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1 Introduction

The Estonian banking sector has undergone a profound restructuring and transformation process during the last few years of economic reform. Estonia leads the way in the number of banking sector bankruptcies throughout Eastern Europe and in the rapidity with which the monetary authorities have addressed the growing problems of the banking sector. An analysis of the adaptation of the Estonian banking industry also offers a window onto the banking world in the CIS, whose banking sector was a part of the Soviet banking system in the same way as that of Estonia.

The reform of the Estonian banking sector started in 1989 under Soviet rule and banking legislation. Tartu Commercial Bank in Estonia was the first commercial bank established in the Soviet Union within the framework of the 1989 banking legislation. Since the Estonian declaration of independence in August 1991, the banking sector has undergone profound structural and operational changes. Perhaps ironically, Tartu Commercial Bank was the first Estonian bank to go bankrupt at the end of 1992.

The aim of this article is to discuss developments in the Estonian banking sector against background of transformation from the Soviet past to the turbulent economic environment of today. The article starts with an account of the main legal and institutional developments in the banking sector since 1988 and aims to identify the causes of the financial problems encounted by the banks. It will proceed to analyze the activities of the banks during the past 3 years of economic transformation. Some key issues influencing the banking sector, such as the problem of bad debts, will also be discussed. Finally, the paper will touch upon foreign investment in the banking sector.

2 Banking legislation

The Soviet law of November 27, 1989 granted all three Baltic states a degree of economic autonomy, including the right to organize independent banking systems. Subsequently, the Estonian banking law, which was passed in December 1989, reestablished Eesti Pank(Bank of Estonia) as the central bank of the country after almost 50 years of control by the Soviet State Bank (Gosbank). Those parts of the new law which governed banking were drafted in compliance with the banking legislation under preparation in the USSR at the time but adopted somewhat later, in 1990. Similar legislation was also passed in the Russian Republic of the USSR. The USSR law was outpaced by political developments that led to disintegration of the country and after a "war on central banks" to the merger of the former Gosbank and the Central Bank of Russia (Kivilahti et al. 1992, Hirvensalo 1993). Estonia also had two central banks for two years before the Tallinn branch of Gosbank was closed down at the beginning of 1992 and its operations merged with those of Eesti Pank (Karell 1992).

In June 1992 the introduction of the kroon, the Estonian national currency, separated Estonia from the ruble zone, tied the kroon to the German mark and introduced a limited currency board system. The currency reform was governed by three new laws: the Currency Law of the Republic of Estonia, the Foreign Currency Law of the Republic of Estonia and the Law of the Republic of Estonia on the Security of the Estonian Kroon. The reform was carried out successfully contrary to the many fears expressed both in Estonia and abroad. It is generally understood that the strong will of the Estonians to have their own currency played a significant role in this success (Kallas 1993).

In May 1993 the law on the Eesti Pank was renewed and the status of the bank was clarified further as an independent authority from the government. (Estonija May 19, 1993, The Baltic Observer, May 21–27, 1993). The bank is accountable only to Parliament and cannot issue credit to the state or local budgets. The limited currency board system introduced with the currency reform signifies in practice that the role of the Eesti Pank as a lender of last resort to the banking sector is limited to very exceptional situations (Bennett 1993). Such a situation emerged by 1992, when the central bank had to resolve the first serious banking crisis in the country.

The central bank issues licenses to commercial banks and is in charge of banking supervision, which was organized in 1992. Until 1992 the minimum capital requirement for setting up a bank in Estonia was 5 million rubles (500 000 kroons). There was also a requirement that the shareholders could not be juridical or natural persons residing outside Estonia (Sörg 1991). Foreign investments in the Estonian banking sector became possible in 1992 (Quarterly Review of the Bank of Estonia 1/93).

The minimum capital requirement of the banks was raised to 6 million kroons in June 1992 and took effect in October 1992 (Eesti Pank Quarterly Review 1/93, Ernst & Young 1994). A minimum of ten shareholders is required to set up a bank and all bank directors have to fulfill the educational requirements of the central bank. One shareholder is also limited to 33 % of the total share capital. (Eesti Pank Quarterly Review 1993:1, p. 33).

