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The transformation of the banking sector in the European Union and Northern Europe and its impact on sector competition in the Baltic States

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Summary

Economic Environment and Banking Transformation in the European Union: Dealing with growing uncertainty. Over the past decade, the European Union (EU) has faced several significant challenges. The global financial crisis that began in 2008 had a profound impact on the EU. The interconnectedness of the economy and financial sector facilitated the spread of the crisis from the United States to Europe. The EU initially faced the Great Recession in the 2008-2009 period, followed by the sovereign debt crisis in several Member States. These combined crises had significant consequences for economic growth, investment, employment, and fiscal positions in many EU countries. In response to the crises, the EU implemented short-term measures, including bank bailouts and reforms to address inadequacies and in the long-run efforts were made to improve resilience, such as enhancing financial sector stability, strengthening economic governance, and carrying out structural reforms. *The COVID-19 pandemic has significantly impacted European banking, leading to both challenges and opportunities. European banks have faced revenue drops due to reduced demand and government interventions, but at the same time it also accelerated the digitalization process in the industry*. Last decade has an increasing geopolitical risks and banking sector vulnerabilities. *Banking sector must address issues like, Cyberattacks: The risk of cyber threats targeting financial institutions, Energy-Related Non-Performing Loans: The impact of energy price fluctuations on loan quality, Structural Break in the Euro-Area Economy: Changes in economic dynamics affecting banks, Spillovers Between Energy Markets and Banking: Interconnected risks between energy markets and financial institutions*.

Despite the uncertainties there still clear areas where banking sector will continue the transformation process: Management of geopolitical risks, Regulatory pressure and compliance, Digitalization and FinTech, Implementation of sustainable business model, like *ESG - integration of environmental, social, and governance considerations into the operations and decision-making processes of financial institutions*.

The Banking Transformation of the Baltics: From Soviet to Sustainable. After the fall of the Soviet Union, Estonia, Lithuania, and Latvia opened their economies to foreign banks. Estonia and Lithuania embraced international banks, particularly Swedish ones, that catered to both local residents and international customers. Latvia, on the other hand, aimed to become a financial hub for Russia and the Commonwealth of Independent States (CIS) by attracting deposits from those regions. This strategy, however, led to problems with money laundering. In response, all three Baltic countries have implemented stricter regulations and are now seeking more sustainable approaches for their banking sectors. *This includes transforming their business models to be more sustainable, digital, and environmentally friendly (green).*

Baltic Banking: Balancing Global Strength with Local Growth. While foreign investment has played a significant role in the development of the Baltic banking sector, it has also led to a high concentration of assets. In Estonia and Lithuania, more than 85% of banking assets are controlled by foreign-owned institutions, with Latvia at 76%. This dominance by large international banks, while offering stability, can potentially limit competition within the Baltic market compared to the broader Nordic region. *Moving forward, fostering a balance between foreign investment and domestic participation could be key to ensuring a long-term, healthy, and dynamic banking environment in the Baltics*.

Pre-Crisis Boom, Post-Crisis Shakeup: Banking Employment Across Europe.

- Pre-crisis (1998-2008), the EU saw a surge in banking personnel (19%) alongside a 23% rise in offices. However, the Baltics and Nordics displayed a different story. Latvia led the pack with a staggering 76% employee increase, followed by Estonia (38%) and Lithuania (16%). Interestingly, Finland and Denmark experienced modest growth, while Sweden even saw a decrease.
- The post-crisis era (2009-2022) brought a reversal. The EU faced a significant decline in both offices (40%) and employees (20%). Similarly, Denmark and Finland followed suit. The Baltics, however, diverged. While Estonia and Lithuania defied the trend

with continued employee growth, Latvia experienced a dramatic 57% plunge in banking personnel - the steepest drop in all of Europe.

This trend suggests a move towards digitization, with a focus on efficiency and a changing customer landscape.

The Baltic Lending Paradox: High Rates, Low Loans. Despite constant criticism directed at Baltic banks for insufficient lending, the problem might not stem from a lack of resources. In fact, Latvia and Lithuania hold some of the highest deposit-to-loan ratios in Europe, indicating a cautious lending approach. However, this conservatism doesn't translate into lower interest rates. Borrowers in the Baltics consistently face loan interest rates exceeding the Eurozone average, while neighbouring Scandinavia enjoys some of the most favourable rates in Europe. This stark contrast suggests a potential issue with competition within the Baltic banking sector.

The Price of Profitability. The Baltics boast some of the highest Return on Equity (ROE) and Net Interest Margin (NIM) in the entire EU, signifying high bank profitability. However, this prosperity comes at a cost for borrowers, as the Baltics also experience the highest loan interest rates within the EU. This suggests a focus on maximizing bank profits, potentially due to a less competitive environment reflected in their lower Cost-to-Income Ratio (CIR). In contrast, the Nordics strike a balance between profitability and competition. Their profitability, remains above the EU average but falls short of the Baltic highs. This could be because they prioritize fostering competition, evident in their potentially slightly higher CIR compared to the Baltics. This focus on competition translates to lower interest rates for borrowers compared to the Baltics.

Customer mobility in banking across Europe paints a picture of regional diversity. While the EU exhibits a decent switching rate compared to the US, suggesting a more competitive landscape, significant disparities emerge. The Baltics, particularly Latvia and Lithuania, lag behind the EU average, especially for mortgages, when compared to the mobility leader, Sweden. This intriguing difference begs the question: is low mortgage mobility in the Baltics a cultural preference or is it driven by other factors like complex switching procedures or limited mortgage options?

Beyond Profit Margins: A Look at Swedish Bank Profitability in the Baltics. Analysing financial performance indicators for Swedish banks SEB and Swedbank from 2005 to 2023 across the Baltic States (Estonia, Latvia, Lithuania) and Sweden revealed interesting findings. While profitability metrics like Net Interest Margin and Return on Assets initially suggested higher returns in the Baltics, a more comprehensive analysis presented a more nuanced picture. Return on Equity showed similar results across all regions. This suggests that factors beyond simple profit margins, such as potentially higher operating costs in Sweden reflected in a lower Cost-to-Income Ratio (CIR) for the Baltic States, influence overall profitability. A lower CIR in the Baltics could indicate better cost control by the banks, but it could also suggest a less competitive environment. This study challenges the common perception of a clear profitability advantage for Swedish banks in the Baltics and highlights the need to explore the underlying reasons for these regional variations, including potential differences in competition and cost structures.

Part 1

Factors influencing the development of the banking sector and developments in the European Union and Northern Europe

Picture created with Microsoft Copilot

Part 1. Factors influencing the development of the banking sector and developments in the European Union and Northern Europe

The recent financial turbulence in the global banking sector has amplified the challenges surrounding monetary policy and inflation, adding to the complexities caused by various economic shocks such as the COVID outbreak, Russia-Ukraine war, and rising inflation. Banks and financial institutions have a vital role in fostering economic growth and development by offering capital and financial services that empower businesses and individuals to thrive. Banks support economic development and has a direct impact on the communities.

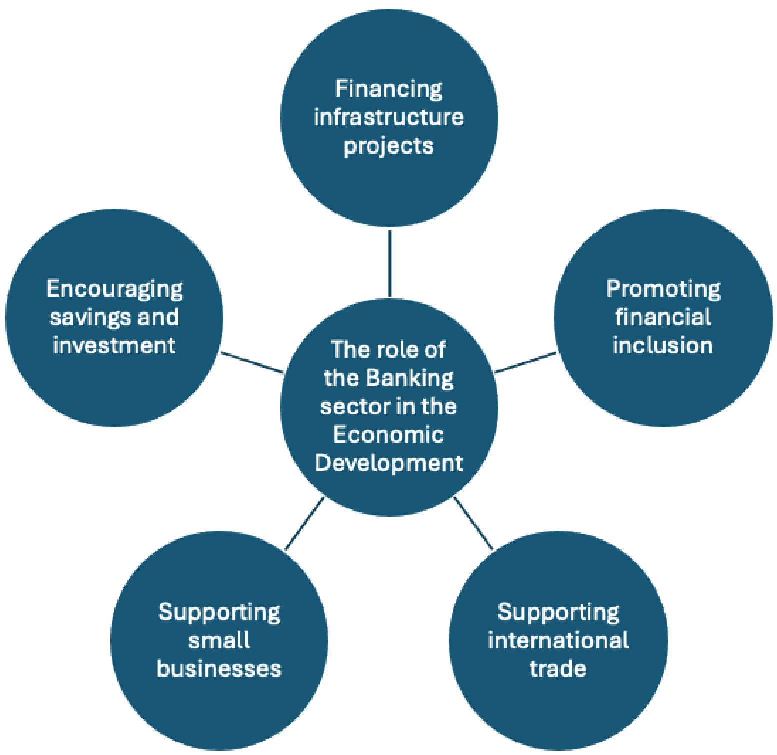

Figure 1. The role of the Banking sector in the Economic Development[1]

Financing infrastructure projects: One way in which banks support economic development is by providing financing for infrastructure projects. Infrastructure is essential for economic

[1] Pradeep Kumar Kondapalli, Importance of Banking in Economic Development, 2023

growth, and it requires significant investment. Banks help to finance large-scale projects such as roads, bridges, and airports, which can provide jobs, increase productivity, and drive economic growth. By providing financing for these projects, banks help to stimulate economic development and create opportunities for communities.

Promoting financial inclusion: Financial inclusion is the idea that everyone should have access to financial services, regardless of their income level or geographic location. Banks promote financial inclusion by offering products and services that are tailored to the needs of underserved communities, such as mobile banking and microfinance. By promoting financial inclusion, banks help to reduce poverty, promote economic development, and build more resilient communities.

Supporting international trade: Banks play a crucial role in supporting international trade by providing letters of credit, trade financing, and other services that help to facilitate cross-border transactions. By supporting international trade, banks help to promote economic growth and development, as well as foster greater global cooperation and understanding.

Supporting small businesses: Small businesses are often the engines of local and regional economies. Banks support these businesses by providing access to capital and credit, as well as other financial services such as cash management and payroll processing. By supporting small businesses, banks help to create jobs, stimulate economic growth, and promote entrepreneurship.

Encouraging savings and investment: Banks play an important role in encouraging savings and investment, which are essential for economic growth and development. By offering savings accounts and investment products, banks help individuals and businesses to build wealth and plan for their future. This, in turn, help to stimulate economic growth and development.

In conclusion, the role of banking in economic development is multifaceted and essential. Banks have the ability to promote economic growth and development by financing infrastructure projects, supporting small businesses, promoting financial inclusion, help to create jobs, encouraging savings and investment, supporting international trade and more. As the financial sector evolves, it is imperative for banks to maintain their dedication to supporting economic development and creating opportunities for everyone.

Banks performance is influence by different internal and external factors.

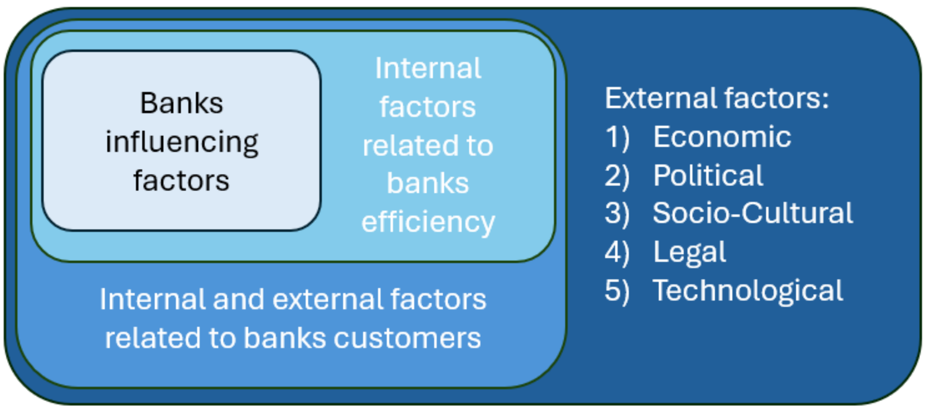

Figure 2. Factors influencing banks

Source: Different sources

If internal factors are mostly controlled by the banks, then external factors are the ones that can significantly determine the development of the banking sector. For example, Economic factors include: State of Development of Financial System, Adequacy of funds, Communication System, Free market economy, Monetary and Fiscal Policy, Industrial Policy, Investment Opportunity, Healthy Competition, Import-Export Policy, General Income Level, Savings Propensity, Easy access to Money Market, Role of Government, Role of Central Bank and other factors.

As we taka a look at the external economic environment, we must address the issue of the inflation in Europe.

