation from investment banking and large corporate clients towards small and medium-sized companies, with particularly strong growth in leasing, as well as wealthy private clients, with rapid growth in mortgage lending. Increased competition has brought down interest rate margins, but lower operating costs and extensive IT implementation have contributed to high levels of profitability. Nonperforming loans have been reduced by half since the Russian crisis, and capital adequacy ratios have improved. Rapid deposit growth has given the leading banking groups ample funds for loans, but considering that loans have not expanded at the same pace as deposits, financial intermediation is perhaps still not as efficient as it could be.

Supervisory and regulatory authorities proved their mettle in forcing the pace of mergers during the crises and thereafter rapidly improved supervision. Estonia and Latvia opted for unifying supervision agencies for their respective financial markets.

Despite these numerous positive trends, the Baltic states remain clearly underbanked, with ratios of assets and deposits to GDP not only a fraction of those in the EU, but also still much lower than in some Central European accession countries. Baltic corporations still receive the bulk of their financing through foreign investment, intracompany loans and retained earnings.

With EU entry expected in 2004, and euro area entry envisaged already in 2007–08, there is therefore still scope for new entrants to Baltic markets to increase competition, in particular for the small number of larger customers.

The internationalization and market orientation of the Baltic countries' banking systems may yield the following conclusions:

– The restrictions of the currency board regimes (and Latvia's quasi-currency board), with the absence of a lender-of-last-resort function (and in practice no use of excess reserves for bank bailouts), high liquidity demands and high reserve requirements have actually contributed to the resilience of the Baltic banks. These restrictions have been instrumental in allowing lending in foreign currency at favorable rates, with confidence in the disinflation process increasing.
– Continued rapid privatizations of state-owned companies and improvements in the legal infrastructure have proved important for the development of the banking sector.
– Increasingly tight regulation and supervision, but also improving transparency and the building of trust by the banks themselves, have contributed to the rapid asset and deposit growth.
– The openness to foreign ownership facilitated the consolidation of the sector and transfers of know-how and technology.
– In Estonia and Latvia, where state ownership was rapidly divested, the banking sector developed more rapidly than in Lithuania, where state ownership lasted several years longer and where many banks survived the crises.
– Despite the rapid asset growth, the main sources of financing for Baltic corporations are still foreign investment, intracompany loans and retained earnings. It could be the case that in small open emerging economies with strong inflows of FDI, more of the asymmetries in information between the supplier and the receiver of capital can be internalized through investment or intracompany finance in a subsidiary than by outside supply of financial capital from the financial markets. This may eventually limit asset growth in Baltic banks to mainly mortgage and retail finance.
– The importance of leasing as opposed to regular loans reflects some inertia in the practice (as opposed to the legal right) of seizing collateral, which is probably typical for many emerging markets. This is likely to have hampered asset growth.
– Although the Baltic states are an example of successful mobilization of domestic savings for productive purposes in the real sector, they are still so underbanked that rapid growth in both assets and deposits is likely to continue – in particular in Lithuania, where the banking sector might be preparing for a takeoff after years of restructuring. However, many large Baltic corporations are likely to find financing elsewhere, from foreign investors or directly on the European financial markets.
– Until now the small number of large actors in the market has not contributed to a lack of competition, as interest rate margins are higher than in the euro area, but similar to those in the most developed accession countries.
– Early entry of foreign investors into the Baltic financial markets with a favorable investment climate created a very strong market position for the first entrants. The two groups of universal banks in the region already appear

to be quite entrenched, with large retail banking networks and a firm grip on small and medium-sized customers.

– "Too small to fail," the perception that the Western European parent banks of much smaller Baltic banks have the overall responsibility for systemic stability in the financial system, might turn out to be an increasingly important factor in supervision and regulation. It enhances the need for cross-border cooperation in supervision and the attentiveness of Baltic supervisory authorities to the state of parent banks.

Annex

Table A1

Banking Sector-Related Indicators for Estonia (1997–2001)

Year	Number of banks (of which foreign-owned, year-end)	Asset share of state-owned banks	Deposit rate (6 to 12 months, end-year)	Lending rate (6 to 12 months, end-year)	Domestic credit (end-year)	Domestic credit to the private sector	Nonperforming loans (share of total loans)	EBRD index of banking sector reform
	number	*%*	*% p.a.*		*% change*	*% of GDP*	*%*	
1997	12 (3)	0.0	12.4	15.0	78.3	26.4	2.1	3.3
1998	6 (2)	7.8	12.9	17.1	16.5	25.2	4.0	3.3
1999	7 (2)	7.9	6.1	10.2	9.6	25.9	2.9	3.7
2000	7 (4)	0.0	5.3	8.4	27.2	25.9	1.6	3.7
2001	7 (4)	0.0	4.0	9.7	24.4	27.8	1.5	3.7

Source: EBRD.

Table A2

Banking Sector-Related Indicators for Latvia (1997–2001)

Year	Number of banks (of which foreign-owned, year-end)	Asset share of state-owned banks	Deposit rate (short-term, under 1 year, end-year)	Lending rate (short-term, under 1 year, end-year)	Domestic credit (end-year)	Domestic credit to the private sector	Nonperforming loans (share of total loans)	EBRD index of banking sector reform
	number	*%*	*% p.a.*		*% change*	*% of GDP*	*%*	
1997	32 (15)	6.8	5.3	12.1	39.3	10.5	10.0	3.0
1998	27 (15)	8.5	6.5	16.4	30.6	15.2	6.8	2.7
1999	23 (12)	2.6	4.2	12.5	15.2	16.0	6.8	3.0
2000	21 (12)	2.9	4.2	11.8	43.6	19.5	5.0	3.0
2001	23 (10)	3.2	5.7	9.9	35.6	31.8	3.1	3.3

Source: EBRD.

Table A3

Banking Sector-Related Indicators for Lithuania (1997–2001)

Year	Number of banks (of which foreign-owned, year-end)	Asset share of state-owned banks	Deposit rate (average rate on demand deposits, end-year)	Lending rate (average rate on loans, end-year)	Domestic credit (end-year)	Domestic credit to the private sector	Nonperforming loans (share of total loans)	EBRD index of banking sector reform
	number	*%*	*% p.a.*		*% change*	*% of GDP*	*%*	
1997	12 (4)	48.8	1.9	11.9	37.6	9.3	28.3	3.0
1998	12 (5)	44.4	2.4	12.6	16.8	9.6	12.5	3.0
1999	13 (4)	41.9	1.6	13.0	24.5	11.1	11.9	3.0
2000	13 (6)	38.9	1.0	11.0	1.7	10.1	10.8	3.0
2001	14 (4)	12.2	0.7	8.1	13.7	11.5	7.4	3.0

Source: EBRD.

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