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Foreign banks increase the social orientation of Estonian financial sector

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**Foreign Banks Increase the Social Orientation
of Estonian Financial Sector**

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Abstract

Reconstruction of Estonian banking system started twenty years ago. Estonia built up for the market economy a banking oriented financial sector, which is centred on commercial banks. During the two decades less than ten banks remained from more than 50 licensed commercial banks, the rest were not able to continue independently, they merged or have failed. The bad result of such kind of development was also the excessive concentration of banking.

Banking sector in Estonia during the transition period was opened to the invasion of foreign banks due to the openness of the economy and excessive risks taken. Two banking crises, selected quickly the very limited number of prosperous banks, and the major commercial banks went into the ownership of Scandinavian banks.

The qualitative effects of foreign banks' entry into the Estonian banking market were new features of competition in banking market and transfer of various know-how from foreign banks. Better liquidity risk management techniques, information systems, credit policy and personnel policy transfer from foreign banks supported banks to have high profitability and low credit losses rates. These directions are noticeable also by quantitative analyses of banking market development.

The takeover of main commercial banks by the large Swedish and Finnish banks was one of important factors in the gradual increase of the social orientation of Estonian banks however the ideas of social responsibility of enterprises are especially popular in Scandinavia. In our paper we analyse also Estonian banks' practices of supporting the social development of Estonia.

1. Introduction

Reforms in Estonian banking sector started in 1988, three years before restoring the political independence in August 1991.

In addition to the transition to market economy, Estonia had one more aim in reconstructing its banking system – to raise their financial independence, and the result was that Estonia became a pioneer in the reformation of banking system in former USSR.

During the two decades five banks remained from more than 50 licensed commercial banks, the rest were not able to continue independently, they merged or have failed. The bad result of such kind of development was also the excessive concentration in banking sector. Market share of the biggest bank by assets is over 50 per cent.

The main roots of the first banking crisis in Estonia came from the deep crisis of the whole economy; poor banks risk management, changed financial environment after the currency reform and weak supervision from the side of the central bank. Reasons of the second banking crisis were pitfall in Tallinn Stock Exchange in autumn 1997 and financial crisis of Estonian important trade partner Russia in autumn 1998. The most notable similarity of both crises was that banks with poor risk management and control levels suffered in harder troubles and a remarkable share of the population either lost their savings in entirety or lost for the high inflation rate part of their savings purchasing value in domestic market.

Banking sector in Estonia during the transition period was opened to the invasion of foreign banks due to the openness of the economy and excessive risks taken. Two banking crises, selected quickly the very limited number of prosperous banks, and after the second banking crisis the major commercial banks went into the ownership of Scandinavian banks.

The qualitative effects of foreign banks' entry into the Estonian banking market where intensification the overall competition in banking market and transfer of various know-how from foreign banks. Better liquidity risk management techniques, information systems, credit policy and personnel policy transfer from foreign banks was highly evaluated by the Estonian domestic banks. These directions are noticeable also by quantitative analyses of banking market development.

The negative experiences of people and entrepreneurs with the financial sector force the financial institutions to make efforts to improve their reputation and trustworthiness. As the transition economies have difficulties with improving the

social sphere because of financial constraints, participation in social programs is useful in order to improve the reputation. Thus one can argue that foreign banks entry increased the social orientation in Estonian financial sector, and the supporting of social development is one of the ways to improve its low image. Such kind of spending some profits for being visible is useful not only to the society, but also to bank's owners themselves.

In our research we try to find answers to the two questions about the qualitative changes of banking business: are the foreign banks entering to the Estonian emerging banking market for they see in host country better profit opportunities and assists or not the social orientation of banks to earn bigger profits.

2. Development stages of the banking sector in Estonia

Introduction of the market economy in transition countries took place simultaneously with structural and legal reforms. Reforms of banking systems and the creation of workable financial markets are among the biggest institutional changes of these states. During the central-planning socialist economy, the banking sector was doing little more than allocating funds to the various sectors and companies, according to the authorities decisions (Stepic, 2002).

Financial sector reforms for transition countries were not an easy task for high speed of changes and for effects of economic and financial crises in this period. Therefore the risk management experience of the staff of banks was short, they practically had not risk hedging funds and the banking regulations were in a forming stage.

Reforms in Estonia banking sector started in 1988, three years before restoring the political independence in August 1991.

The first period of development of new banking in Estonia can be named as a "wild" banking period and it ended with first banking crisis. Wild banking means that former soviet banking regulations were not in force, but central bank had not developed new ones. Crisis started in autumn 1992 and decreased the number of operating banks twice. The main roots of the first banking crisis in Estonia came from the deep crisis of the whole economy; poor banks risk management, changed financial environment after the currency reform and weak supervision from the side of the central bank.

The second period can be called as a "naïve-optimistic" banking period and was interrupted by second banking crisis in 1998. This period began when economy after crisis started again to grow. It was noticed that in risk management banks did

not take into the account the cyclical development of economy, they did not protect them against the risk of economic slowdown. Reasons of the second banking crisis were pitfall in Tallinn Stock Exchange in autumn 1997 and financial crisis in Estonian important trade partner Russia in autumn 1998. The most notable similarity of both crises was that banks with poor risk management and control levels suffered in harder troubles and a remarkable share of the population either lost their savings in entirety or lost part of their savings purchasing power due to freezing deposits in period of high inflation. It led to the mergers of certain banks, coming of foreign banks into Estonia as the strategic investors for Estonian banks and the bankruptcy of three smaller banks. After the second banking crisis in Estonia operated only 5 banks and one branch office of a foreign bank and the market share of the biggest bank by assets was over 50%.

The essential difference of the banking crisis in 1998–1999 from the previous one was the fact that the Swedish banks SE Banken and Swedbank were involved in saving the two major banks of Estonia, the Hansabank and the Union Bank of Estonia. Those banks had just merged with weaker banks and now their share in the banking market of Estonia was respectively. 50% and 30%. They had also been evaluated by international rating agencies. As they were not able to carry on their business independently any longer, the owners and managers had to look for strategic investors. The troubles had lowered the price of shares, so international banks found it the right time to come to help. The small banks of Estonia also looked desperately for partners, but as their market share was small and they did not own international ratings, they were not able to draw international interest. Empirical results from 15 emerging markets (Roldos, 2001:15) showed that each crisis of the banking system led to a further increase in participation and control by foreign banks in the domestic banking sector. During the crisis it is necessary to intervene to further capitalize banks or to sell unsuccessful banks. Foreign banks are the only ones with have resources to do so.