In May 1993 Eesti Pank decided to increase the minimum capital requirements to 15 million kroons for new banks. The existing banks should reach the minimum of 15 million kroons by April 1995, 25 million kroons by April 1996 and 35 million kroons by April 1997. At the same time Eesti Bank declared a period of stabilization in the banking sector until the beginning of 1994. No new banking licenses would be issued during that period. It is further expected that the Council of the Bank of Estonia will demand that authorized capitals of commercial banks be brought into compliance with EC standards within the next one or two years. In that case the minimum capital requirement, 5 million ECUs would amount to about 75 million Estonian kroons (Baltic News Service, February 28, 1994).

It is likely that the smallest banks will face difficulties in fulfilling these requirements, which is why new mergers in the banking sector are expected.

In April 1993 Eesti Bank decided on new reliability requirements or prudential ratios with which the banks had to comply as of July 1, 1993. These include a minimum solvency ratio of 8 per cent, a minimum liquidity ratio of 30 per cent and a maximum risk concentration ratio of 800 per cent. In addition the maximum loan available to any one client should not exceed 50 % of the bank's own funds[1].

Since the currency reform the ratio of compulsory reserves to be held in the Bank of Estonia was set at 10 % of the total deposits held by the bank. The intention was to raise the ratio gradually to as high as 15 %, but subsequently the ratio was dropped again to 10 %, where it remains. The Savings Bank was subject to 100 % reserve requirement until 1/3 of its shares were acquired by Hansapank. At that point the requirement was lowered to 70 %. The reserve requirement is so high on the Saving Bank because the central bank has issued a guarantee on the deposits of the bank (Estonian Kroon, June 1993).

According to Eesti Pank regulation from January 26, 1993, the banks are required to make reservations for bad loans amount into 25 % of the net profit. Since January 5, 1994 Eesti Pank also requires that loans which have not been serviced for more than 150 days be considered bad. Until then the definition of bad loans was not made explicit for the banks.

The law on securities was passed in 1992, but the mortgage law was adopted only in June 1993 and became effective in November 1993. However, it is difficult in practice to provide securities for loans. Privatization and registration of ownership rights have not proceeded very far. The most commonly used securities therefore are pledges on machines and equipment, often cars.

A new law on commercial banks has been under preparation since 1992. In addition to banks it is expected to regulate the activities of financing companies and limit the ownership of the banks in other companies, which the present law does not do. The present law does not contain any definitions on money laundering, either (The Baltic Independent, March 25, 1994). A law on a deposit insurance mechanism is also under preparation.

In developing the banking legislation and governance of the banking sector Estonian authorities have chosen a very pragmatic way and introduced relatively

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[1] The solvency ratio is calculated as ratio of the bank's own funds to the sum total of risk-adjusted and non-balance-sheet items ratio and corresponds roughly to the generally used capital adequancy ratio; the risk concentration ratio is calculated as the ratio of the high risk concentration clients' debts to the bank's net assets (Eesti Pank Quarterly Review 1993:3).

simple and easily controllable regulations. In the beginning political unanimocity helped to pass the necessary laws but lately differing views have emerged and somewhat slowed down new legislation. The new law on Eesti Pank had to be amended somewhat after review by the constitutional court, the legal procedures used in restructuring the Savings Bank are also under court supervision and the new law on commercial banks has taken longer to draft than expected due to differences of opinion among various interest groups.

It would be tempting to draw conclusions from the Estonian banking developments for the other former USSR republics, which have detached themselves from the ruble zone. Sörg has argued that in its early days the Estonian banking reform served as a model for the Russian banking legislation (Sörg 1991). However, as far as later developments are concerned, different financial and political environments make comparisons very difficult. Estonia's early introduction of a national currency and adoption of a currency board system distinguishes the country clearly from the other CIS countries. On the other hand, the common heritage of Soviet institutions and learned behaviors within those inherited institutions will most likely continue to influence the banking sector throughout the former USSR republics even though the legislation already differs from country to country.