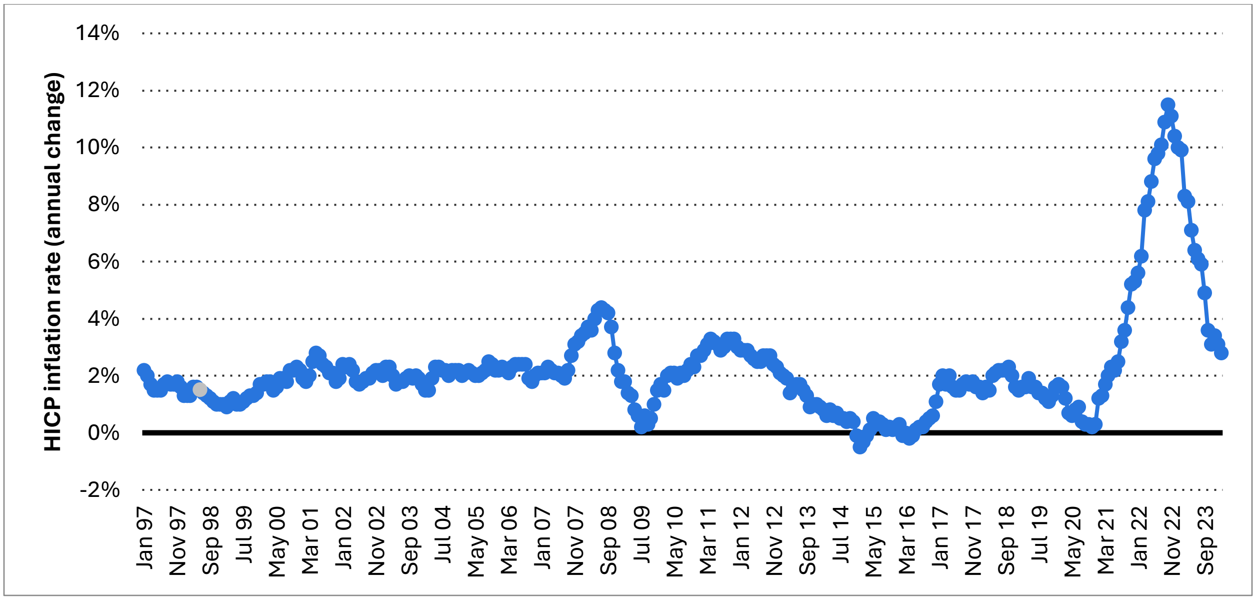

Figure 3. Harmonized index of consumer prices (HICP) inflation rate of the European Union from January 1997 to February 2024

Source: Statista

Recent years have been challenging in terms of high inflation. Soaring energy prices was one of the main driving forces behind the rise in costs. Strong inflation momentum for a broad set of goods and services in the consumer basket led to a record high inflation rate in June 2022, standing at 9.6 % in the EU and 8.6 % in the euro area, driven mainly by energy and food prices, which rose by 42 % and 8.9 % respectively.

The main objective of central banks is to keep prices stable, to preserve the integrity and purchasing power with the euro area inflation target of 2 %.

In July 2022, the European Central Bank (ECB) increased its fixed interest rate to 0.5 percent. This was the first increase since March 2016. After July 2022, the ECB increased its fixed interest rate almost monthly. As of December 2023, the rate was 4.5 percent, the highest since the global financial crisis in 2007 and 2008.

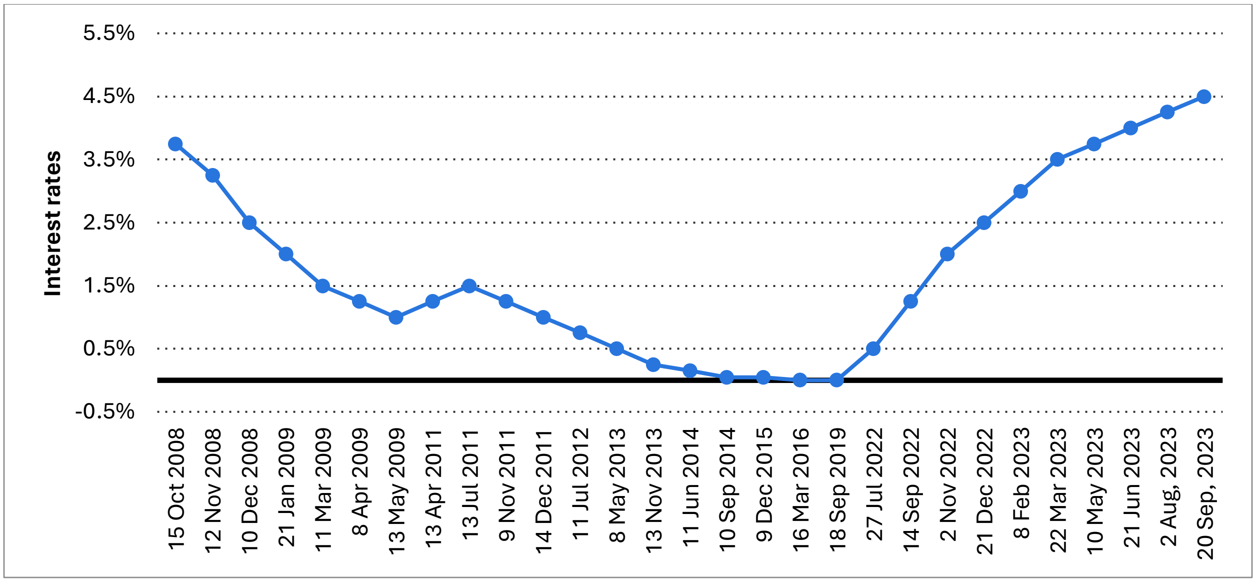

Figure 4. Fluctuation of the European Central Bank fixed interest rate from 2008 to 2023

Source: Statista

Since inflation has been reducing lately, there a certain indication that central banks might reduce the interest rates in a near future.

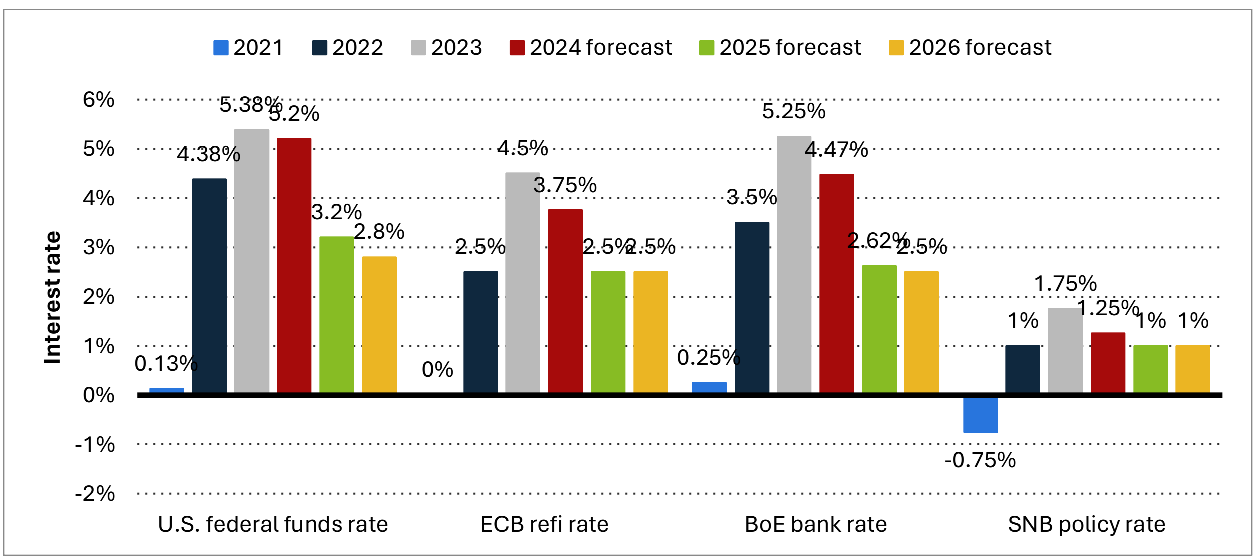

Figure 5. Central bank interest rates in the United States, eurozone, United Kingdom, and Switzerland in 2022 and 2023, with forecasts from 2024 to 2026

Source: Statista

Inflation has left a significant impact on the households and firms that has led to growing pressure to the political environment.

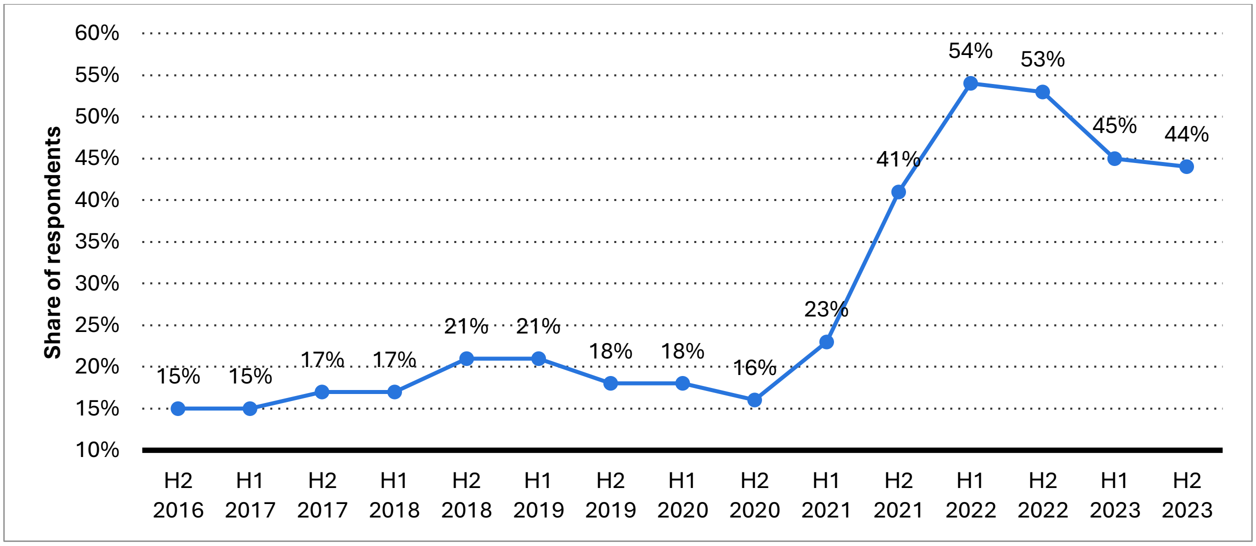

Figure 6. Percentage of people who see rising prices, inflation, and the cost of living as an important national issue in the European Union from 2016 to 2023

Source: Statista

Different European countries experienced different levels of inflation that affected the cost of living and thus an opinion if it is becoming a growing problem[2].

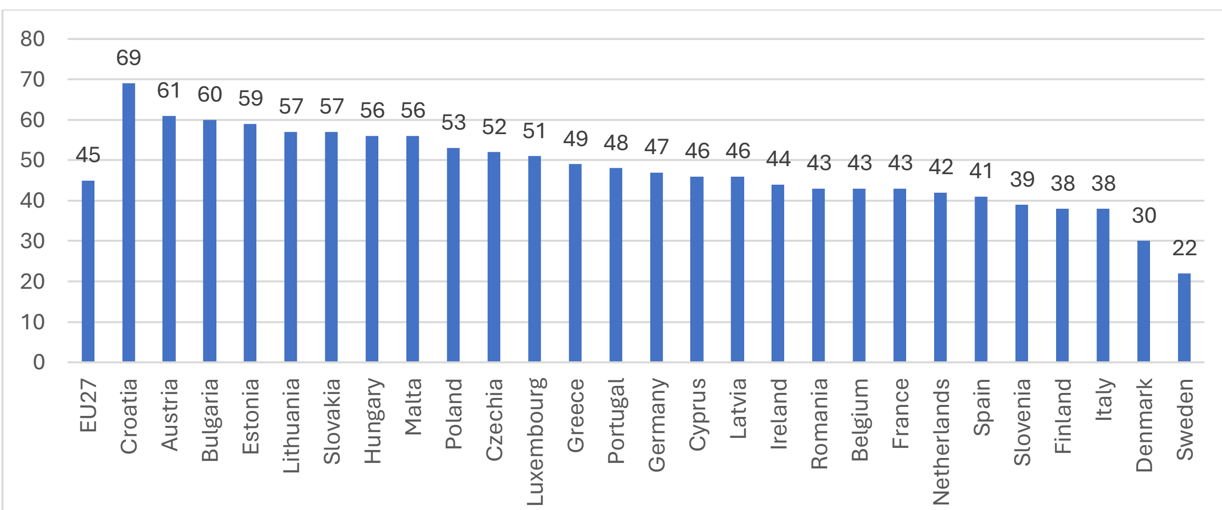

Figure 7. Percentage of people who see rising prices, inflation, and the cost of living as an important national issue in the European Union 2023, by country

Source: Eurobarometer

[2] European Commission, Eurobarometer, May to June 2023, n = 26523

One of the most visible public debates in different European countries were related to the growing mortgage rates that significantly influence the households.