The Bank of Estonia (BOE) did not allow before the currency reform in 1992 any foreign share in Estonian commercial banks. But the new regulations of the issuance of banking licences after the currency reform did not impose such restrictions. Therefore on 26 August 1992 Ameerika-Balti Ühispank (American Bank of the Baltics), whose sole proprietor was an USA businessman, received a licence as well as INKO Balti Pank (INKO Baltic Bank) on 29 September 1994, which was the subsidiary bank of the Ukrainian INKO Bank. But the Board of BOE did not approve all applications. For example, the representatives of the Austrian Doonau Bank had to return bare-handed. In September 1994 Merita Bank established a branch in Tallinn. As the first two banks, created on the basis of foreign capital, did not find their place in Estonia and had lost their licences by now, then the branch of Merita-Nordbanken (now Nordea) after a long period of

quiet growth has began to apply an expansion strategy and wishes to increase its market share in Estonia.

In spite of some unsuccessful foreign banks the “open doors” policy of BOE was undoubtedly a right strategy, because the positive aspects of the coming of foreign banks balance up the possible negative ones. Arguments, why foreign owned banks can exploit efficiency gains are given in Appendix 1. The policy of the central bank of India, that allows only 20% of foreign capital shares in an Indian bank, is a warning example. The Economist stated in its January copy this year that one of the main reasons for the poor situation in Indian banking is untrustworthiness to foreign banks (India’s ..., 2001).

Experts are on the opinion that in transition countries it is necessary to allow the foreign capital to enter the banking sector. For example, the research of Eller et al. (2006) about impact of financial sector FDI on economic growth in 11 Central and Eastern European countries from 1996 to 2003 find a hump-shaped impact of financial sector FDI on economic growth.

The European banks have always been waiting for a suitable moment to come into Estonia. Schleswig-Holsten Landesbank, based on the German capital, started a bit too early and met in autumn 1997 the resistance of the management of Eesti Investeerimispank to the wish to acquire 60% of the shares of the Estonian bank. The resistance was justified by the necessity to continue the activities as an investment bank and not to turn to a retail bank. But this idea was not realized. In June 2000 Optiva Pank, which was established by the merger of Eesti Investeerimispank and Forekspank, and had received financial injections from the central bank, was acquired in favourable conditions by Sampo Finance Ltd, a joint company owned by the Finnish banking and insurance company Sampo-Leonia and the Estonian Kaleva Mutual Insurance Company. The new owners turned Optiva Pank to Sampo Pank that offers both insurance and banking retail services.

The foreign banks got an opportunity to acquire shares in Estonian banks because the local banks turned to quoted companies. Hansapank was the first one to reach the foreign stock exchanges in 1994. The banks also faced a need to raise foreign capital in connection with the schedule of the growth of share capital and equity capital prescribed by the central bank. By the end of 1995 foreigners (foreign banks ownership formed 29.2% and 5.7% were the clients of foreign banks) held 35% of the share capital of Estonian banks.

The Swedish major banks (Swedbank and SEB) managed to wait their time. They bought from the stock exchange the cheapened shares of the Estonian major banks and in 1998 they were able to acquire without resistance an essential share of the

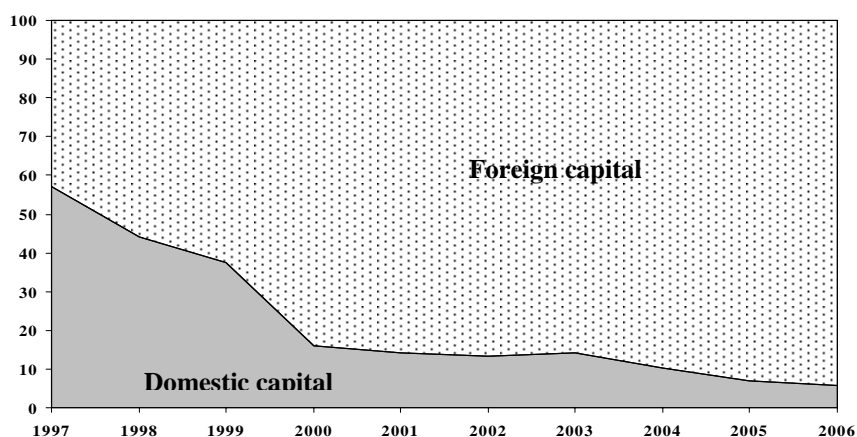
share capital of Hansapank and Eesti Ühispank that were facing financial difficulties. Last news were that Sweden's SEB Group had signed an agreement to acquire 97,25% of Factorial Bank in Ukraine. Following completion of the deal, which is subject to regulatory approval the bank will be merged with and rebanded as SEB's existing subsidiary, SEB Bank Ukraine (ex-Bank Agio) (European banks ..., 2007).

The question why the Nordic banks are especially active in the Baltics has its own logic. The Baltic region is geographically ideal for Nordic banks in their expansion spree. Decisive action can be observed in Estonia, which banking sector is the most advanced Baltic State as far as the banking sector is concerned (Tiusanen & Jumpponen, 2000).

Banking research in Lithuania and Romania also showed that the main reason for foreign banks' entry into Lithuanian and Romanian banking market has been realization their strategy of searching for new business opportunities (Dubauskas, 2002; Florescu, 2002).

By the end of 1998, the share capital of Eesti Ühispank and Hansapank were on the hands of foreign credit institutions respectively 68.4% and 64.9% and the foreign share in the share capital of Estonian banks had increased to 55.8%. By the end of 2006, already 94.4% of the shares of Estonian commercial banks were in the ownership of non-residents (Figure 1).

Figure 1. Shareholders structure of Estonian commercial banks
(end of the year*, %)



* October 1th 1997

Source: Data of Bank of Estonia.

Foreign banks came to other transition countries the same way as to Estonia – when the local banks were in difficulties. For example, the analysis of the Croatian banking proves that during the period of the third banking crises (1999–2000) the share of private capital in the banking sector increased to 90%, most of it was a foreign share (Barisitz, 2000).

At the end of 1996 there was made a survey of the main banks, which had invested in CEE countries (Konopielko, 1999). The survey showed that the main motivation for entry in CEE banking market according to factor's level of importance (1 – not important at all; 2 – not important; 3 – important; 4 – very important) was the following: the first rank got supporting client base (3.46 points) and the second was looking for new business opportunities (3.32 points) (Table 1).

Table 1. Prevailing elements of entry strategies* and country characteristics

	Poland	Czech Republic	Hungary
Reason for entry	Follow client	Follow client	Search for new opportunities
Method	Subsidiary	Branch	Take-over
Activity	Corporate financing	Corporate financing	Corporate financing
Branching	Underbranched	Overbranched	Overbranched
Profit growth expectation	Yes	Yes	Yes
Period of investment return**	3.12 years	3 years	2,5 years

* Table lists highest rated or dominant answers for each question in the survey.