3 Institutional development in the Estonian banking sector

3.1 Restructuring of the former state-owned banks

Until 1989, banking in Estonia was carried out by branches of the Soviet monobanking system. The banking reform started in 1988 under Soviet rule, when the two-tier banking structure was introduced in the USSR as part of the "perestroika" reform process. The two-tier banking system was instituted by separating 5 specialized banks from the former monobank (Kivilahti et al. 1993, p. 54). In Estonia the separation of the central banking and commercial banking functions did not create major changes in the banking sector, because the Moscow-based central organizations of the former specialized Soviet banks continued to control the activities of their branches in Estonia. The Soviet banking system operated in the allocation of money and credit according to state plans and official decisions rather than in the intermediation of money and credit based on supply and demand.

Locally banking was governed and controlled by the Tallinn branch of Gosbank until December 15, 1989, when the Supreme Soviet of Estonia passed a decree establishing Eesti Pank, which was to become the central bank of the independent Estonia.

In 1990 most of the specialized Soviet banks were restructured into joint stock companies and as the political disintegration of the former USSR gathered momentum the branches of these banks became independent from the former parent bank in many republics. The shares of the banks were normally transferred from the direct ownership of the state through various ministries to state-owned companies and local authorities.

In Estonia the branches of Promstroibank, Agroprombank and Zhilsotsbank became independent by the end of 1990 and the rights of Vneshekonombank to conduct foreign exchange transactions were transferred to Eesti Pank (Sõrg, 1991). As part of the political battle between the former USSR and Estonia, the banks had no longer been allocated credit quotas according to the needs of the economy, especially in the agricultural sector. Also, the branches of the specialized banks had been deprived of the right to transfer payments directly to other states within the former USSR or abroad, which slowed down payment transactions enormously. (Sörg 1990, p.19)

The new law on Gosbank and banks, which was passed in the USSR in 1990, was intended to govern Gosbank's activities as the central bank of the entire Union (Kivilahti et al., 1993, p.54), but political developments had already outpaced the law in Estonia when the Estonian Supreme Soviet accepted the decree on the Eesti Pank. The final political division between the banking systems of the former USSR and Estonia was provided by the Estonian declaration of independence in August 1991. The formal separation between Estonian and the former Soviet banking system came only in 1992 when the branch of Gosbank was merged with Eesti Pank and when Estonia introduced its own currency, the kroon, in June 1992.

The banks which continued the work of the branches of the old specialized state-owned banks of the USSR were reorganized into Estonian entities and privatized. However, this process has not been entirely smooth. In 1994 there are still some unresolved ownership issues among these old banks. The banks were reestablished as separate legal entities and new shares were issued to the public in excess of the initial government holding. The banks were privatized on an ad-hoc basis without reference to the Privatization Agency which was established to privatize the remainder of the economic sector. The procedures were not openly questioned before privatization of the Savings Bank was initiated by Eesti Pank. An open competition was declared to sell 1/3 of the shares of the Savings Bank to the bank presenting the best plan for developing the Savings Bank. The process has later been publically questioned and the matter taken to court.

The former branch of the Soviet Promstroibank was liquidated only in October 1993 but its main assets were transferred to the Estonian Bank of Industry and Construction (Eesti Tööstuse ja Ehituse Kommertspank) already in 1990. The Estonian authorities split the bank into two legally separate institutions because the bank faced serious portfolio problems having financed mainly Soviet state owned industrial companies at subsidized interest rates (World Bank 1993). For almost three years there existed two banks with the same name but different balance sheets. However, the former Soviet branch did not carry out any activities during this period (Estoniya, October 20, 1993).

The former branch of the Soviet Zhilsotsbank was reorganized into the Social Bank (Eesti Sotsiaalpank), which mainly served governmental organizations and municipalities. As a result of the restructuring and privatization of the bank there are more than 50 companies among the major owners. According to Estonian press (Äripäev, Oct 29, 1993) there is also a group of Russian businessmen among the owners of the Social Bank, which has caused some political concern in the country. In August 1994 Eesti Pank declared a moratorium on the Social Bank which faced difficulties after the state treasury withdrew deposits from the bank. As a rescue operation the bank decided to sell the majority of its shares to the Development Bank (The Baltic Observer, August 11-17, 1994).