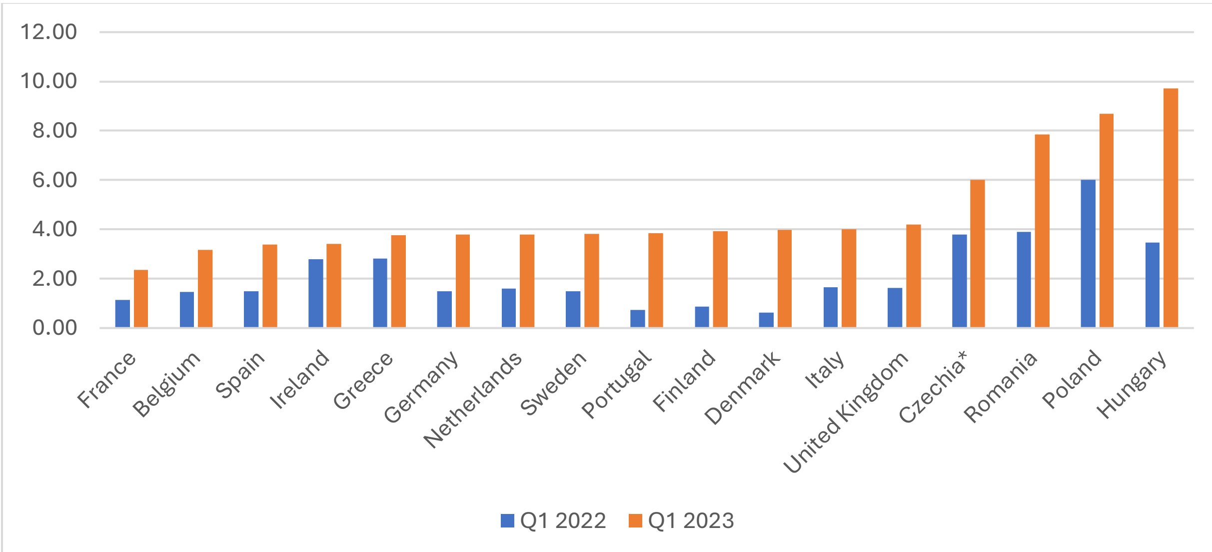

Figure 8. Average mortgage interest rate in Europe in 1st quarter 2022 and 1st quarter 2023, by country

Source: European Mortgage Federation

Mortgage interest rates soared in Europe in 2022, resulting in many countries seeing rates double in just a year. During the COVID-19 crisis, mortgage rates in Europe were at their lowest, as countries tackled the economic effects of the pandemic. With inflation rising, central banks gradually increased the interest rates, resulting in higher mortgage borrowing costs. In Hungary, the average mortgage interest rate reached close to 10 percent in the first quarter of 2023, up from about 3.5 percent in 2022. Mortgage interest rates tend to be lower in the Nordic countries due to the financial stability and reliability of its borrowers. Other factors that influence the mortgage interest rates include inflation, economic growth, monetary policies, the bond market and the overall conditions of the housing market. More stable markets also tend to have higher average prices. France, Austria, the United Kingdom, and Germany have some of the highest new dwellings prices in Europe. The size of a country's economy correlates to the stability of the interest paid on a mortgage. In countries

such as Germany and France, interest rates remain under five percent, even after the interest hikes. Historically, these countries enjoyed interest rates below two percent.
Legal and regulatory environment experiences certain trends as well[3]: regulatory scrutiny of risk management and governance intensifies, shifts in regulatory frameworks and consumer safeguards create expanding challenges, financial risk takes central stage again and growing digitization and innovation require more investment.

Technological and digitalization processes in the banking sector can be measured with different indicators, like increasing numbers of penetration rate of online banking and decreasing numbers of bank branches.

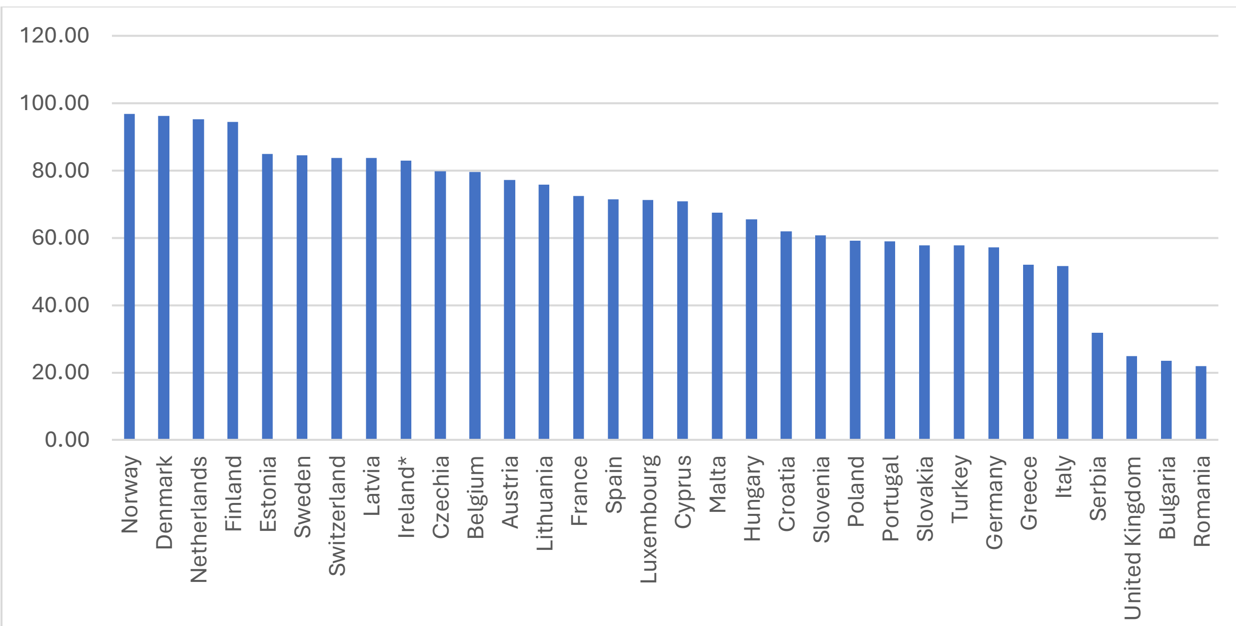

Figure 9. Penetration rate of online banking in Europe in 2023, by country

Source: Eurostat

In 2023, Norway had the highest internet banking penetration rate among the observed European countries, with 96.85 percent. It was followed by another Scandinavian country, Denmark, with a penetration rate of 96.22 percent. The Netherlands ranked third, with 95.13 percent.

[3] 2024 banking regulatory outlook, Deloitte

Since penetration rate of online banking is increasing, there is less necessity for physical infrastructure of bank branches.

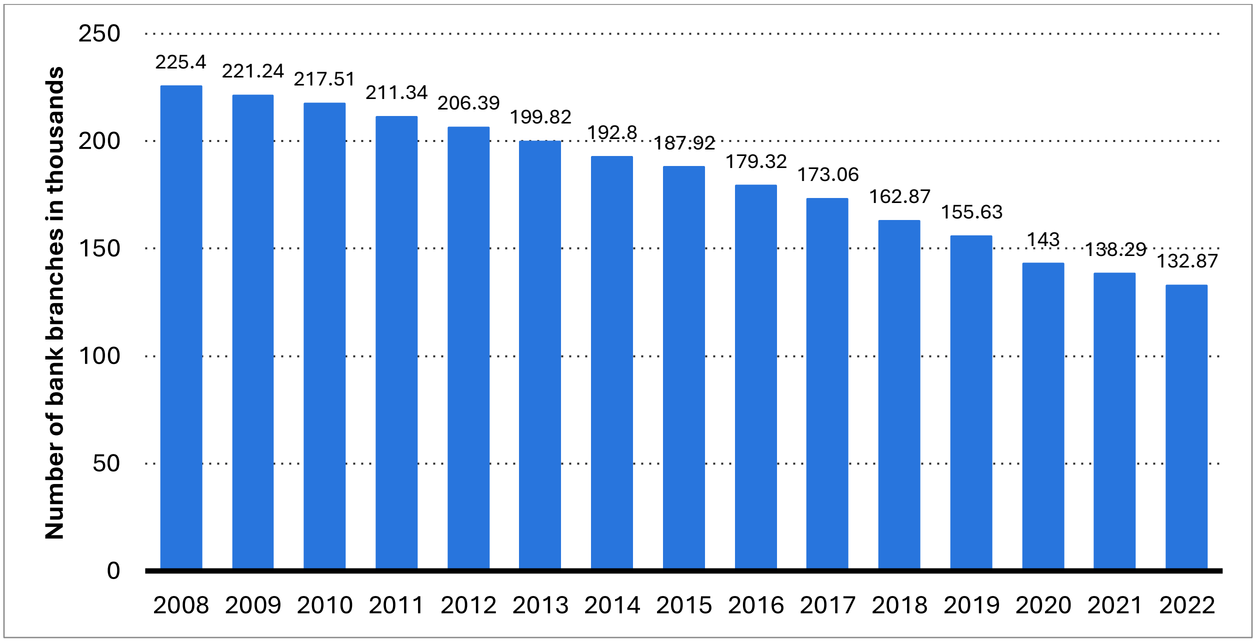

Figure 10. Number of bank branches in the European Union from 2008 to 2022 (in 1,000s)

Source: European Central Bank

As a result of digitalization and less branches, there is structural employment change at the banking sector with less employees.

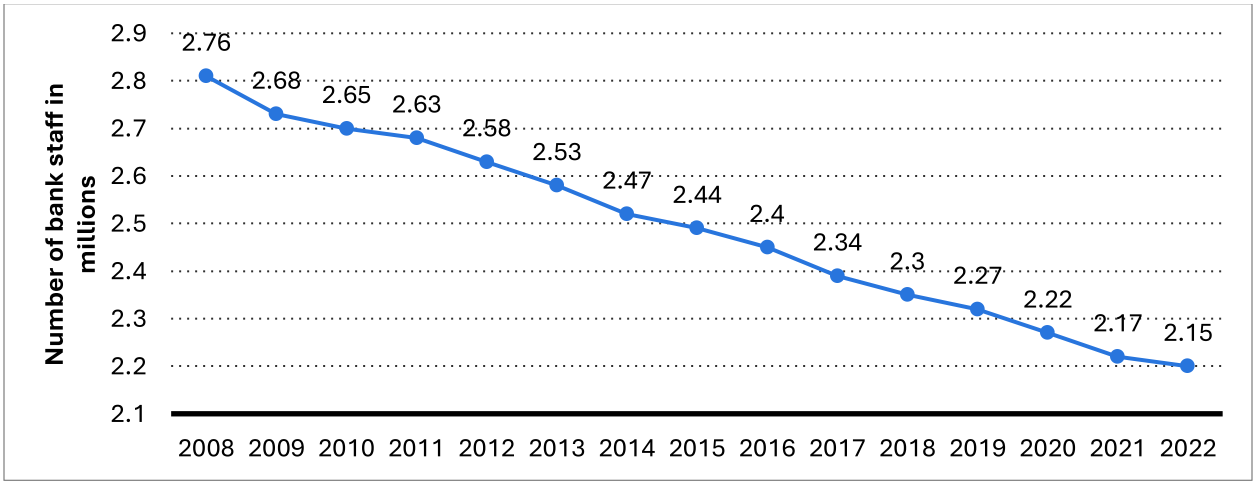

Figure 11. Number of individuals employed by credit institutions in the European Union (EU) from 2008 to 2022 (in millions)

Source: Statista

With the digitalization and development of technologies, conventional banks are facing increasing competition from neobanks.

A neobank is a type of challenger bank that solely operates digitally. Neobanks are newly established banks that do not belong to large conventional banks. They do not have any physical branches and can provide their services both via mobile and desktop devices. They require their clients to go through a digital onboarding process, which is most frequently done via a smartphone. Neobanks can be of two types: those which have a banking license and those that do not. Key players in this market: Revolut, Chime, Nubank, N26, and Monzo.

The global transaction value in the Neobanking market came to US$3.21 trillion in 2022[4]. By global comparison, with US$1.46 trillion, Europe had the top transaction value in 2022. The U.S. comes in second, having generated a transaction value of US$1.07 trillion. The lowest transaction value generated was in China, which was US$17.9 billion. Within Europe, the highest transaction values came from the United Kingdom and France, with transaction values totalling to US$527.3 billion and US$179.1 billion, respectively. With a CAGR[5] of 25%, Europe is forecast to have the strongest annual growth rate between 2022 and 2027 and is expected to generate a market volume of US$4.45 billion by 2027. The U.S. is projected to have an average annual growth rate of 19.3% (2022–2027) and a total market volume of US$2.6 trillion by 2027. China is expected to see a CAGR of 25.9% (2022–2027) and a total market volume of US$56.5 billion by 2027.

The Neobanking market is experiencing rapid growth and is expected to continue this trend in the future. Some of the market trends and future developments that are likely to shape the neobanking industry in the coming years include partnerships with traditional banks, expansion of services, and regulations:

[4] Statista market insights, Neobanking, 2023

[5] CAGR: Compound Annual Growth Rate / average growth rate per year

- Partnerships with traditional banks: As neobanks continue to grow, some are partnering with traditional banks to expand their services and reach. This trend is expected to continue as traditional banks look to collaborate with neobanks to remain competitive in the digital age.
- Expansion of services: Neobanks are likely to expand their services beyond traditional banking products and services to include additional financial products, e.g., loans, insurance, and investment products.
- Regulations: As the Neobanking market continues to grow, regulators are likely to increase their scrutiny of the industry to ensure that consumers are adequately protected. This could result in new regulations and compliance requirements for neobanks.