** Period of investment return is given as an average of answers.

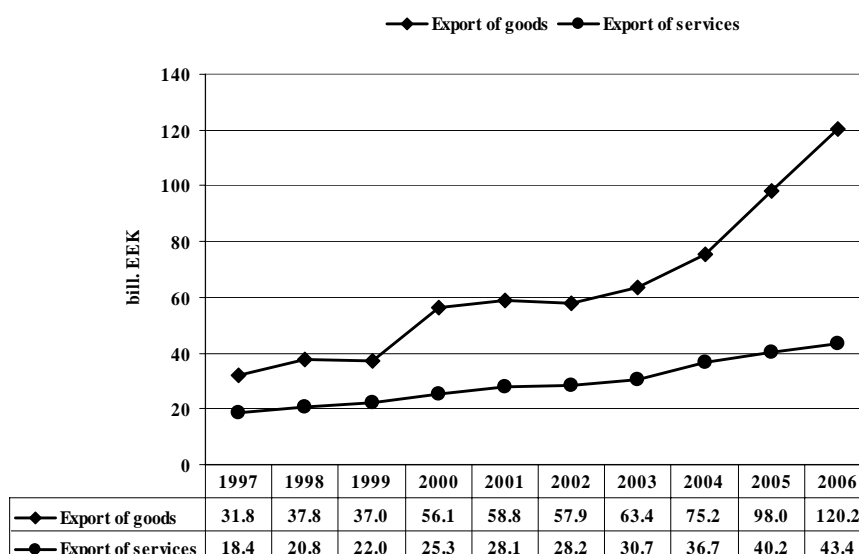
Source: Konopielko, 1999.

The mentioned survey showed that the entry strategies were different for different transition countries. Table 1 shows that in the Czech Republic and in Poland the preferred entry strategies were similar. For the Hungarian banking sector, as the most mature, it is necessary to adopt a more aggressive strategy, characterized by the willingness to search for new business as well as an expectation of a relatively short period of investment return.

Several analyses have showed that the relationship between trade and FDI is strong and positive (Carlin and Landesman, 1997; Kaminski, 2000; Jensen, 2004/2005). From Figure 2 (see also Appendix 2) we see that Estonian export of goods grew during last nine years near four times and export of services more than three times. So we may conclude that Estonian case showed also a very strong positive

influence of FDI inflow to the banking sector to the export activity of Estonian companies.

Figure 2. Estonian export dynamics in 1997–2006



Source: Balance of Payments Yearbook 2003, 2004; Estonian Balance of Payments Yearbook 2006, 2007; compiled by the authors.

Most of Estonian banks had quite ambitious growth strategies. Growth was achieved by introducing new ideas, by cheaper service or by cheaply acquiring competitors during banking crises. Already the researchers analysing the Finnish banking crisis at the beginning of 1990es discovered the fact that a banking sector that grows faster than the overall economy will in the long run end up in a banking crisis (Koskenkyla, 1995). The economists analysing the Japanese banking crisis came up with two reasons for this: deregulation and excess power of the banking sector. These were the reasons why they did not pay very much attention on risk management and regulative measures (Kanaya and Woo, 2001). Apparently, this was also the case in Estonia: rapid growth in several years led to excess capacity of banking and also to underestimation of risk management in 1997. The banking crisis in 1998 brought the banking back to the ground from the clouds (Table 2), when number of operating banks decreased twice and sector was in losses.

After the banking crisis in 1998 started the *modern* banking period. Modern period means that Estonian bank managements had two crisis experiences and got know-how from Scandinavian parent banks. Joining the EU in 2004 even accelerated

growth of the loan portfolio, which was in 2006 near twice bigger than in 2004. It was a good basis for growth profits of the banks. During three last year profits of the banks near tripled.

Table 2. Development of banking in Estonia

Year	Number of operating banks*	Totally by the end of the year, bill EEK (€1 = EEK 15,6)			Banks assets, % of GDP	Loan portfolio per bank (bill EEK)
		assets	loan portfolio	profit		
1992	41	5.2	2.1	0.09	36.4	0.05
1993	22	6.4	2.7	0.25	28.0	0.12
1994	24	10.4	4.5	0.04	33.2	0.19
1995	18	15.5	7.1	0.29	36.0	0.39
1996	13	22.9	12.3	0.51	41.0	0.95
1997	11	40.6	21.3	0.96	59.2	1.99
1998	6	41.0	23.9	-0.50	52.6	3.98
1999	7	47.1	26.7	0.67	57.6	3.81
2000	7	57.8	34.3	0.61	60.5	4.90
2001	7	68.4	40.7	1.68	63.2	5.82
2002	7	81.7	50.0	1.15	67.3	7.14
2003	7	98.8	69.2	1.32	72.6	9.89
2004	9	133.6	92.6	2.46	94.2	10.29
2005	13	185.1	125.5	3.11	105.5	9.66
2006	14	239.5	177.7	3.63	115.6	12.70

* incl. branches of foreign banks

Source: Eesti Pank.

We agree with opinion of ECB that the rapid growth of credit to the private sector observed in a number of countries in the region could pose risk to both macroeconomic and financial stability. Macroeconomic risks relate, in particular, to an overheating economy and an associated worsening of the current account. (ECB Monthly Bulletin, 2006). And really in Estonia current account deficit was over 15% in 2006 comparing with GDP and GDP growth was 11,4%.

Probably loan portfolio extremely quick growth has increased the banking sector crisis risk in Estonia. Loan portfolio of banks grew in Estonia to the end of 2005 comparing with previous year 35,5% and growth of the year 2006 was even 41,6%.

3. Development of profitability of Estonian banks after entry of foreign capital

While reconstructing their banking systems to adjust them to a market economy, some transition countries like Estonia have preferred commercial banking. The main purpose of commercial banks' shareholders and executive management is to increase the value of the company, which requires both a quick rise in the capacity of financial services and a high level of profitability of the business activities.

The managements of banks must therefore ensure high profitability of banks in order for their banks to remain competitive despite any unforeseeable developments in the market. Thus, they eagerly grasp at any profit opportunities.

Researches have shown that efficient banking sector accelerate economic growth in a transition country (e. g. Levine 1997, Wachtel 2001, Koivu 2002). Estonian experiences have shown the same.

In spite of the large amount of empirical literature devoted to banking efficiency on all continents (Molyneux *et al.*, 1996; Berger and Humphrey, 1997; Dietsch and Lozano-Vivas, 2000; Goddart *et al.*, 2001), there are only a few studies that measure banking efficiency in transition economies. A likely reason for this deficit may be the relative lack of banking data in these countries, with long periods of data missing.

The most extensively studied developing countries are in Asia, where markets of Thailand (Leightner and Knox Lovell, 1998), Korea (Gilbert and Wilson, 1998), Singapore (Rezvani and Mehdian, 2002), Pakistan (Hardy and Bonaccorsi di Patti, 2001), India (Bhattacharyya *et al.*, 1997), Turkey (Isik and Hassan, 2002) were analyzed. Some studies investigate a number of countries in Central and Eastern Europe and the Commonwealth of Independent States (Grigorian and Manole, 2002; Tomova *et al.*, 2003; Uiboupin, 2005), Hungary (Hasan and Marton, 2003), Croatia (Kraft and Tirtiroglu, 1998), Poland (Opiela, 2001; Havrylchuk, 2003), and Ukraine (Mertens and Urga, 2001) and Baltics (Hansson and Tombak, 1996) were studied. After 1998, the profits in Estonian banking sector have stabilized (Table 3). In 2006 in euro area banks average cost-income ratio was 60,4% and ROE 19,6% (ECB, 2007: S30).