The Social Bank has also given birth to other new banks. Two of its earlier branches became independent banks, the Revalia bank in Tallinn and Narva Pank in Narva. In 1993 both of these banks went bankrupt. A moratorium was declared on Revalia Bank in January 1993 (Äripäev MAY 18, 1993) and bankruptcy proceedings started. Narva Bank was also declared insolvent, and a moratorium declared in July and bankruptcy in December 1993 (Baltic Observer 56/93, Baltic News Service March 19,1993, Baltic Business News, July 27, Hommikuleht, Dec. 15, 1993). Both Revalia Bank and Narva Bank had engaged in extensive connected lending to enterprises which held their shares.

The 14 branches of the former Soviet Agroprombank were also separated from the Soviet parent and formed the Estonian Landbank under the Estonian government (Sõrg, 1991). Most of the branches of the Landbank subsequently became independent regional banks in May 1992. At the beginning of 1993 ten of these were merged to form the Union Bank of Estonia. The move was necessitated by the new minimum capital requirements, which the small regional banks could not fulfill (Quarterly Review of the Bank of Estonia 2/93). The remaining regional offices and branches of the Landbank were also reorganized into a joint stock company in 1992 (Estonija, October 11, 1993).

The situation of the Savings Bank was rather peculiar in Estonia. The bank continued to be connected to the Soviet Gosbank, because the Soviet banking legislation secured the assets of the savings banks as property of the former

USSR. It was possible for the Soviet republics to separate the savings banks from the Gosbank system on the condition that the republic assumed that part of the Soviet state debt which has been financed by savings collected from the republic. In Estonia this requirement would have taken all the assets of the savings banks. For this reason deposits in the savings banks had also declining during 1990 and the amount of cash in circulation had increased. (Sörg 1991)

Eesti Pank became the owner of all the shares of the Savings Bank and guaranteed all the deposits of the bank in 1991. As described earlier, the privatization process of the bank was initiated in 1993, when the central bank declared a competition among banks to buy a third of the bank's shares. Hansapank won the competition on the best development scheme and subsequently bought a third of the shares. However, the Estonian government has later been accused of violating the privatization law and the matter was to taken to court for settlement.

The Estonian branch of the Soviet Vneshekonombank was transformed into a department of the Eesti Pank in 1990. Later all the commercial transactions of the central bank were transferred to North Estonian Bank Ltd, which later merged with the Union Baltic Bank and was recapitalized by the central bank after the losses incurred when Vneshekonombank froze their accounts.

In the course of this process the bank was first privatized but then renationalized as a result of the recapitalization and rescue operation of the Bank of Estonia. Thus the bank faces the need for reprivatization in the future.

The Estonian Investment Bank was founded in February 1992. The Investment Bank was needed because the Central Bank could not borrow from abroad and there was a large demand for loans in hard currencies to finance investments in the country. The central bank is the major shareholder of the bank. The European Bank of Reconstruction and Development (EBRD) became a minority shareholder in January 1993. The bank has also received considerable technical aid from the Nordic Investment Bank. The bank plans to provide financing for investments which are too large for the commercial banks and too small for the EBRD.

3.2 The development of the commercial banks and the banking crisis in 1992–93

In the new Estonian commercial banking sector reform started in 1989 when the Tartu Commercial Bank (TCB) was founded. TCB was the first commercial bank established in the Soviet Union under the renewed Soviet banking legislation of perestroika. In 1990 it was given foreign exchange rights after consultation with Eesti Pank. TCB was also the first Estonian bank to go bankrupt at the end of 1992. However, TCB has also given birth to another bank, Hansapank, which in 1994 has become the largest bank in the country. Hansapank started operations as the Tallinn branch of TCB and became independent at the beginning of 1992 as a result of management buyout (Korkeamäki, p. 36).

By the end of 1990 12 new commercial banks had been issued licences by Eesti Pank and 5 others were in the process of applying for a license. By the end of 1992 the number of commercial banks had risen to 42, including the banks which had been created on the basis of the old Soviet branches of the state-owned banks. By that time, however, significant problems had already started to surface in the banking industry. In addition to TCB, which was declared bankrupt and liquidated later on, two other banks, the Union Baltic Bank (UBB) and the North Estonian Bank (NEB) had run into financial difficulties.