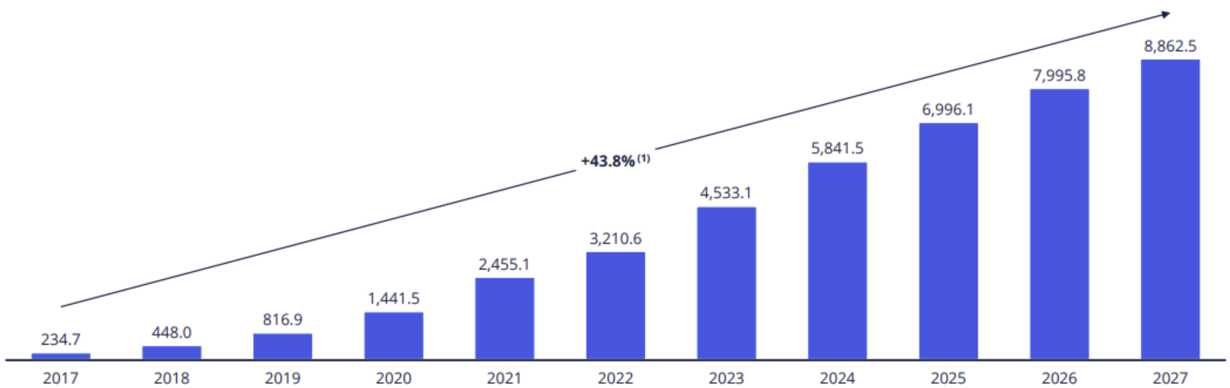

Figure 12. Neobanking's transaction value (billions of US$) is estimated to increase at a CAGR of 43.8% from 2017 to 2027

Source: Statista market insights, Neobanking, 2023

Transformation process in the banking sector in Europe is an ongoing process that is determined by different external factors. In recent decades there has been many events with significant influence – geopolitical risks, COVID – 19 pandemic, financial crisis in 2008 and others that has accelerated many areas and transitions in the banking sector – regulation, digitalization, and risk assessment.

“Uncertainty is a new normal”, said International Monetary Fund Managing Director Kristalina Georgieva in the interview in 2020[6], but it is still very topical today. External environment has a lot of uncertainty that banking sector must deal with.

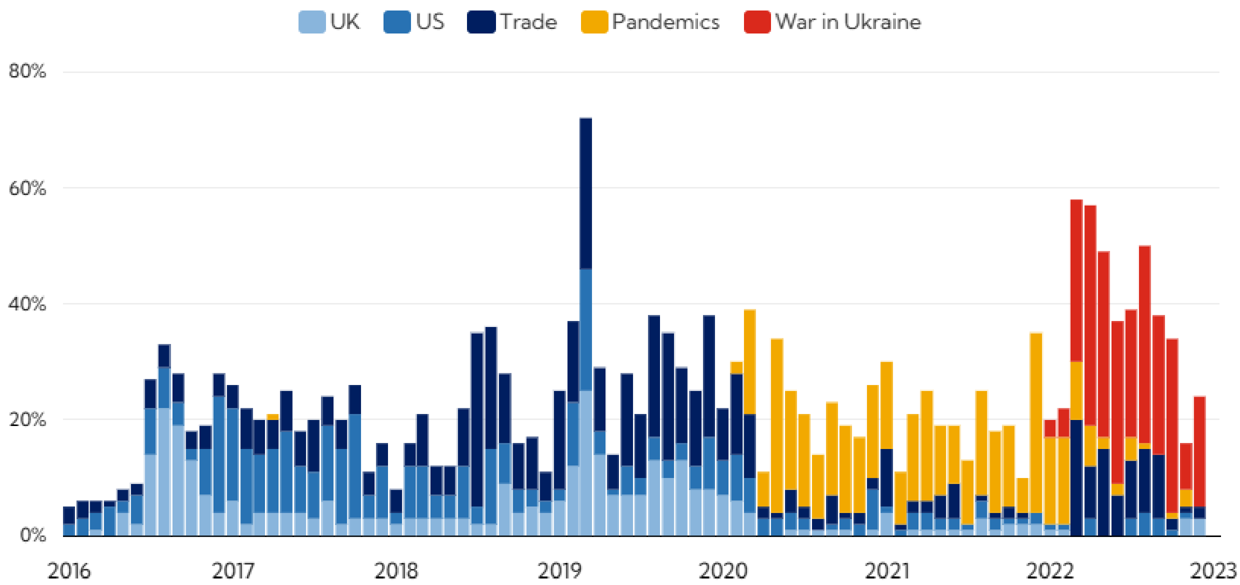

Figure 13. Uncertainty drivers (uncertainty related to listed factor as a share of overall uncertainty)

Source: International Monetary Fund

Despite the uncertainties there still clear areas where banking sector will continue the transformation process[7]:

1. Management of geopolitical risks
2. Regulatory pressure and compliance
3. Digitalization and FinTech
4. Implementation of sustainable business model

Artificial Intelligence (AI), Blockchain and Robotic process automation can enhance overall sectoral performance. Digitalisation is expected to further shift labour demand and will require reskilling the banking workforce.

[6] IMF Head Kristalina Georgieva: "Uncertainty Is the New Normal" - DER SPIEGEL
[7] European Central Bank, European Commission

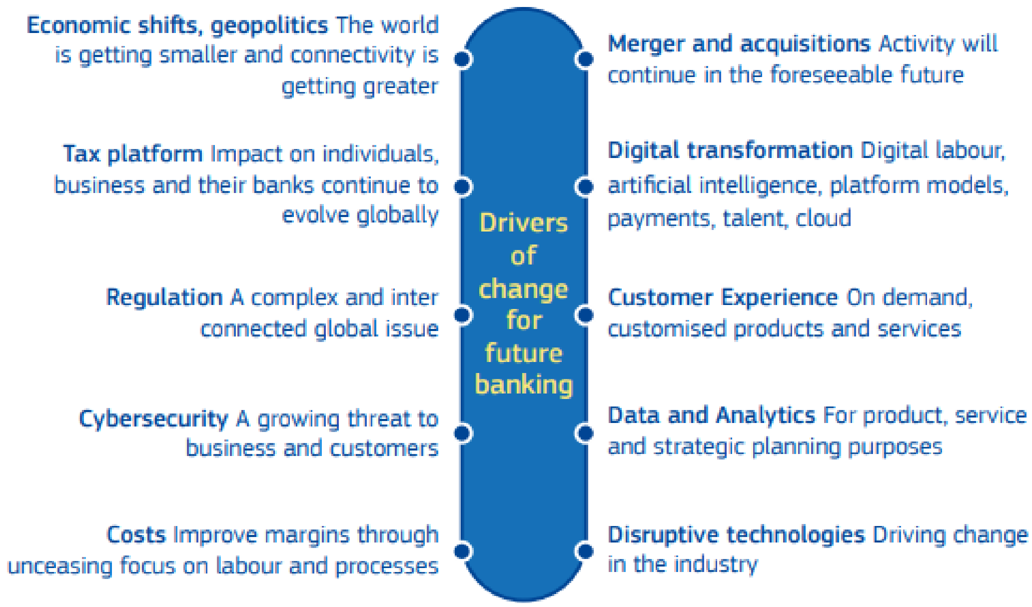

Figure 14. Drivers of the changes for the future banking

Source: European Commission

The adoption of Environmental, Social, and Governance (ESG) criteria in banking represents a paradigm shift, offering both environmental benefits and new opportunities for the financial sector. This 'ESG awakening' in finance is not just a trend but a strategic realignment, reflecting the sector's recognition of its responsibility and influence in shaping a sustainable future[8].

Additionally, the European Banking Authority (EBA) has been actively addressing ESG risks. They recently launched a public consultation on draft Guidelines on the management of ESG risks. These guidelines set out requirements for institutions regarding the identification, measurement, management, and monitoring of ESG risks. The focus includes addressing risks arising from the transition toward an EU climate-neutral economy. Sustainable finance aims to integrate ESG criteria into financial services, supporting sustainable economic growth[9]

[8] European Institute of Management and Finance
[9] European Banking Authority

Part 2

Competition in the Nordic banking sector

Picture created with Microsoft Copilot

Part 2. Competition in the Nordic banking sector.

Banks, owners, and business models

Transitioning from a planned economy to a market economy, the Baltic countries liberalized their financial systems and removed restrictions on the entry of foreign investors into the banking markets. Since then, the proportion of banks owned by foreign investors in the Baltic States has steadily increased, contributing significantly to the region's banking sector landscape. In the first years, foreign capital entered the banking sector mainly from Scandinavian countries and Germany, later also from America. However, the arrival of foreigners was not uniform in all three countries. In Estonia, the entry of foreign owners was faster than in Lithuania and Latvia, and at the end of the 90s, banks with foreign capital accounted for approximately 90% of all bank assets[10]. In Lithuania, the massive entry of foreign capital happened later, but since 2002, foreign banks owned more than 90% of bank assets[11]. In contrast, the presence of foreign capital in Latvia was much smaller. If at the end of 1994 non-residents owned 25% of the paid-up share capital of Latvian banks, then at the end of 2001 non-residents already owned 68.8%, and in 2022 already around 80%[12][13]

The business models of banks in the Baltic countries have also developed differently. Lithuania focused on domestic customers, providing a wide range of universal banking services to businesses and individuals provided by foreign, mainly Swedish, banks.

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[10] Gallizo, J. L., Moreno, J., & Salvador, M. (2018). The Baltic banking system in the enlarged European Union: The effect of the financial crisis on efficiency. Baltic Journal of Economics, 18(1), 1–24. https://doi.org/10.1080/1406099X.2017.1376430

[11] Gallizo, J. L., Moreno, J., & Salvador, M. (2018). The Baltic banking system in the enlarged European Union: The effect of the financial crisis on efficiency. Baltic Journal of Economics, 18(1), 1–24. https://doi.org/10.1080/1406099X.2017.1376430

[12] Bank of Latvia. (2024). Publiskie ceturkšņa pārskati banku dalījumā. Uzraudzība. https://uzraudziba.bank.lv/statistika/kreditiestades/publiskie-ceturksna-parskati-banku-dalijuma/

[13] Rupeika-Apoga, R., Zaidi, S. H., Thalassinos, Y. E., & Thalassinos, E. I. (2018). Bank Stability: The Case of Nordic and Non-Nordic Banks in Latvia. International Journal of Economics and Business Administration, VI(Issue 2), 39–55. https://doi.org/10.35808/ijeba/156

A different banking model was introduced in Latvia, influenced by historical and geopolitical factors. The banking sector consisted of two main segments: domestic customer service, which was dominated by subsidiaries of large Scandinavian banks, and international customer service, which was mainly formed by local Latvian banks. Latvia has positioned itself as the international financial centre of the region of Russia and the Commonwealth of Independent States, because Latvia has a significant number of Russian-speaking inhabitants, it is geographically close to Russia and since 2004 it is also a member of the European Union[14]. Deposits of non-residents gradually increased since the early 2000s, making up half of all deposits or 40% of GDP in 2015. Both segments together accounted for approximately 50% of the country's total assets in 2015[15]. About 78% of all international deposits in the three Baltic States were deposited in Latvian banks in 2015. Latvian banks served as a financial bridge between East and West and advertised themselves as a gateway to Western markets, promising the secrecy of Swiss-style banking. Latvia's ambition to become an international regional financial centre has faced difficulties, mainly due to the high level of non-resident deposits. The large influx of such deposits has attracted the attention of US authorities, forcing them to focus on money laundering problems. In response to these problems and broader concerns about financial abuse, Latvia introduced enhanced anti-money laundering (AML) requirements. The purpose of these strict regulations was to strengthen the integrity of the country's finances and reduce the risks associated with the use of its banking system for illegal activities. As a result, non-resident deposits experienced a sharp decline, and several banks faced financial challenges. "Non-resident banks" had to change their business models and look for new customers and products.

Estonia, on the other hand, chose a middle path, following more the business model of Lithuanian banks. According to IMF data, non-resident deposits in the Estonian banking

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[14] Verbeken, D., & Dessimirova, D. (2018). Latvia Cracks Down on Unscrupulous Banking (p. 4) [Briefing]. https://www.europarl.europa.eu/thinktank/en/document/IPOL_BRI(2018)631027

[15] OECD. (2016). LATVIA: REVIEW OF THE FINANCIAL SYSTEM (p. 40). https://www.oecd.org/finance/Latvia-financial-markets-2016.pdf

sector decreased from 19.1% in 2015 to 7.9% at the end of 2018, and the remaining non-resident activities took place mainly in the Nordic and Baltic region or other EU countries[16]. The decrease in non-resident deposits can be explained by efforts to reduce the money laundering and terrorist financing risks associated with non-resident deposits, focusing on servicing Estonian or related companies and households.

Concentration of the banking sector

The entry of strategic foreign investors into the largest Baltic banks has made the industry more resistant to external shocks, but raised the issue of bank competition. At the end of 2022, in Lithuania, 90% of bank assets belonged to banks whose main shareholders were foreigners, in Estonia - 85% and in Latvia - 76%[17]. As can be seen in Figure 13, the share of assets of the five largest banks in Lithuania and Estonia has been significantly higher than in other countries over the past 10 years, but also in Latvia as of 2018, the situation is similar to that of other Baltic countries. This reflects less competition between banks compared to the Nordic and EU average (68.27% in 2022). At the end of 2022, 9 banks and 4 foreign branches were operating in Latvia and Estonia, and 12 banks and 6 foreign branches were operating in Lithuania. 2022 In the Baltic States, only four banks had a share of banking assets exceeding 5% of total assets, of which Swedbank and SEB bank were clearly dominant, and only in Estonia Luminor Bank AS was the second largest bank.