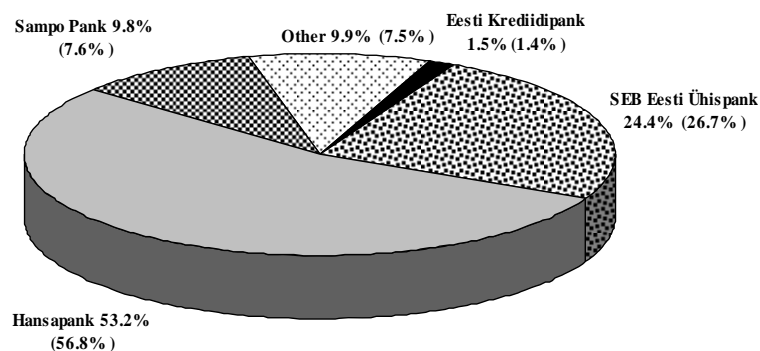
Table 3. Key efficiency ratios in Estonian banking (%)

	Solo banks				Euro area financial institutions average 2006
	2000	2002	2004	2006	
Cost to income ratio	72,5	61,6	45,8	46,6	60.51
Return on assets	1,2	1,6	2,1	1,7	1.48
Equity multiplier	7,4	7,3	8,8	10,7	11.4
Return on equity	8,0	14,7	20,0	19,8	18.75
Net interest income/assets	4,3	3,6	2,4	2,2	0.95

Source: Eesti Pank. Financial Stability Review; ECB Financial Stability Review, 2007.

Researches have shown that the increase in the degree of concentration in the European banking sector is negatively related to competition (Bikker and Groenveld, 2000). Lower competition is linked to higher profitability. As banking concentration in Estonia is very high (see Figure 3) it is helping bigger banks to increase their profits and profitability. For example Hansabank declares to the press that in year 2007 its loan portfolio grew approximately 50% and is forming near 20% share of Swedbanks portfolio, but share of profit of Hansabank is ca 40% of Swedbanks result (Tänavsuu, 2007).

Figure 3. Market Shares of Banks in Estonia According to Total Assets at the End of 2006 (end of 2000 in brackets)



Source: Eesti Pank; authors' calculations.

Banks' profit growth has also been supported by the continuous expansion of loan portfolio and the rise in key interest rates. As most of the loans in Estonia have been granted with a floating interest rate, banks' interest income on interest-earning assets has increased by 1 percentage point, year-on-year, to 4.9% on an

aggregate basis. The interest paid on interest-bearing liabilities has increased by only 0.7 percentage points to 2.7%. The impact of the changes in key interest rates, however, has been reduced by the decreased share of deposits (as it is a cheaper resource than external financing) in banks' funding.

Besides the enhances incomes the profitability of the banking sector has also been fostered by the so far relatively low risk costs. Although the share and volume of the net write-downs of claims has continued to increase, banks' total net write-downs of claims did not exceed 0.1% of assets as an annual average. In case of banking groups the share of write-downs is somewhat higher (0.26%) (Eesti Pank. Financial Stability Review, May 2007).

As regards the future profitability of banks, the further rise in key interest rates would probably facilitate the continuing growth of the net interest margin. However, this would occur at a slower pace, should the growth of loan portfolios still exceed that of deposits. In that case, the share of the more expensive external funds in banks' liabilities would increase.

One way to increase the profit capacity is to establish and overtook financial institutions which offer nonbanking services. From Table 4 we see that in year 2006 in Estonian banks groups profit was bigger than in solo banks (except Sampo Bank).

Table 4. Estonian banks profits before taxes in 2006 (mln. EEK)

Banks	Solo banks	Bank group	Share of solo bank %
Eesti Krediidipank	75,7	80,3	94,3
SEB Eesti Ühispank	913,0	1389,6	65,7
Hansapank	2012,4	5527,3	36,4
Sampo Pank	337,0	333,0	101,2
Tallinna Äripanga AS	35,2	57,8	60,9
BIG	155,5	178,4	87,2
SBM	3,5	3,5	100,0

Table 4 we may also see that our biggest bank Hansapank earned two third of profits outside of banking services. The second biggest bank SEB Eesti Ühispank earned one third of profits from additional financial services. Last published data from the year 2003 are showing that banks ownership in other financial intermediaries was in leasing sector 99,2%, in life insurance 68,3%, in investment funds 90,3% and in pension funds 87,8% (Eesti Pank Annual Report 2003, 2004).

4. Improvement of social orientation of Estonian banks

Reconstructing Estonian banking sector began in 1988, when the first commercial banks were founded. The development of the banking sector during the past 20 years has been stormy and has undergone crises in which a remarkable share of the population either lost their savings in their entirety or lost part of their savings exchange value.

Such developments have after the crisis period made the population suspicious of the banking sector. The research which was ordered by Eesti Pank in November 2008 showed that one quarter of respondents are doubtful about creditability of banking sector in Estonia even now (Estonian residents opinion ..., 2007). This is indicated by the large share of demand deposits of banks' deposits in Estonia. From Figure 4 we see that credibility of banks started to decrease during the second banking crisis in years 1998–1999 when the share of demand deposits grew and stabilized on the level a bit higher of 60%. Surely demand deposits share is too high taking into account Estonian stable economic policy and development.

Extremely high share of demand deposits has also second reason. Near every adult citizen in Estonia has the banking account and gets his or her every month incomes this account. But more than half of bank account holders are not able to save. It may be noticed also from the average sum of the deposits, which was at the end of 2006 approximately 36,2 thousand kroons and of individuals only 15,2 thousands (€1000) (Table 5).