While the cause of problems in TCB was unprofessional management, inherited from the Soviet banking culture and its soft budget constraints, the main reason for the problems in the two other banks was the freeze on assets deposited at the Vneshekonombank in Moscow. Eesti Bank rescued these two banks by merging and recapitalizing them. This was accomplished by issuing government bonds in the equivalent amount of the frozen assets. In all these cases the financial problems of the banks were connected with the old Soviet banking system. The bankruptcies of Revalia Bank and Narva Bank were examples of unhealthy insider practices, as pointed out above, and the connected lending and dividend policies of the owners of the bank.

In 1993 the restructuring of the banking sector was speeded by the failure of 8 smaller commercial banks, which could not comply with the new minimum capital requirements of the Bank of Estonia. In addition, a wave of mergers or closures among the smallest land banks brought the number of banks down to 22 by the end of 1993 (Eesti Pank Quarterly Review 1993:1, pp. 30–33)

The banks which have survived the Estonian banking crises of 1992 belong to two different groups. First there are the former state-owned banks, which have been corporatized and privatized as a result of the privatization of the owner companies. Secondly, there are the "second wave commercial banks", which started operations after 1991. The largest "first-wave commercial banks" created between 1989 and 1991 have left the scene.

The reasons for the bank failures, in addition to those that were due to the frozen assets at Vneshekonombank, have been identified above mainly as incompetent management or bad insider practices in the failing banks. As these were mainly banks of the "first wave of commercial banks", one is tempted to conclude that the reason behind the failures was a deficient understanding of the risks entailed in banking. Secondly, these banks started operations in an environment which was very difficult to control. The Estonian economy was still a part of the ruble zone and the soft lending practices prevalent in the zone were also adopted by the newly created banks. Thirdly, as opposed to the state-owned banks, the first wave of privately owned banks did not have recourse to the state when they faced difficulties.

The central bank has been complimented for the swiftness with which it has tackled the major problems of the banking sector. In order to understand the magnitude of the problem it suffices to realize that the three large banks that experienced financial difficulties in the fall of 1992 accounted for almost 1/3 of the total balance sheet of the Estonian banking sector (Ross, p. 4). On the other hand, the problems were solved with relative ease, because the significance of the banking sector was still limited in the economy. Banks were generally regarded as unreliable and the move of the central bank was deemed necessary to enhance the credibility of the banking sector as a whole.

The main institutional developments in the Estonian banking sector from 1988 until 1993 are summarized in chart 1.

Chart 1. **Major institutional developments in the Estonian banking sector from 1988 until 1993**

1988–1989	1990–1991	1992–1993
Central Bank		
The Tallinn branch of Gosbank	Eesti Pank (The Tallinn branch of Gosbank)	Eesti Pank
State owned banks of the former USSR		
Branch of Promstroibank	Estonian Bank of Industry and Construction (Promstroibank)	Estonian Bank of Industry and Construction
Branch of Zhilsotsbank	Estonian Social Bank Revalia Bank Narva Bank	Estonian Social Bank Revalia and Narva Banks placed under moratorium
Branches of Agroprombank	Estonian Landbank + several independent Landbanks	Estonian Landbank Union Bank of Estonia
Branches of Sberbank	Estonian Savings Bank (under Gosbank)	Estonian Savings Bank
Tallinn branch of Vneshekonombank	Foreign exchange rights given to Eesti Pank	North Estonian Bank privatized in 1992 but taken over by Eesti Pank in 1993 Estonian Investment Bank
The new commercial banks		
Tartu Commercial Bank Innovationbank EVEA Bank Esttexbank and a few other privately owned banks were established	12 commercial banks established by the the end of 1990	total number of banks 42 by the end of 1992 and 23 by the end of 1993 3 banks placed under moratorium in 1992 first foreign bank American Baltic Bank Hansapank became independent in 1992