[16] International Monetary Fund. European Dept. (2020). Republic of Estonia: Selected Issues. IMF Staff Country Reports, 20(13). https://doi.org/10.5089/9781513526911.002
[17] Bank of Latvia. (2024). Publiskie ceturkšņa pārskati banku dalījumā. Uzraudzība. https://uzraudziba.bank.lv/statistika/kreditiestades/publiskie-ceturksna-parskati-banku-dalijuma/; Bank of Lithuania. (2024). Banking Activity Review. https://www.lb.lt/en/reviews-and-publications/category.39/series.171?category=&series=&ff=1; Finantsinspektsioon. (2024). Quarterly reviews of the banking sector | FSA. https://www.fi.ee/en/marksonad/quarterly-reviews-banking-sector

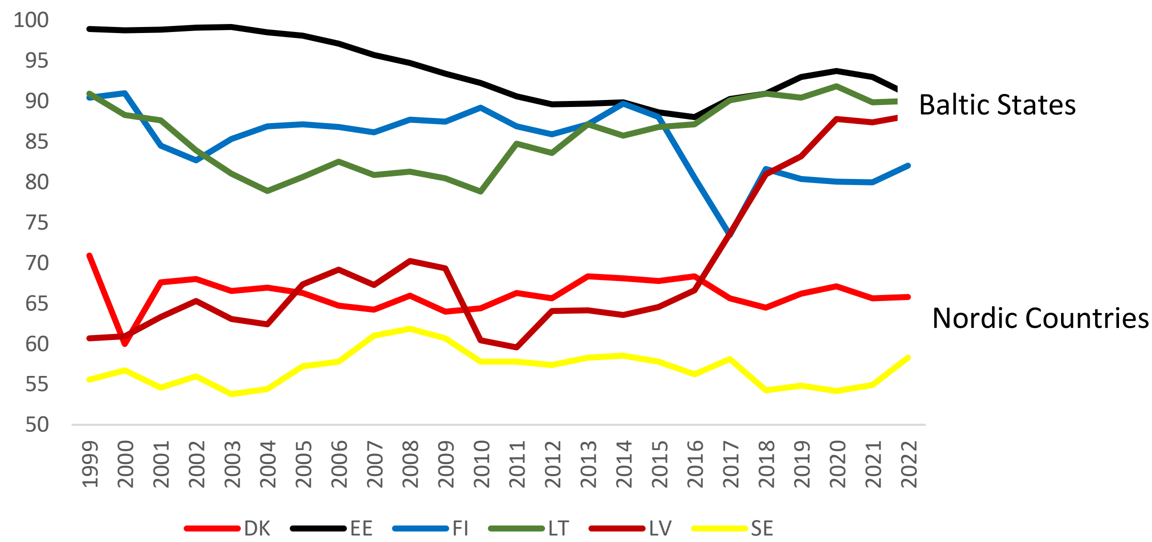


Figure 15. The share of the five largest banks in total assets from 1999 to 2022.

Source: ECB data Portal (2024)[18]

The Herfindahl–Hirschman Index (HHI) measures the concentration of assets in the credit institutions sector. In essence, it measures how much market power or control a few large banks have compared to a more fragmented ownership structure.

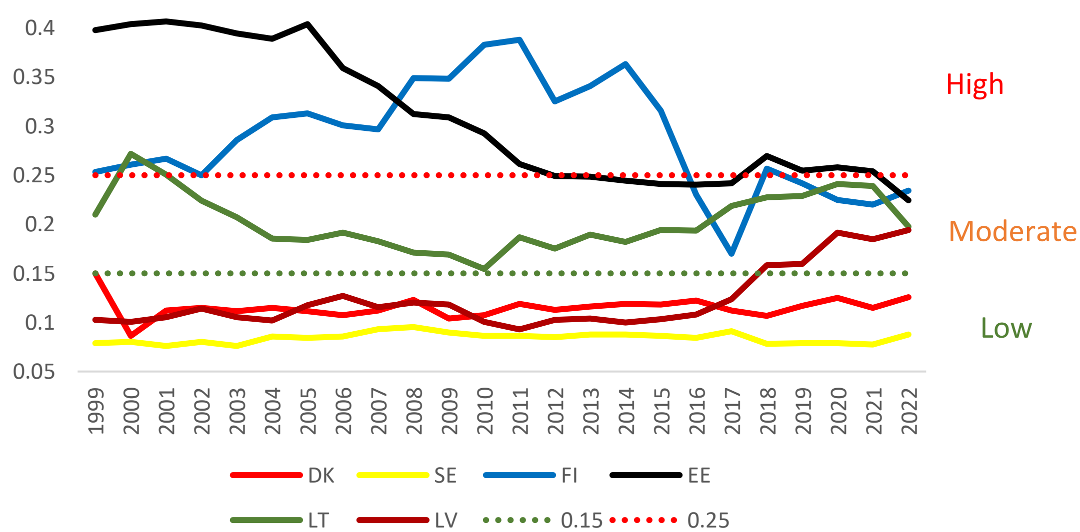


Figure 16. Herfindahl index (HII) for total assets of credit institutions from 1999 to 2022.

Source: ECB data Portal (2024)

[18] ECB. (2024). ECB Data Portal [dataset]. https://data.ecb.europa.eu/

As can be seen in Figure 16, the concentration of credit institutions in terms of assets has been consistently low in Sweden and Denmark, and Latvia also had a similar situation to Sweden and Denmark until 2016. In Lithuania, on the other hand, the concentration is in the moderate range, while Finland and Estonia have moved from high concentration to the moderate range, but even closer to the upper limit. The concentration of credit institutions in Latvia has worsened since 2016, reaching the average high level of other Baltic countries. A similar situation is observed with regard to concentration in terms of lending, which shows the extent to which lending activities are concentrated in a few dominant banks. The exception is Latvia, where the concentration of loans issued until 2020 was significantly higher than the concentration of bank assets (Figure 17).

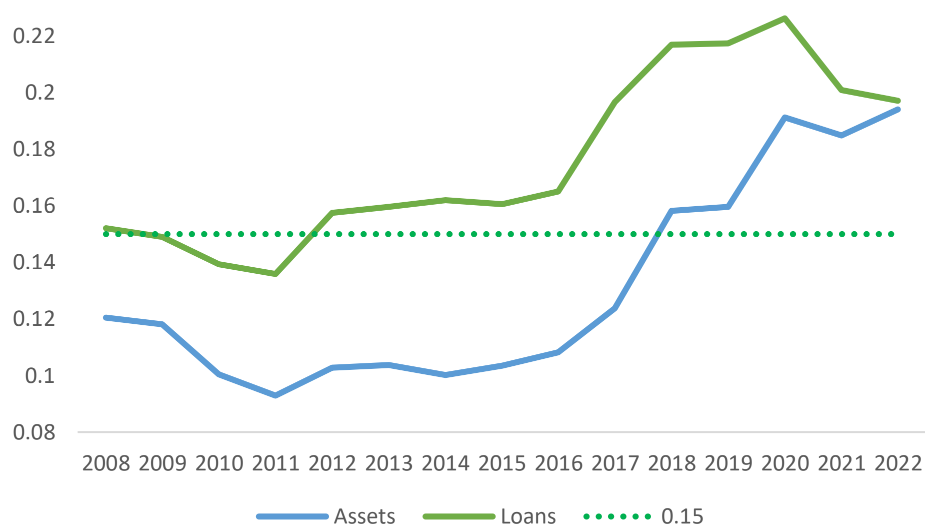


Figure 17. Herfindahl-Hirschman indices (HII) for total assets and loans of credit institutions from 2008 to 2022 in Latvia.
Source: ECB data Portal (2024)

Given the significant presence of foreign-owned banks and the dominance of the largest banks, such as Swedbank and SEB bank, the level of concentration in the Baltic banking sector is high. This high concentration indicates a lower level of competition, especially compared to the Nordic countries and the EU average. The dominance of some of the largest banks of Swedish origin shows the concentration of capital in the banking sector of the Baltic countries, which probably has a negative impact on the overall level of competition. At the same time, market concentration in the Swedish banking sector is at the European average. From 2010 to 2022, Swedish small banks significantly contributed to net loan growth, with their market share expanding over this period[19]. This shows a dynamic Swedish banking market with developed competition.

Number of banks and employees

Between 1999 and 2008, the sector of credit institutions in the European Union (EU) expanded significantly; the number of bank offices increased by 23% and the number of employees by 19% (see Figure 16 and Figure 17). However, after the global financial crisis, there was a downward trend in most EU countries. In the period from 2009 to 2022, the number of bank offices decreased by 40% and the number of employees by 20%.

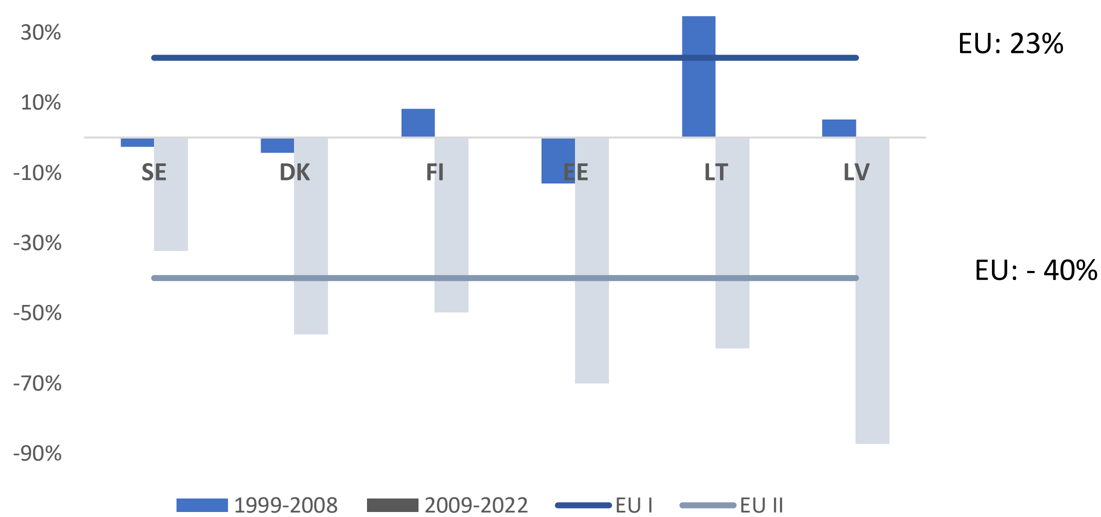


Figure 18. Changes in the number of bank offices in 1999-2008 and 2009-2022, %
Source: ECB data Portal (2024)

[19] Swedish Bankers' Association. (2023). Competition in the Swedish banking sector 2023 (p. 22)

The situation with the number of bank offices in our region from 1999 to 2008 differed from the EU average. Only in Lithuania the number of branches increased by 35%, in Latvia and Finland - slightly, but in Sweden, Denmark and Estonia - decreased. After the global crisis, the reduction of the number of offices was observed everywhere, but in Latvia and Estonia it happened much faster than in other countries.

Between 1999 and 2008, there was a significant increase in the number of employees in Latvia - by 76%, in Estonia - by 38%. Considerable growth was also observed in Lithuania, with the number of employees increasing by 16%. In addition, Denmark and Finland showed positive growth figures, although below the EU average. In Sweden, on the other hand, the number of employees in credit institutions decreased during this period.

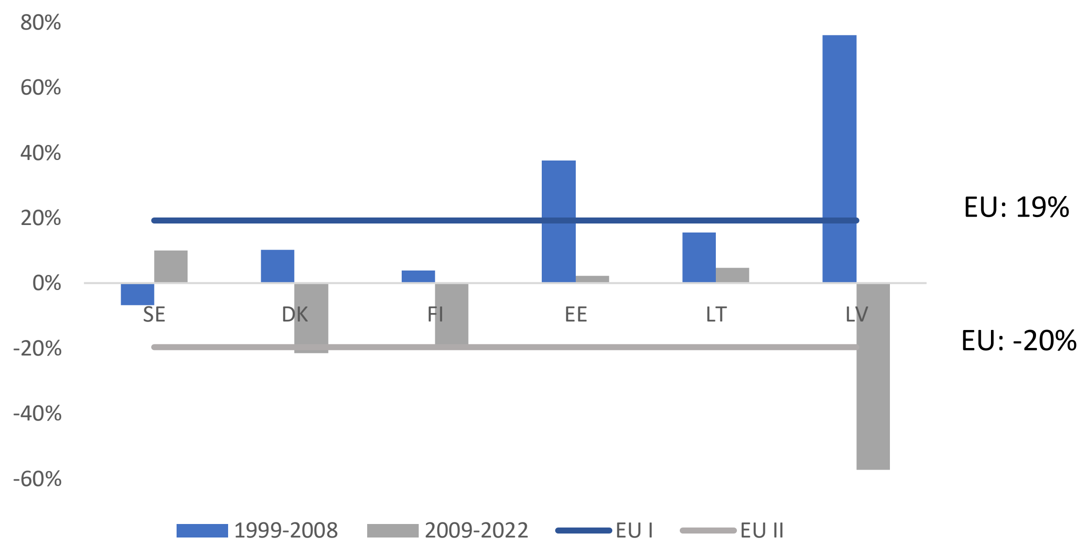


Figure 19. Annual percentage changes in banks' employee numbers: 1999-2008 vs. 2009-2022

Source: ECB data Portal (2024)

Between 2009 and 2022, the employment situation in Denmark and Finland was similar to the EU average. In Latvia, on the other hand, there was a rapid decrease in the number of employees of banks, reaching a staggering 57% decrease. At the same time, Estonia, Lithuania and Sweden differed from most EU countries as employment in the banking sector continued to grow, despite an overall decline in the EU region.