*Table 5. Average deposits by groups of customers
(end of the year, EEK thousands)*

	2004	2005	2006
Average deposit	22.1	30.0	35.2
Average deposit attracted from general government	308.0	492.9	796.1
financial institutions	1,996.5	1,671.4	1,993.1
commercial undertakings	163.8	246.3	277.3
individuals	10.7	13.0	15.3

Source: <http://www.eestipank.info>

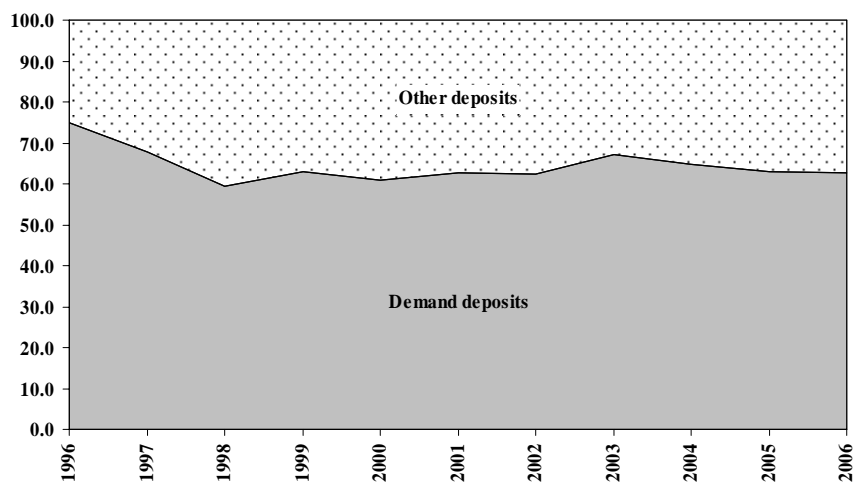
Denizer and Wolf (2000) suggest that savings increased, in the ex-communist countries, after the fall of the communist regime, which is explainable, taking into account three mechanisms:

- The state got less involved in financing public services, which made people resort to savings for paying their access to health services, educational services, legal services, etc.

- During the communist regime, a greater than usual amount of cash in hand (in home) was necessary for the rapid purchase of consumption good which might have appeared in town over night (for instance, a superior quality blanket, or a chandelier). Afterwards, the free distribution of these goods made superfluous the amount of cash retained for “surprise” buying.
- Finally, the elimination of involuntary savings (like mutual help funds, or the lists for buying a car) allowed more rational individual and/or family saving plans to emerge.

This would count as an indicator of transition progress in developing countries, as savings rate is high in developed countries (Tomkiewicz, 2003).

Figure 4. Structure of Deposits of Individuals in Commercial Banks
(%, end of year)



Source: Eesti Pank, authors' calculations.

The negative experiences of people and entrepreneurs with the banking sector forced commercial banks to make efforts to improve their reputation and trustworthiness. As the transition countries have difficulties with improving the social sphere because of financial constraints, participation in social programs is

useful in order to improve the reputation. For example, social protection expenditure in Estonia amounted to 16–17% of GDP in 1995–1999, and in 2000 and 2001, it decreased to 15.6% and 14.8% of GDP, respectively. Social protection expenditure in the EU countries on the average accounted for 27.3% of GDP in 2000, ranging from 14.1% in Ireland to 32.3% in Sweden (Püss and Viies 2003, p. 257). Corrected data of 2001 show that in 2001 social expenditure in Estonia amounted only 13,1% of GDP (Estonian Human Development Report 2006 2007, p. 112).

Thus one can argue that for the Estonian commercial banks, supporting social development is one of the ways to improve its low image. One example, SEB Eesti Ühispank is the first in Estonia to offer its customers a possibility personally to design the picture of their credit cards. The bank has developed a simple and convenient photo-shop environment on the Internet for printing one's picture on the credit card (visit the website at www.seb.ee/pildikaart). Such spending, we might add, profits from being visible, not only to others, but also to themselves. Of course, the SEB Eesti Ühispank picture bank card costs for customer more than ordinary card.

All market participants must go along with this, in order not to lose clients to competitors in an extremely concentrated market. As can be seen from Figure 3, the market share of two largest commercial banks in Estonia was 77,6% by the end of the year 2006, whereas had given up some of their market share to smaller market participants.

Here Estonia is not an exception. In research of a highly concentrated banking sector in the Netherlands retail banks aim is to distinguish themselves from their competition by maintaining or creating a different image. Through this diverging behaviour they try to attract different market and/or customer segments (Boonstra and Groenveld, 2006).

Two concentration ratios are usually used: the Herfindahl-Hirschman index (HH) and the market share of the top five banks. In Estonia these indexes are highest in EU. In the Table 6 we see that these indexes in EU are rising but Estonian indexes are much higher than even in Malta, which is much smaller than Estonia.

Table 6. Indicators of banking concentration in Europe

	G5 (2001) %	G5 (2004) %	HH (2001)	HH (2004)
Belgium	78.3	84.3	1587	2100
Czech Republic	68.4	64.0	1263	1103
Denmark	67.6	67.0	1119	1146
Estonia	98.9	98.6	4067	3887
Finland	79.5	82.7	2240	2680
France	47.0	44.7	606	623
Germany	20.2	22.1	158	178
Hungary	56.4	52.7	892	795
Italy	28.8	26.0	260	230
Lithuania	87.6	78.9	2503	1854
Malta	79.6	78.7	2163	2015
Netherlands	82.5	84.0	1762	1726
Poland	54.7	50.2	821	692
UK	28.6	34.5	282	347
EU-25 average	37.8	40.2	506	569

Source: The New Banking in Economics, 2007:122.

It is necessary to distinguish between moral, political, and legal responsibility. Moral responsibility may be related only to consciousness; its extreme expression is Dostoevski's statement: "Everybody is guilty of everything" (Responsibility 1972).

The takeover of the two largest commercial banks (Hansapank and Eesti Ühispank) by the large Swedish banks, Swedbank and SEB, has surely been a factor in the gradual increase of social orientation of Estonian banks. The ideas of social responsibility are known to be especially popular in Sweden, certainly affecting also the banks' policies. After the takeover of Hansapank and Eesti Ühispank, representatives of the Swedish side were appointed to their councils and directives were issued from Sweden on the need to pay more attention to supporting the social development.

In the new Millennium while other countries fell into a period of stagnation Scandinavia showed robust growth, moved up into the leading group of innovative counties, maintained its welfare state (Becker, 2007). He sees, that one of cornerstones of it is the comparatively low social inequality and poverty and the corporatism, which makes it possible to coordinate economic and social objectives.

The banks that own the third and fourth largest commercial banks in Estonia (Nordea Pank, Sampo Pank) are of Finnish origin. In Finland, like in Sweden, the emphasis on social development is especially strong. This explains well why

Nordea Pank and Sampo Pank are unwilling to lag behind the leaders with their social programs.

To achieve the rapid growth of assets, it is necessary to ensure that the number of clients as well as their financial assets in the bank increase. To win new clients from competing banks is neither easy nor cheap, however. Thus, the appropriate method to get more clients is to look for new ones by offering various benefits and investment opportunities.

One method to get new clients and tie them strongly to the bank is to grant student loans. The conditions for this type of loan are the most favourable ones offered by Estonian banks. The maximum annual amount of the government-guaranteed loan is 25,000 kroons (ca €1280) and the fixed interest rate is 5%. This is granted for the whole period of post-secondary education, with either two sureties or with real estate as collateral. Because government-guaranteed loans are not granted to distant education and self-financed students, banks have on their own initiative and risks started to grant student loans for them, too. To the end of 2006 student loans formed in Estonia totally EEK 3,2 bil., and they grew 73,5% comparing with 2000.