Table 1. **Assets of Estonian Authorized Banks December 31, 1993**

	mill. Kroon	Share of total balance volume
Eesti sotsiaalpank Estonian Social Bank	1 035	15.5
Hansapank	989	14.8
United Bank of Estonia Union Bank of Estonia	890	13.3
Pohja-Eesti Pank North-Estonian Bank	832	12.4
Eesti Hoiupank Estonian Savings Bank	777	11.6
Eesti Tööstuse ja Ehituse Kommertspank, Estonian Commercial Bank of Industry and Construction	388	5.8
Tallinna Pank	341	5.1
Eesti Maapank, Estonian Land Bank	231	3.5
Virumaa Kommertspank Virumaa Commercial Bank	170	2.5
Eesti Investeerimispank Estonian Investment Bank	127	1.9
ERA Pank	116	1.7
Raepank	115	1.7
EVEA Pank	108	1.6
Esttexpank (Development Bank)	80	1.2
Eesti Krediidipank Estonian Credit Bank	80	1.2
Nowe Pank	79	1.2
Rahvapank	79	1.2
Eesti Forekspank	76	1.1
Keila Pank	69	1.0
Eesti Innovatsioonipank Estonian Innovation Bank	54	0.8
Ameerika Balti Pank	24	0.4

Source: Eesti Pank Quarterly Review 1993/4, Baltic News Service February 22, 1994.

By the end of 1993 the number of banks in Estonia had diminished to 22. Table 1 lists the authorized banks and their assets December 31, 1993. The five largest banks, Social Bank, North-Estonian Bank, Hansapank, United Bank and Savings Bank together account for slightly more than two-thirds of the total banking assets of the country.

During the first months in 1994 Hansapank and Union Bank surpassed the Social Bank as the largest bank of the country mainly because the state treasury moved a part of its deposits from the Social Bank to other banks (Baltic News Service, April 17, 1994).

4 Development of banking activities

The activities of the Estonian commercial banks have also undergone significant changes during the restructuring period. Payment transfers among the Estonian banks were notoriously slow in 1991–92 and culminated in liquidity problems throughout the banking sector in the fall of 1992. The situation has improved greatly since the restructuring of the banking sector in 1993. Most payments within Tallinn can presently be effected within the 48 hours determined by the central bank as the maximum transfer time for interbank settlements. However, payments to other cities often take longer. Foreign payments are transferred quickly through the Swift-network, which the major Estonian banks joined in December 1993. Payments to and from Russia and other CIS countries are mostly effected in convertible currencies through bank accounts in third countries.

From the corporate customers point of view the banking services were very unreliable until the middle of 1993. One assessment is provided by a survey on the direct investments of Finnish companies in Russia and the Baltic states carried out by the Bank of Finland in June 1993. The survey included questions concerning the availability and quality of banking services in Russia and Estonia. According to the survey results the banking services in both countries were generally considered poor. However, the experiences of the Finnish companies in both domestic and foreign payment transfers were somewhat better in Estonia than in Russia. The availability of credit from the banks was considered equally difficult in both countries (Laurila, 1994. p. 17).

In 1991 and 1992 most Estonian banks engaged in foreign exchange operations which brought in large profits. In the highly inflationary conditions of those years nominal interest rates were very high but real interest rates were negative and companies could not provide acceptable collateral for loans and consequently banks scarcely engaged in even short-term lending activities. In 1993 competition among the banks in the foreign exchange business brought the margins down and the profitability of that business decreased. Consequently banks increased cautious short term lending mainly to finance trade. However, the willingness of banks to provide long-term financing to Estonian companies is still low. In effect, most banks face the problem of overliquidity, as low-risk investment opportunities are scarce.

The income statements of Hansapank for the years of 1992–93 provide a good illustration. The income of the bank almost tripled from 1992 to 1993. However, the share of foreign exchange income of the total income decreased from about 48 % in 1992 to 36 % in 1993. At the same time the share of interest income increased from 21 % in 1992 to 40 % in 1993. Also the balance sheets of the bank for the same years reflect the shift in activities. The share of loans in the total assets of the bank rose from 20 % in 1992 to 31 % in 1993. Simultaneously the share of cash and cash equivalents diminished from 76 % in 1992 to 58 % in 1993. At the same time the balance sheet total also grew by 60 % (Hansapank Annual Report 1993).