In response to changing customer habits and market conditions, parallel to the reduction in the number of banks and employment in Europe and the world, there is a shift towards digitization and greater efficiency. This restructuring has resulted in industry consolidation and a reduction in the total number of credit institutions, reflecting the growing reliance on digital banking services.

Loans and interest rates

In Baltics, it is customary to blame banks for insufficient lending. Domestic lending by banks to the private sector is systematically lower than the EU average, and Latvia is a leader in this respect. On the other hand, in the Nordic countries, this indicator is well above the European average, and Denmark and Sweden are among the leaders (see Figure 20).

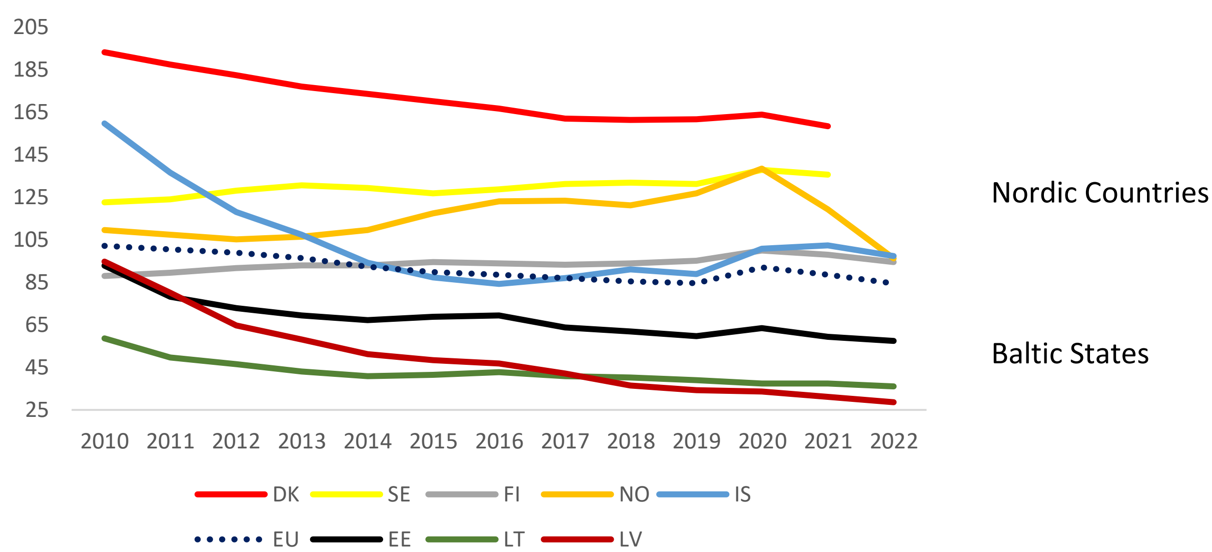


Figure 20. Banks' domestic loans to the private sector as a percentage of GDP: 2010-2022

Source: World Bank database (2024)

Why? Baltic States banks do not have resources, that is, they lack the main source of lending - household and business deposits?

No, Baltic States banks do not lack resources for lending. Latvia and Lithuania have one of the lowest ratios of available resources (deposits) and loans in Europe. A lower loan-to-deposit ratio (see Figure 20) may indicate that Baltic banks follow conservative lending practices. They are likely to be more cautious in lending and hold a larger proportion of deposits in liquid assets to ensure sufficient liquidity and manage risks.

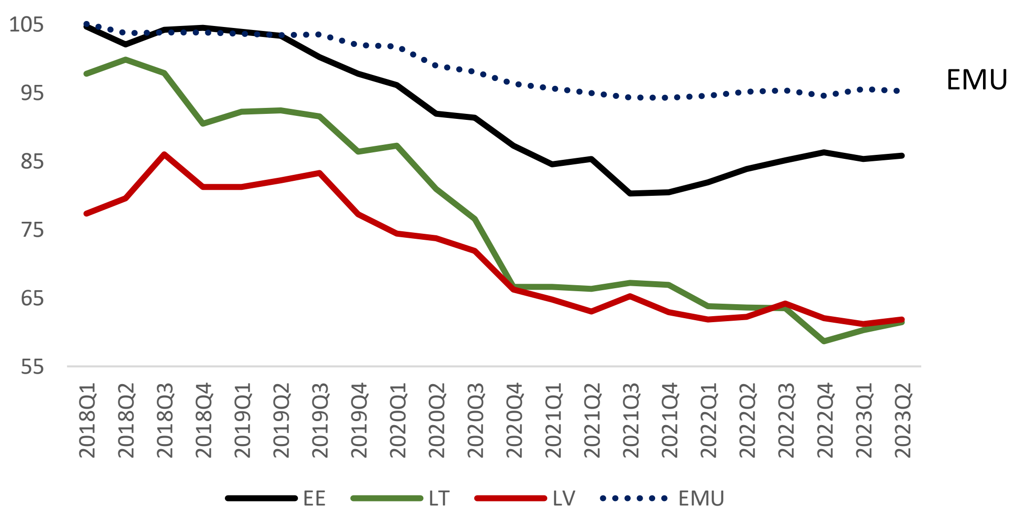
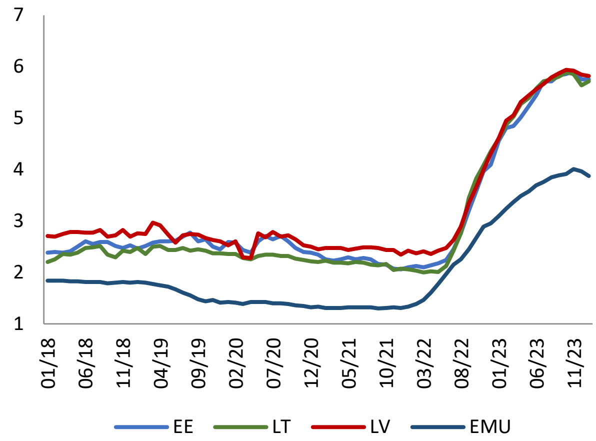


Figure 21. Ratio of loans to deposits in the Baltic States and the Eurozone (EMU) from 2018-2023, %

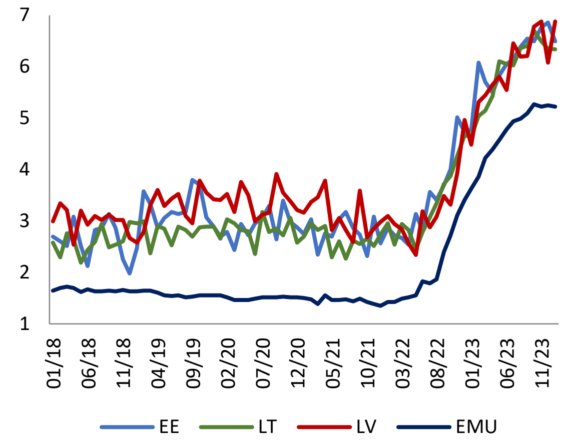
Source: ECB data Portal (2024)

If banks follow conservative lending practices, one would expect lower loan interest payments. However, this is not the case. As depicted in Figure 22, both households and companies in the Baltic countries have consistently paid more than the Eurozone average when acquiring a home, a trend that has endured for many years. High interest rates indicate problems related to healthy competition in the financial industry. At the same time, interest rates in Scandinavia have historically been among the lowest in Europe[20].

[20] Swedish Bankers' Association. (2023). Competition in the Swedish banking sector 2023 (p. 22).



a) Household borrowing costs for housing purchase,%



b) Borrowing costs of companies, %

Figure 22. Borrowing costs for households and companies in the Baltic States and the Eurozone (EMU) from 2018-2024(01), %

Source: ECB data Portal (2024)

If competition between banks in a given market is limited, they may have less incentive to offer borrowers competitive interest rates and other favourable terms. The absence of competition can lead to a scenario where banks are able to sustain higher interest rates without concern for losing customers to more competitive lenders.

However, it is likely that the reason is not solely attributed to the supply side but also to the demand side. The primary factor is probably the decline in demand for loans by companies and individuals, driven by structural factors such as economic uncertainty, evolving consumer preferences, and the availability of alternative financing options.

Efficiency and profitability of the banking industry

In markets with a low level of competition, banks may earn profits in excess of what is necessary to satisfy investor demand above the sum of the risk-free interest rate and the market risk premium. If profits were higher and investors could make excessive profits over a longer period, new firms would enter the market and underbid incumbents to gain market share. This would happen until the profitability of the industry was again equal to the corresponding yield.

ROE, or return on equity, is a financial indicator that measures the profitability of a bank by assessing how effectively the bank earns profit from shareholders' equity.

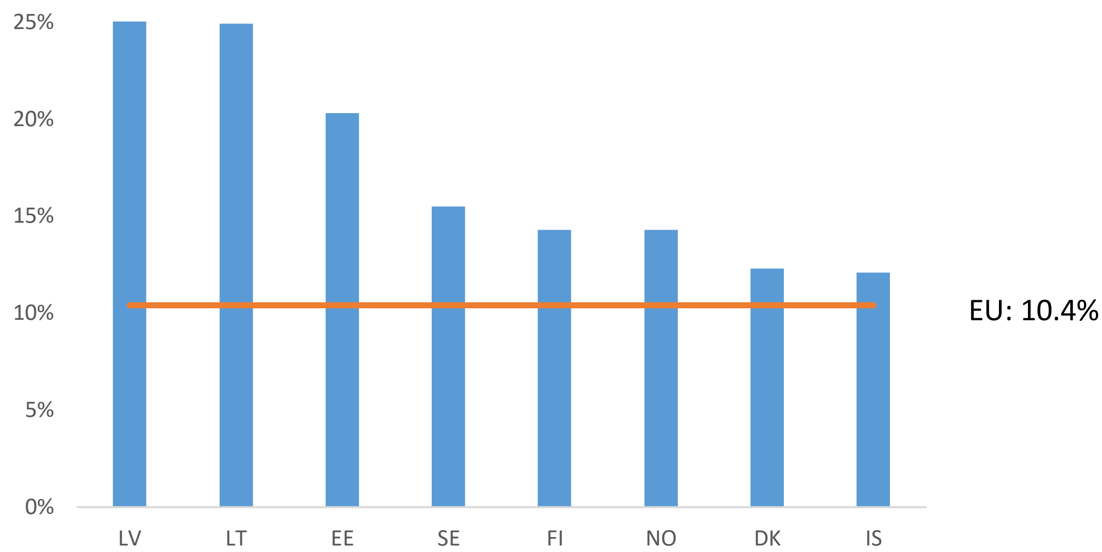


Figure 23. Return on equity (ROE) of European banks in March 2023

Source: Statista (2023) Return on equity (ROE) of banks in Europe as of March 2023, by country

In March 2023, the return on equity in the Nordic countries was higher than the EU average, but in the Baltic countries, it was one of the highest in Europe.

Another measure of bank profitability is Net Interest Margin (NIM). This ratio represents the percentage that a bank earns from interest compared to the expenses it pays to customers.

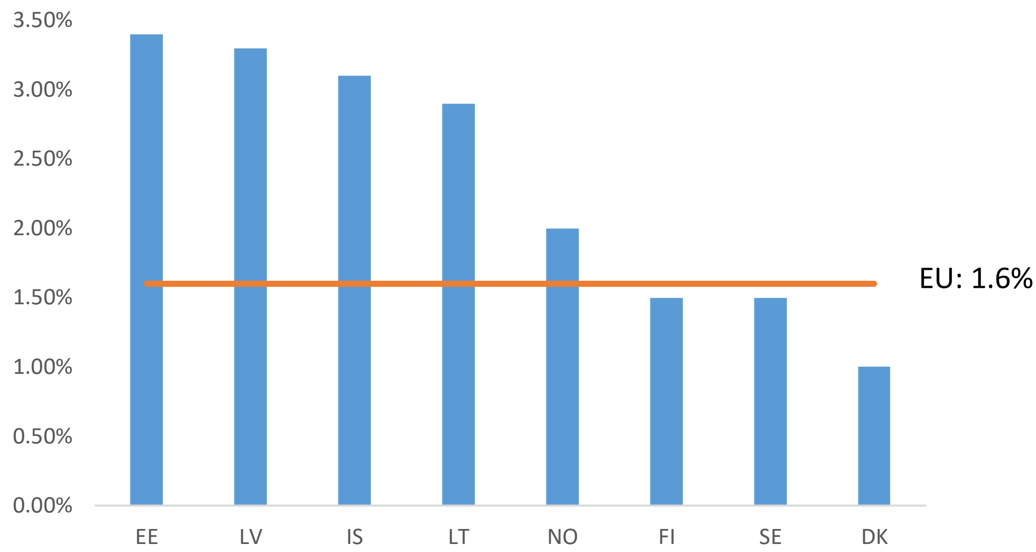


Figure 24. Net interest margin (NIM) of European banks in March 2023 by country.

Source: Statista (2023) *Net interest margin (NIM) for banks in Europe as of March 2023, by country*

Again, the Baltic countries are the ones that earned the most, except for Iceland and Norway, the rest of the Northern European countries are below the EU average. On average, the profitability of banking business models in the Baltic States was higher than the EU average, with a small exception during the global crisis and in Latvia in 2019, and significantly higher than in Sweden[21].