In addition to finding new clients, an important component of growth strategies of financial institutions is also offering the products that could attract the clients to save more. This is an explanation for why the share of banks in other financial intermediaries was so high.

By now, banks have lowered the interest rate paid on demand deposits to 0.20–0.25% per year. Also some periods their interest rates of the time deposits were below the inflation rate. Because the main motive for saving is precautionary motive in Estonia (see also Figure 4), banks are not afraid of outflow of deposits. Growth of deposits, however, is ensured only by the addition of new motives for saving. Such motives can be e.g. financially insuring of the future against accidents or old age. It is therefore not surprising that in addition to ordinary investment opportunities, banks offer also pension insurance in the form of either an insurance certificate or an insurance fund. The latter kind is especially beneficial for the banks, as it ensures them stable, very long-term risk-free resource for financial investments. Because payments from the pension funds to future pensioners will be paid out not on the basis of the sum actually paid, but its present value, the fund can use the money without risk, because the possible loss and costs of administering the fund reduce the amount paid out as pensions.

The above analysis shows that the Estonian financial sector has several motives for supporting social development, which ultimately can be reduced to the intention to improve their image and facilitate the growth of profits.

As the Estonian financial sector is centred around banks, the Estonian commercial banks naturally also have a central role in supporting the socio-economic development. They do so by offering novel saving schemes, various benefits for the less-insured client groups, and sponsorship. The costs of running and advertising such programmes are remarkable. For example, according to the annual report of Sampo Pank for 2005, its consolidated group communication and data processing expenses were EEK 52,5 mln., and advertising expenses EEK 23,9 mln. That the amounts are significant can be seen from comparison with their 2005 year profits, which was EEK 172.2 million (AS Sampo Pank ... 2006, p. 11).

The most significant part of social responsibility of the financial sector seems to be the participation of banks in the introduction of Estonian three-pillar pension system. Discussion of the pension reform in Estonia started already at the beginning of the 90s, as it was clear that in the future, government pension could not ensure the sufficient standard of living for most pensioners. The rise in the overall dependency ratio is mainly due to rise in the old age dependency ratio (defined as the ratio of those people older than 64 to those of working age), which is projected to continue to increase from the current level of about 26% to a level close to 55% by 2050 (ECB 2006, p. 50). Thus, on September 12, 2001, Estonia approved the Funded Pensions Act, which became the basis for the three-pillar pension system. Share of old age population on Estonia is twice higher than in the world (Table 7).

Table 7. Share of more than 65 years in population and place in the world in 2005

Country	Place among world countries	More than 65 years old people share (%)
Japan	1	20
Italy	2	19
Germany	3	18
Belgium	7	17
Spain	8	17
EU-25	12	16
France	12	16
England	17	16
Estonia	17	16
Denmark	26	15
Netherlands	33	14
Russia	34	13
USA	44	12
World	91	7

Source: Pison, 2006.

The theoretical framework of the three pillars is adopted internationally mainly in order to enable convenient description and international comparisons of pension systems. The first pillar (Pillar I, national pension) is financed according to the principle of pay-as-you-go, i.e. payments to people at the pension age are financed from taxes of the working generation. Pillar II is a pre-funded private capital-based mandatory pension. Pillar III is voluntary pre-funded pension, which is meant mainly for people who wish for the future a standard of living higher than that offered by the state. The third pillar of the pension system is like an agreement between people and the state that if the person takes care of her own future, the state demands less in taxes from him or her. So far, almost all responsibility for the pensions has been borne by the state, whereas now, people themselves have to assume part of it.

Administration of state-supported mandatory pension funds is a profitable business. Because of the favourable opportunity for business, six Estonian financial institutions are fighting for a good position in the pension market – Hansapank, Eesti Ühispank, Seesam, Sampo Pank, LHV and ERGO, who have altogether brought to market 16 pension funds. Because administration fees of pension funds will be a stable source of income, the pre-funded pensions are important for the fund manager.

Business newspaper Äripäev calculated that when 25 years old worker will join the pension system II Pillar and when his salary is 10 000 kroons per month, then he will pay to the foundation until his pension age 978 510 kroons from which 30–40% will get foundation in form of servicing fees (Tuul, 2007). Already started discussion that it is necessary to cut fees rates because Estonian fees are the highest in Europe. For example, funds servicing fees in Estonia are from 1/3 to 2/3 over average levels in Europe says Estonian Financial Supervision Authority (Linnamäe and Uusen, 2007).

Voluntary pension insurance (Pillar III) is offered by five Estonian life insurance companies and four voluntary pension funds are also growing. Most of the market participants have several different products – there are altogether some twenty possibilities to choose from.

Pillar II of the pension system was launched in May 2002 in Estonia. Advertising campaigns by banks and insurance companies brought more than 200 thousand entrants (for those older than 18 years, joining was not mandatory), which exceeded even the most optimistic forecasts. In one year, the Pillar II funds had accumulated EEK 530.5 million. Investments into the supplementary funded pension (III pillar) funds reached a record last year, with the volume of funds increasing from MEEK 343 to BEEK 1.1 in the year. In addition to the growth of

funds, the number of the clients of supplementary funded pension increased from the 25 107 at the end of 2006 to more than 42 000 investors at the end of 2007. By funds, Hansa Pension Fund V3 has the most clients for a supplementary funded pension. The number of clients joining the Hansa Pension Fund V3 has doubled every year. If at the end of 2006, Hansa Pension Fund V3 had 11 000 unit holders, then by the end of 2007, the number had increased to 21 000. In terms of the number of unit holders, the Pension Fund Active of SEB Ühispank is second (8 363 unit holders) (Press release of ECSD, 2008).

Pillar III funds, although they were launched already in 2001, have accumulated less resources however they only involve people with higher than average incomes. The number of people who joined the mandatory funded pension (II pillar) increased from 519 726 people to 554 3534 in 2007. The total volume of the funds of mandatory funded pension increased from BEEK 7.5 to BEEK 11 last year. The EPI index, which reflects the average rate of return of funded pension funds, increased by 5.6% in 2007 – from 145.67 points to 154.32 points.

At the turn of the year, the persons who had expressed a wish to collect their mandatory funded pension into a new fund were able to do so and transfer the funds collected so far into the new fund as well. Last year, 42 902 investors directed their deposits into a new fund (35 129 in 2006) and 13 000 investors exchanged units (8 152 in 2006). Hansa Pension Fund K3 was the most popular among people changing their pension fund (Press release of ECSD, 2008).

If compared with an average household, then the welfare level of older people and big families has shown a declining trend. The government has identified the increasing inequality as a serious problem and has, thus, granted several benefits for the groups in the risk of poverty. Child benefit as well as benefits in the form of free public transport for both minors and pensioners could serve here as an example. The banks have an incentive to provide similar kind of benefits in order to promote their reputation, and they do so, quite often. For example a small bank Eesti Krediidipank (look Figure 3) in his Annual Report writes: for several years (from 1996) Krediidipank has focused its attention on expanding the opportunities for supporting families with many children, and making society aware of the problems related to big families and the Estonian demographic situation. For Krediidipank, this is an opportunity to take social responsibility for the society's less well-off members (Krediidipank 2007, p. 15).