For the Estonian banking sector in general the balance sheet development since the beginning of 1993 is summarized in tables 2 and 3. Comparisons to earlier figures are made difficult by the new way of reporting for commercial banks, which was introduced at the beginning of 1993.

Table 2. **Deposit money bank's accounts in 1993–94 (million kroons, end of period)**

Assets	Jan–93	June–93	Dec–93	March–94
Reserves	977.6	1079.2	1437.4	1346.0
Cash	*234.9*	*265.8*	*349.3*	*307.7*
Deposits with BOE	*742.7*	*792.8*	*1028.4*	*978.6*
required reserves	*726.4*	*568.4*	*679.4*	*777.1*
Claims on BOE	*0*	*20.5*	*59.7*	*59.7*
Foreign assets	813.0	774.4	1055.3	1139.5
Kroons	2.7	2.8	2.5	46.9
Claims on general government	305.8	310.4	294.6	293.4
Claims on other fin. institutions	18.3	7.1	8.7	4.1
Claims on nonfin. public enterprises	405.0	473.0	416.7	372.5
Claims on private sector	925.2	1333.5	2348.5	3037.5
Businesses	*879.5*	*1236.4*	*2169.5*	*2778.3*
Individuals	*45.8*	*97.1*	*179.0*	*259.2*
in foreign currency	*123.2*	*155.5*	*158.5*	*136.7*
Other assets	561.3	633.5	534.2	703.6
Fixed assets	*75.1*	*154.0*	*242.1*	*305.5*
Credits in transit	*53.8*	*40.1*	*52.2*	*38.4*
Claims on banks	*215.6*	*159.0*	*103.2*	*215.6*
Other	*216.7*	*280.3*	*136.8*	*144.1*
Total Assets	4006.2	4611.0	6395.5	6896.6

Source: Eesti Pank Quarterly Review 1993:4; Eesti Pank Information Service publication of May 15, 1994.

Table 3. **Deposit money bank's accounts in 1993-94 (million kroons, end of period).**

Liabilities	Jan-93	June-93	Dec-93	March-94
Demand deposits	1502.3	1985.7	2845.6	2788.6
Nonfinancial public enterprises	*573.5*	*615.4*	*654.7*	*783.4*
Private sector	*898.5*	*1353.2*	*2161.8*	*1979.0*
Business	*577.9*	*836.6*	*1402.4*	*1178.4*
Individuals	*320.6*	*516.5*	*759.4*	*800.6*
Time deposits	110.4	258.6	516.1	593.4
Savings deposits	33.7	37.5	55.8	59.7
Foreign currency	579.4	150.1	279.7	400.1
Debt certificates	0.3	0.2	0.7	0.6
Counterpart fund	40.4	70.7	114.3	129.3
Government lending funds	11.4	58.8	104.9	151.1
Foreign liabilities	37.7	96.2	199.0	257.5
General government	404.8	514.8	916.7	1019.2
Liabilities to BOE	273.5	356.0	329.7	245.3
Bank capital	337.3	548.2	679.5	640.6
Other liabilities	675.0	534.3	353.5	611.3
Items in transit	*0*	*39.2*	*119.1*	*265.4*
Other banks	*122.1*	*147.6*	*91.8*	*204.6*
Other	*552.9*	*347.5*	*142.6*	*141.3*
Total Liabilities	4006.2	4611.0	6395.5	6896.6

Source: Eesti Pank Quarterly Review 1993:4; Eesti Pank Information publication, May 15, 1994.

The total assets of the Estonian banks grew in 1993 by 50 % and during the first quarter of 1994 by a further 6 %. The growth in assets has mainly taken place in loans to the private sector, whose share had increased from 25 % to 45 % of the total assets by March 1994. However, cash reserves deposited with Eesti Pank and foreign currency deposits with foreign banks were still larger than the loans extended to the private sector at the end of 1993. By March 1994 both of these items had diminished from the year end level and the volume of loans had grown larger. The credits in transit diminished considerably from 1992, which testifies to the increased efficiency of the banking system in transferring payments.