In the banking industry, the Cost-to-Income Ratio (CIR) is an important indicator that reflects the efficiency of a bank's operation by evaluating operational costs in relation to its income. In countries where competition is greater, banks may feel more pressure to invest in customer service, technology and innovation, which can increase operating costs. Therefore, the cost-to-income ratio may be higher in countries with strong competition. As can be seen in the Figure 23, the CIR efficiency coefficient in June 2023 was lower than the EU average in both the Baltic and Nordic countries, but it was the lowest in Latvia and Lithuania.

[21] ECB. (2024). ECB Data Portal [dataset]. https://data.ecb.europa.eu/

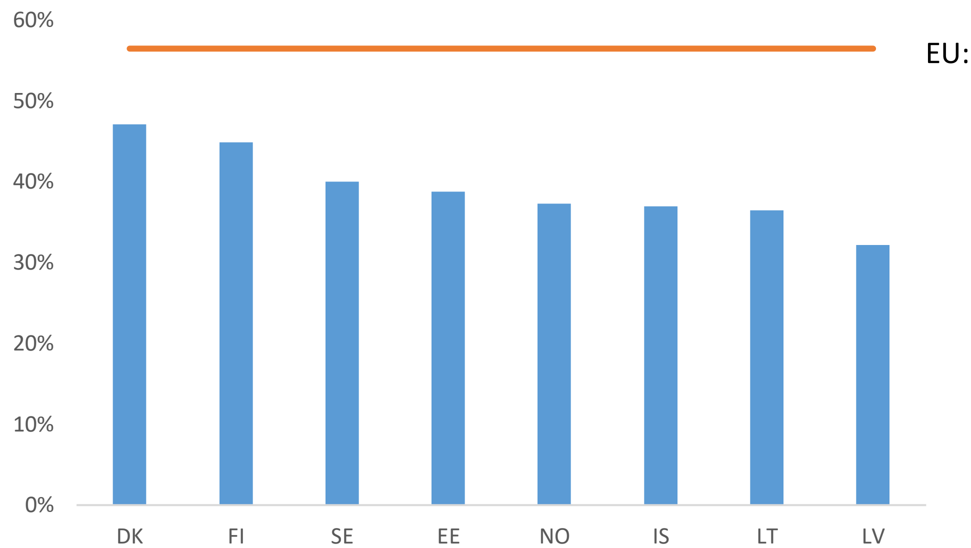


Figure 25. Cost-to-income ratio of the banking sector in Europe in June 2023.

Source: Statista (2023) *Cost-to-income ratio of the banking industry in Europe as of June 2023, by country*

The observed phenomenon that the Baltic countries have higher loan interest rates, higher ROE and net interest margins compared to the Nordic countries can be explained by differences in the dynamics of competition. In the Nordic countries, strong competition is likely to put pressure on profit margins, prompting companies to offer lower interest rates. In contrast, the competitive environment in the Baltic States could be more favourable, allowing companies to maintain higher interest rates and other commissions and achieve a higher profit margin. Lower CIR also indicates lower competition in Latvia. However, higher profitability indicators (ROE, NIM) and lower cost-to-income ratio (CIR) in the Baltic States are probably not just the result of low competition. An alternative explanation could be the higher risks that exist in this region compared to other European and Nordic countries.

Customer mobility

Low customer mobility has been identified as a potential barrier to promoting greater competition in the US banking industry in 2023[22]. However, there is also another point of view, which shows that the low level of customer mobility is not related to obstacles to changing accounts, but to the fact that customers are generally satisfied with the services provided by the current bank. Accenture's Global Banking Consumer Survey 2023, which surveyed 49,000 customers in 33 countries, reveals that only 23% rate their bank's product range highly. Dissatisfaction is driving the trend to diversify across multiple providers, with 59% purchasing new financial services from other providers in the past year. Digital banks are changing the situation: 52% of customers, especially in Asia and Latin America, have accounts for special purposes, such as payments or currency exchange[23]. What is the situation in our region?

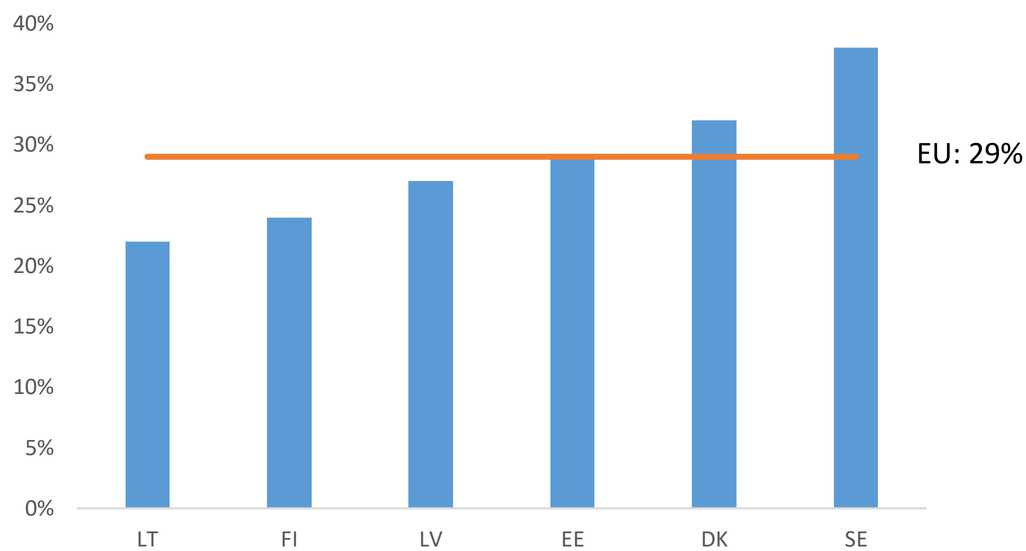


Figure 26. Proportion of customers who have switched products from one or more financial service providers in the last five years (2017-2022)

Source: European Commission (2022): "Flash Eurobarometer FL509 : Retail Financial Services and Products"

[22] Kanter, J. (2023, June 20). Promoting competition in banking. https://www.brookings.edu/events/promoting-competition-in-banking/

[23] Accenture. (2023). Reignite human connections to discover hidden value (Global Banking Consumer Study, p. 44). https://www.accenture.com/us-en/insights/banking/consumer-study-banking-reignite-human-connections

As can be seen in Figure 26, in the period from 2017 to 2022, an average of 29% of EU residents changed their financial service provider; in addition, customer mobility reached 38% in Sweden and 22% in Lithuania. Although Sweden is one of the leaders in the EU, Lithuania is not significantly behind Europe in terms of customer mobility. The situation changes significantly when you have to change the mortgage loan provider.

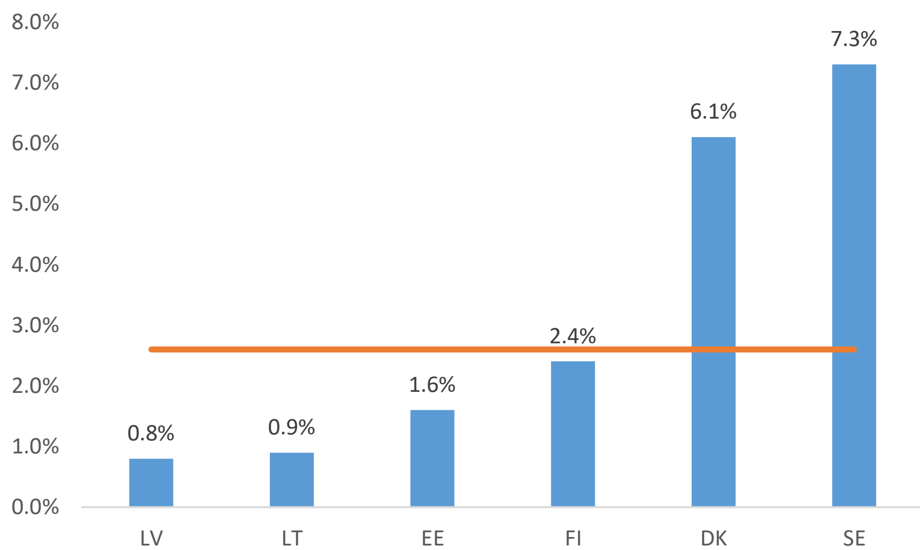


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Figure 27. Proportion of customers who have changed their mortgage loan provider in the last five years (2017-2022)

Source: European Commission (2022): "Flash Eurobarometer FL509: Retail Financial Services and Products"

From Figure 27, it is evident that the Baltic countries fall behind the EU average and notably trail behind Sweden. In Latvia and Lithuania, customers switch mortgage credit providers nine times less frequently than in Sweden.

The question arises, is low customer mobility a feature of the local mentality or is it influenced by other factors?

Part 3

A tale of two markets: Swedish banking in the Baltic States and Sweden

Picture created with Microsoft Copilot

Part 3. A tale of two markets: Swedish banking in the Baltic States and Sweden

Profitability is the main indicator of a bank's success. There is an opinion that Swedish banks in the Baltic region earn more than in Sweden. This study analyses the financial indicators of the Swedish SEB banks and Swedbank in all Baltic countries (Estonia, Latvia, and Lithuania) and Sweden. Our study focuses on annual financial data spanning from 2005 to 2023. We analyse return on equity (ROE), return on assets (ROA), net interest margin (NIM) and cost-to-income ratio (CIR) to assess the competitive dynamics of the banking sector in these regions. Data on bank statistics was obtained from Orbis (2024), a comprehensive database by Moody's.

Analysing these ratios for both banks in all possible country combinations (for example, Latvia vs. Lithuania, Latvia vs. Estonia, Latvia vs. Sweden, etc.), we plan:

- to determine statistically significant differences in the profitability of SEB and Swedbank between each Baltic state and Sweden;
- to estimate the magnitude of these differences to determine their practical significance.
- gain insight into the relative performance of these banks across regions.

Since the financial data are not normally distributed, we used the Mann-Whitney U-test to assess statistically significant differences in financial performance across countries for each bank. This test is suitable for comparing two independent groups and does not require normality of the data. The Cliff Delta test was used to determine the magnitude of these differences, thereby allowing us to assess their practical significance.

Return on Equity (ROE)

This ratio illustrates the bank's profitability relative to its equity. A higher Return on Equity (ROE) in the Baltic countries compared to Sweden would suggest more efficient utilization of shareholders' equity. As of March 2023, the return on equity in the Nordic countries surpassed the EU and Baltic States' averages, ranking among the highest in Europe (Figure 23). However, what was the long-term trend for return on equity?

Table 1. Results of Mann-Whitney U-test for Return on Equity (ROE)

Group 1	Group2	U	p_value	Group 1	Group 2	U	p_value
SEB LT	SEB LV	195	0.682724	SWED LT	SWED LV	215	0.324859
SEB LT	SEB EE	223	0.222961	SWED LT	SWED EE	195	0.686145
SEB LT	SEB SE	152	0.578257	SWED LT	SWED SE	139	0.342679
SEB LV	SEB EE	204	0.501892	SWED LV	SWED EE	149	0.369686
SEB LV	SEB SE	136	0.29445	SWED LV	SWED SE	110	0.065555
SEB EE	SEB SE	96	0.022*	SWED EE	SWED SE	135	0.284413

From Tabula 1 it can be seen that the return on equity of the Baltic States and Sweden does not differ statistically significantly, except for SEB EE (Estonia) and SEB SE (Sweden). The practical significance shows that the return on equity in Sweden is significantly higher than in Estonia (Cliff Delta coefficient 0.44). The absence of significant differences in equity return indicators in different countries shows that SEB and Swedbank ensure similar profitability in relation to invested capital (equity) in all regions (Baltic countries and Sweden). This could be due to several factors:

- Thoughtful capital deployment: SEB and Swedbank were able to strategically deploy capital in different regions to increase the overall return on capital.
- Standardized operation: Consistency of core operations across regions, such as credit risk management, product offering and operational efficiency, which ensures comparable return on capital.

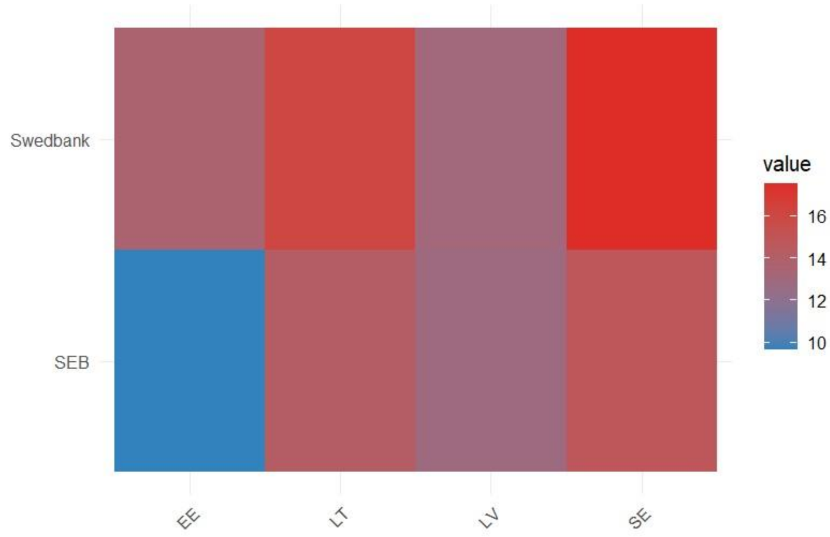

Figure 28. Median Heat Map of SEB and Swedbank's Return on Equity (ROE)

In order to effectively compare the competitiveness of these banks in different countries, we use heat maps. These visual tools represent data as a colour gradient, revealing trends and patterns clearly and transparently. As can be seen in Figure 28, the return on equity of both SEB and Swedbank was higher in Sweden than in the Baltic countries. Swedbank's return on capital was higher than SEB's in all countries. In Latvia, both banks had very similar results, in Lithuania Swedbank's return on equity was slightly higher than SEB's, but in Estonia Swedbank's return on equity was significantly higher than SEB's. The results show that the return on equity of the Swedish banks operating in the Baltic States in the period from 2005 to 2023 was not higher compared to their parent market (Sweden).