Banks have introduced the clients' loyalty programs like other servicing sectors (see Appendix 4). In the view of Kumar and Reinartz (2005) loyalty programs can be divided into four major categories: building real loyalty, modification of purchase behaviour, learning and development, and adjusting the exchange value.

Most of the banks have set lower prices for transactions made by senior and junior clients. The price list for private customers of SEB Eesti Ühispank is brought in Table 8. Some benefits are also applied to the customers in the student age (18–25). The price list for seniors applies to the customers who are at least 60 years old. In addition, lower fees are applied to the older and handicapped people in opening privatization voucher accounts and to the young people in formalizing housing loans.

Table 8. Prices of more important bank services of SEB Eesti Ühispank by client groups as of December 1, 2007 (in kroons)

	Usual customer	Senior customer (60 years and older)	Junior clients (younger than 18 years)	Student age clients (18–25 years old)	New clients to the end of quarter
Cash transactions fees (over the counter)	12	12	12	12	6
Transactions via electronic services	3	free of charge	free of charge	free of charge	free of charge
Cash withdrawal (over the counter)	0.25%, min. EEK 20	0.25%, EEK 1000 free of charge	0.20%, EEK 1000 free of charge	0.25%, min. EEK 20	min. EEK 10
VISA Elektron monthly fee	15	free of charge	15	10	10
VISA Elektron prolongation	30	free of charge	free of charge	free of charge	free of charge

Source: <http://www.seb.ee>

The benefits offered by the banks and other financial institutions to the young and older people have, along with humanitarian goals, a more pragmatic benefit for the banks as well. These clients make transactions very rarely and higher transaction fees would probably scare them away and, thus, support more intensive using of cash. This, in turn, means the withdrawal of deposits from the banks.

The benefits for juniors seem to be even higher than for older people. This may be due to the fact that the bank is afraid to lose a potential life-long client. The saving and intensity of transactions of older people is, however, expected to decline and thus the attention is drawn more towards younger people.

The banks are, in addition to the benefits, involved in providing direct sponsorship. This makes them visible and respectable. The homepage of Hansapank lists the

sponsoring principles, which state that “Hansapank is a company that due to its size feels certain responsibility for the society. Our goal is to support Estonia’s development” (<http://www.hansa.ee>). Appendix 3 includes the sponsoring principles of Hansapank. Main fields sponsored by Hansapank are education, culture and sports.

The goals and principles of education sponsoring by Hansapank are brought here as an example:

Human resources, an educated population and new ideas are key words that we emphasise in speaking of Estonia’s opportunities to stand out among other developed countries. As the rest of society, educated people are also the most valuable resource for Hansapank, as an employer.

It is for that reason that we think of the future and support youth with various stipends, the provision of favourable student loans, education loans or master’s loans and the organisation of conferences.

Since 1999 we issue, in co-operation with Tallinn Technical University, annual stipends to support masters and doctoral studies at the university. As of 2000, we will also support the ten most successful students at the Estonian Information Technology College with annual stipend bearing the Hansapank name.

They have also made a contribution through the publishing of economics-related high school textbooks and workbooks, which will appear through the Junior Achievement Fund.

Other banks and financial institutions have followed the example of Estonian leading bank by trying to be on the list of sponsors of popular cultural events, as well as by supporting the fields like education and health that are acknowledged as the priorities in the society. For example SEB Eesti Ühispank has issued the Basketball card for basketball is very popular in Estonia. The Basketball card with benefits for a sports fan was prepared in co-operation with SEB Eesti Ühispank and the Basketball Association. Besides the traditional debit card functions, the card provides several sports-related benefits. A card application may be sent to the bank from Internet address ([HTTP://www.seb.ee/korvpall](http://www.seb.ee/korvpall)).

5. Conclusions

Reconstructing Estonian banking sector began in 1988, when the first commercial banks were founded. The development of the banking sector during the past near twenty years has been stormy and has undergone crises in which a remarkable share of the population either lost their savings in their entirety or lost part of their

savings exchange value. Such developments have after the crisis period made the population suspicious of the banking sector.

The negative experiences of people and entrepreneurs with the banking sector forced commercial banks to make efforts to improve their reputation and trustworthiness. As the transition countries have difficulties with improving the social sphere because of financial constraints, participation in social programs is useful in order to improve the reputation.

Thus one can argue that for the Estonian commercial banks, supporting social development is one of the ways to improve its low image. Such spending, we might add, profits from being visible, not only to others, but also to themselves.

The takeover of the two largest commercial banks (Hansapank and Eesti Ühispank) by the large Swedish banks, Swedbank and SEB, has surely been a factor in the gradual increase of social orientation of Estonian banks. The ideas of social responsibility are known to be especially popular in Sweden, certainly affecting also the banks' policies. After the takeover of Hansapank and SEB Eesti Ühispank, representatives of the Swedish side were appointed to their councils and directives were issued from Sweden on the need to pay more attention to supporting the social development.

Estonian commercial banks are the main owners of leasing and life insurance companies and investment funds. Such control of commercial banks over the Estonian financial sector means that the social orientation of banks will be carried over to their subsidiary financial institutions and the securities exchange, forming their policy.

One method to get new clients and tie them strongly to the bank is to grant student loans. The conditions for this type of loan are the most favourable ones offered by Estonian banks.

The most significant part of social responsibility of the financial sector seems to be the participation of banks in the introduction of Estonian three-pillar pension system. Discussion of the pension reform in Estonia started already at the beginning of the 90s, as it was clear that in the future, government pension could not ensure the sufficient standard of living for most pensioners.

Administration of state-supported mandatory pension funds is a profitable business. Because of the favourable opportunity for business, six Estonian financial institutions are fighting for a good position in the pension market – Hansapank, Eesti Ühispank, Seesam, Sampo Pank, LHV and ERGO, who have altogether brought to market 15 pension funds.

Most of the banks have set lower prices for transactions made by senior and junior clients. The benefits offered by the banks and other financial institutions to the young and older people have, along with humanitarian goals, a more pragmatic benefit for the banks as well. These clients make transactions very rarely and higher transaction fees would probably scare them away and, thus, support more intensive using of cash. This, in turn, means the withdrawal of deposits from the banks.

The banks are, in addition to the benefits, involved in providing direct sponsorship. This makes them visible and respectable.

Other smaller banks and financial institutions have followed the example of Estonian leading banks by trying to be on the list of sponsors of popular cultural events, as well as by supporting the fields like education and health that are acknowledged as the priorities in the society.