Return on Assets (ROA)

This ratio shows how profitable a bank is relative to its total assets. A higher ROA in the Baltic States would indicate that banks in this region earn more profit per euro of assets.

Tabula 2. Results of Mann-Whitney U-test for Return on Assets (ROA)

Group 1	Group2	U	p_value	Group 1	Group 2	U	p_value
SEB LT	SEB LV	113	7.31E-01	SWED LT	SWED LV	132	1.63E-01
SEB LT	SEB EE	68	1.23E-01	SWED LT	SWED EE	110	4.10E-02*
SEB LT	SEB SE	190	3.87E-06***	SWED LT	SWED SE	263	5.43E-03**
SEB LV	SEB EE	135	1.89E-01	SWED LV	SWED EE	174	8.61E-01
SEB LV	SEB SE	268	3.36E-03**	SWED LV	SWED SE	285	5.62E-04***
SEB EE	SEB SE	319	6.48E-07***	SWED EE	SWED SE	304	5.66E-05***

As can be seen in Table 2, statistically significant differences in the return on assets between Sweden and all three Baltic banks exist in both SEB and Swedbank.

Table 3. Cliff Delta Effect on Return on Assets (ROA) among banks

SEB	SEB LV	SEB LT	SEB EE	SEB SE	SWED	SWED LV	SWED LT	SWED EE	SWED SE
SEB LV	NA				SWED LV	NA			
SEB LT	0.081	NA			SWED LT	-0.269	NA		
SEB EE	0.252	0.349	NA		SWED EE	0.036	0.391	NA	
SEB SE	-0.567	-0.919	-0.865	NA	SWED SE	-0.667	-0.538	-0.778	NA

Analysing the size of the impact (Table 3), it can be seen that the ROA of SEB and Swedbank in Sweden is significantly lower than in Lithuania, Latvia and Estonia. There is also a significant difference between Lithuania and Estonia, where ROA is higher in Estonia. In the Baltic region, the return on assets of both banks was the highest in Estonia.

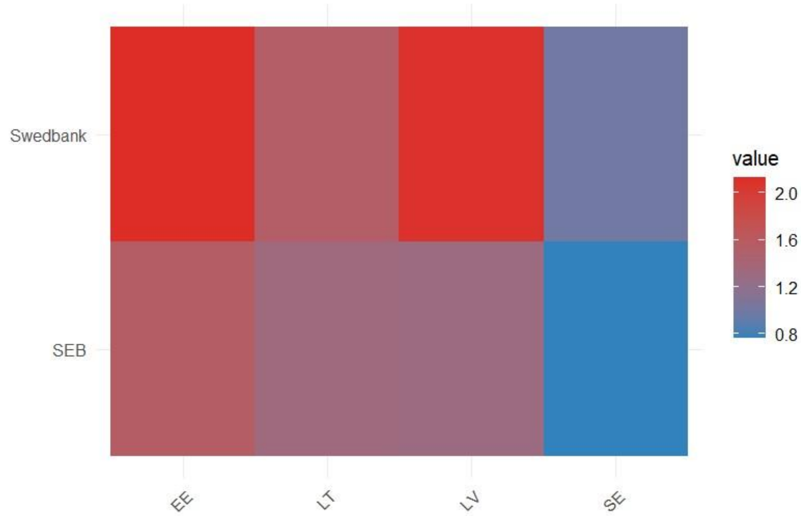

Figure 29. Median Heat Map of SEB and Swedbank's Return on Assets (ROA)

From Figure 29 it can be seen that Swedbank's ROA was also higher than SEB's in all countries, and the differences were greater than in the case of ROE.
Significantly lower ROA figures in Sweden compared to the Baltic states indicate that SEB and Swedbank earn less profit relative to their total assets in Sweden. This could be due to several reasons:

- Lower profitability: Banks probably earn less profit on loans or other assets in Sweden compared to the Baltic countries.
- Larger asset base: In Sweden, compared to the Baltic countries, banks could have a larger and potentially less profitable asset base. This could be due to factors such as a greater focus on non-interest-bearing assets or a greater concentration of loans in lower-yielding sectors.

ROA analysis shows that from 2005 to 2023, banks in the Baltic States had a significantly higher return on assets than banks in Sweden.

Net interest income (NIM)

The higher ROA of Swedish banks in the Baltic States raises the question: is net interest income (NIM) one of the main drivers?

This ratio represents the difference between the interest income a bank earns on loans and the interest expense it pays on deposits. A higher NIM in the Baltic States could indicate that banks here are making more profit from the difference in interest rates on loans and borrowings.

Tabula 4. Results of Mann-Whitney U-test for Return on Net Interest Margin (NIM)

Group 1	Group2	U	p_value	Group 1	Group 2	U	p_value
SEB LT	SEB LV	32	1.18E-03**	SWED LT	SWED LV	78	2.22E-03**
SEB LT	SEB EE	38	3.30E-03**	SWED LT	SWED EE	118	7.00E-02
SEB LT	SEB SE	192	1.73E-06***	SWED LT	SWED SE	336	3.40E-09***
SEB LV	SEB EE	214	3.39E-01	SWED LV	SWED EE	248	4.97E-02*
SEB LV	SEB SE	342	1.13E-10***	SWED LV	SWED SE	341	2.26E-10***
SEB EE	SEB SE	342	1.13E-10***	SWED EE	SWED SE	340	4.53E-10***

As can be seen in Table 4, there is a statistically significant difference (p-value < 0.001) between Sweden and all the Baltic states regarding NIM. The differences in NIM between the Baltic States are mixed. Some comparisons show statistically significant differences (p-value < 0.05 or p-value < 0.01), while others are non-significant (p-value > 0.05).

Table 5. Cliff Delta Effect on Net Interest Margin (NIM) among banks

SEB	SEB LV	SEB LT	SEB EE	SEB SE	SWED	SWED LV	SWED LT	SWED EE	SWED SE
SEB LV	NO				SWED LV	NO			
SEB LT	-0.694	NO			SWED LT	-0.568	NO		
SEB EE	-0.186	0.636	NO		SWED EE	-0.374	0.346	NO	
SEB SE	-1.000	-0.939	-1.000	NO	SWED SE	-0.994	-0.965	-0.988	NO

Effect size analysis shows that there is a large effect size (Cliff delta > 0.33) and a statistically significant difference (p-value < 0.001) between Sweden and all Baltic countries. This shows that the net interest profit margin in the Baltic States is significantly higher than in Sweden. The effect size is very large, close to 1, which is much larger than for ROA and shows that the differences between the Baltic region and Sweden are very significant. The analysis of the heat map shows that also in the case of NIM, Swedbank earns more than SEB in all countries. However, in the case of NIM, the leader in the Baltics is no longer Estonia, as it was in the case of ROA, but Latvia. One of the reasons could be higher lending rates in Latvia.

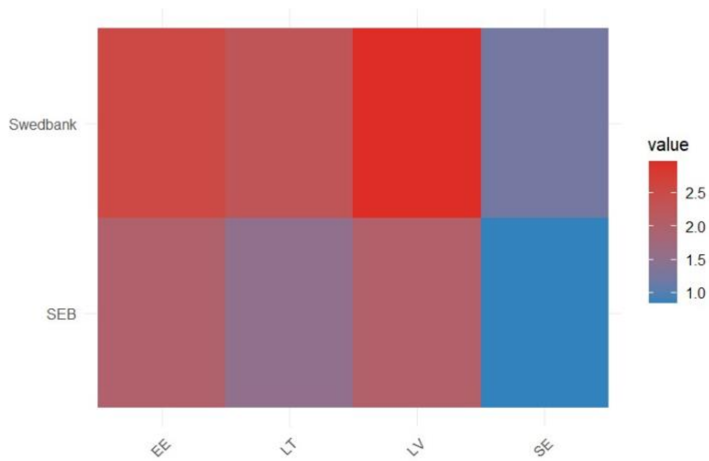

Figure 30. Median Heat Map of SEB and Swedbank's Net Interest Margin (NIM)

As expected, net interest margin (NIM) results are consistent with return on assets (ROA). The lower NIM in Sweden indicates that SEB and Swedbank earn less profit from their lending activities in Sweden compared to the Baltic countries, because the interest rates on loans in the Baltic countries are higher.

Cost-Income Ratio (CIR)

NIM focuses on the revenue side, but profitability is also significantly affected by how effectively the bank manages its operating expenses. This ratio measures how effectively a bank manages its expenses relative to its income. A lower CIR in the Baltic States indicates that banks in the region are better able to control their costs, but it could also indicate less competition.

Tabula 6. Results of Mann-Whitney U-test for Cost-Income Ratio (CIR)

Group 1	Group2	U	p_value	Group 1	Group 2	U	p_value
SEB LT	SEB LV	159	5.40E-01	SWED LT	SWED LV	240	8.50E-02
SEB LT	SEB EE	221	2.46E-01	SWED LT	SWED EE	307	1.06E-04***
SEB LT	SEB SE	123	1.51E-01	SWED LT	SWED SE	161	7.75E-01
SEB LV	SEB EE	286	2.17E-03**	SWED LV	SWED EE	245	6.12E-02
SEB LV	SEB SE	119	1.18E-01	SWED LV	SWED SE	116	9.81E-02
SEB EE	SEB SE	59	4.10E-04***	SWED EE	SWED SE	62	6.11E-04***

There is a significant statistical difference in CIR between Estonia and Sweden, but no clear trend between the other countries.

Table 7. Cliff Delta Effect on Cost-Income Ratio (CIR) among banks

SEB	SEB LV	SEB LT	SEB EE	SEB SE	SWED	SWED LV	SWED LT	SWED EE	SWED SE
SEB LV	NO				SWED LV	NO			
SEB LT	-0.119	NO			SWED LT	0.330	NO		
SEB EE	-0.584	-0.224	NO		SWED EE	-0.357	- 0.701	NO	
SEB SE	0.304	0.281	0.655	NO	SWED SE	0.322	0.058	0.637	NO

There is a large effect between Sweden and Estonia (Cliff delta > 0.33), accompanied by a statistically significant difference (p-value < 0.001). This means that in Sweden CIR is significantly higher than in Estonia, moderately higher than in Latvia and slightly higher than in Lithuania. This shows that SEB and Swedbank have a higher cost structure relative to their income in Sweden compared to the Baltic States. A moderately lower CIR was observed in

Estonia compared to Lithuania and Latvia. Heat map analysis shows mixed results between Lithuania and Latvia: in Latvia, SEB has the highest CIR, while Swedbank has the lowest.

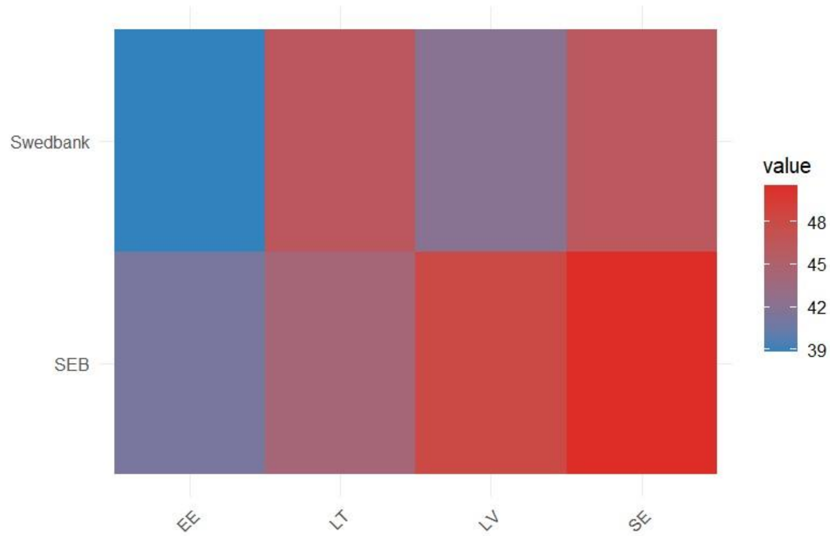

Figure 31. Median Heat Map of SEB and Swedbank's Cost-Income Ratio (CIR)

Based on the obtained results, it is difficult to unequivocally state that SEB and Swedbank "really earn more" in the Baltic States than in Sweden. While the higher NIM and ROA in the Baltics initially support the existing view, the higher CIR in Sweden and other factors undoubtedly affect the overall profitability. Interestingly, the analysis of ROE shows a similar return on invested capital in different regions, which prompts an in-depth study of profitability factors.

In the next chapter, by interviewing experts, the further development and transformation of the Latvian banking industry in the wider Baltic and Northern European context will be studied. This analysis is important for understanding the upcoming challenges and opportunities that will shape the future of financial services for Latvian consumers and companies.

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