Professor Hans Blommestein found that society expects that banks take on increased gatekeeper responsibilities in the new business landscape. This means that banks are expected to play a central and active gatekeeper's role to monitor the behaviour of their clients and other counter-parties (Blommestein, 2006). Our research showed that Estonian banks very well understand their new role and responsibilities in the changed business environment.

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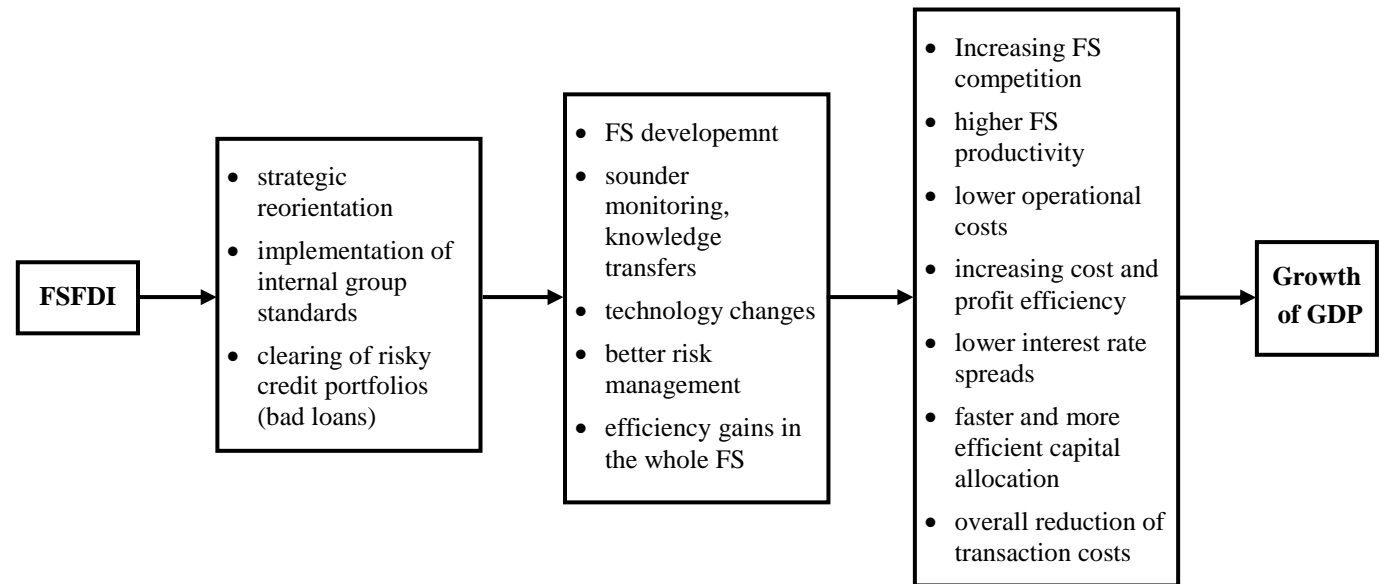
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Appendix 1. Financial Sector (FS) FDI-induced efficiency-led growth



Source: Eller et al., 2006.

*Appendix 2. Key economic indicators of Estonia for 2005–2009**

	2005	2006	2007	2008	2009
GDP (EEK bn)	175.4	207.1	241.8	271.5	301.4
Real GDP growth (%)	10.2	11.2	7.3	4.3	5.7
HICP (%)	4.1	4.4	6.3	7.4	4.6
GDP deflator growth (%)	6.1	6.2	8.8	7.7	5.1
Current account (% of GDP)	-9.9	-15.5	-15.0	-11.8	-9.6
Current account plus new capital account balance (% of GDP)	-8.9	-13.0	-12.9	-9.9	-7.8
Real private consumption growth (%)	10.6	15.1	11.4	6.4	6.1
Real government consumption growth (%)	1.6	2.6	4.1	2.2	2.6
Real investment growth (%)	9.9	22.4	7.5	-1.6	1.8
Real export growth (%)	20.5	8.3	5.2	5.3	7.1
Real import growth (%)	16.3	17.1	5.0	3.9	5.3
Unemployment rate (%)	7.9	5.9	5.2	5.8	6.2
Change in the number of the employed (%)	2.0	6.4	1.3	-0.2	0.0
Value added growth per full-time employee (%)	8.2	5.3	6.1	4.5	5.9
Real wage growth (%)	8.5	11.9	15.1	8.8	5.0
Average gross wage (%)	11.4	16.2	20.4	15.0	9.7
Nominal money supply growth (%)	42.0	28.2	24.5	15.0	11.6
Nominal credit growth (%)	50.4	51.6	28.5	15.6	12.0
External debt (% of GDP)	85.3	96.4	107.5	108.9	108.4
Budget balance (% of GDP)	2.3	3.7	2.8	1.1	0.7

Source: Monetary Developments & Policy Survey 2007:8.

* Forecast of Eesti Pank for years 2007–2009.

Appendix 3. Sponsoring principles of Hansapank

We carry social responsibility

Hansabank is a company that due to its size feels certain responsibility for the society. Our goal is to support Estonia`s development:

- we conduct our business activities so as to support Estonian economic growth and contribute to higher living standards with the means available to us
- we contribute to the debate about the development trends in the society
- we support the development of the society through sponsorship

Vitality and innovation - the principles we support

In our development strategy, we have prioritised vital and innovative development. Therefore, in our sponsoring activities, we prefer co-operation projects that are consistent, original and promote the development of the society.

Education, culture, social sphere find more support

Hansabank does not allocate money subjectively based on momentary impressions. We have firm preferences in the areas the society needs most. We support children, young people and education, big families, culture, and sports.

Source: <http://www.hansa.ee>

Appendix 4. Hansabank's key customers program

Our key customers in 2007 have to fulfil the following criterions – to have a regular monthly income **from 15,000 kroons**, received at the bank, or to start the collection of pension money in Hansabank and simultaneously to have a valid home loan agreement.

Fast lane at the branch

In token of our gratitude we have joined together conveniences, preferential prices and best offers from our partners into our key customer offer.

It might seem a small thing, but you may be able to save time significantly during the rush hour. The key is your bank card, which you should insert in the machine when getting a queue ticket.

1517

Our support and advice on banking services are available for the key customer round the clock. From abroad, dial +372 613 1517.

Good conditions

Overdraft – the interest rate is 2% lower. Key customers get 50% discount when concluding the Unit-linked pension insurance, College Fund, Children Unit-linked Insurance and Hansa Fund Plan agreements.

Special Offer

Every key customer can choose one of the following special offers: Intra-bank payments from internet bank free of charge; credit card premium account 50 points; Hansa Property insurance home insurance product for 1 year 20% discount.

Hansaleht

An in-depth overview of bank services and new directions direct to your door.

Co-operation partners

Hansabank's good co-operation partners also offer special conditions to the key customer. The offers which are renewed at least once a quarter are displayed on the offers page of internet bank.

Source: <http://www.hanza.net>