Among the liabilities of the banks growth has come mainly from demand deposits of the private sector, which account for 40 % of the total at the end of March 1994. However, their growth stopped after December 1993. The fastest growing items have been time deposits, which also grew in the first quarter of 1994. Foreign currency deposits dropped fast during the first months of 1993 but have started to grow again after that. Most probably the loss of confidence in the whole banking sector after the banking crisis of 1992 was reflected particularly in the withdrawal of foreign currency deposits from the banks. Liability items in transit have increased considerably in 1994, which probably reflects the changes taking place in the placement of the government funds. Liabilities to other banks also increased in 1994, which probably reflects growing confidence among the banks on each other.

also increased in 1994, which probably reflects growing confidence among the banks on each other.

The maturity structure of the loan portfolio of the banks has also started to change. As in April 1993 short term loans of up to 6 months accounted for 54 % of the total loan portfolio, that share had decreased to 37 % by March 1994. Most of the loans have been extended to companies. The share of individuals of the total loan portfolio of the banks reached only 8 % at the end of 1993 (Eesti Pank Information Service Publication, May 15, 1994).

The level of lending interest rates has decreased constantly from January 1993, when the average interest rate charged for a 3 month loan was 38 %. In December it was about 28 % and the level has not changed greatly in the first months of 1994. Long-term interest rates were considerably lower than the short-term rates, which reflects lower inflation expectations in the future. However, the interest rate development during the last few of months is surprising, because contrary to expectations inflation is expected to reach the level of 40–50 % for the whole year of 1994. This means that the real interest rate has again become negative.

Deposit interest rates have also decreased but at a slightly slower pace than the lending rates. Therefore the interest rate margin of the banks has also decreased. Tables 4 and 5 illustrate the average lending and deposit rates of Estonian banks.

Table 4. **Weighted average annual interest rates of loans granted to individuals and companies by commercial banks, by types of loans Oct 1993 - Mar 1994.**

	Oct	Nov	Dec	Jan	Feb	Mar
TOTAL	28.50	27.10	25.40	26.55	24.58	23.27
1. Short-term loans total	29.60	27.80	27.30	28.02	26.13	24.83
up to 1 month	30.90	30.90	31.40	36.33	29.00	27.77
1 - 3 months	32.70	28.10	29.20	26.43	26.16	27.9
3 - 6 months	30.20	26.00	30.40	27.86	27.48	23.92
6 - 12 months	25.10	27.30	22.10	24.00	24.04	22.62
2. Long-term loans total	20.10	21.70	16.50	17.17	16.20	17.50
1 - 3 years	25.30	27.40	21.90	21.80	17.20	18.21
3 - 5 years	12.70	14.40	12.10	13.90	16.20	16.65
over 5 years	7.60	15.30	9.60	7.20	10.16	10.40

Source: Eesti Pank Information Service Publication, May 15, 1994.

Table 5. **Weighted average annual interest rates of deposits with commercial banks in Oct 1993 - Mar 1994**

	Oct	Nov	Dec	Jan	Feb	Mar
Demand deposits*	2.67	2.64	2.64	2.58	2.67	2.74
Time deposits**	14.20	13.90	12.69	11.48	12.30	11.58

* calculations based on net deposit balance
** calculations based on monthly turnover

Source: Eesti Pank Information Service Publication, May 15, 1994.

The problem of bad debts has not been fully resolved and even an estimation of the magnitude of the problem is made difficult by the uninformative accounting practices. Until the beginning of 1994 the definition of a bad or non-performing loan was unclear and the banks were free to report loans past due to the central bank each according to their own understanding of the term. According to Eesti Pank, loans past due, registered in this way, amounted to 6.8 % of the total outstanding loans at the end of 1992. How correctly this figure reflects loans that were simply rolled over and amounts of unpaid interest that were capitalized can only be guessed.

In the first half of 1993 the share of non-performing loans as reported by the central bank rose to above 10 % but diminished to 6.8 % of the total again by the end of 1993 (Eesti Pank Quarterly Review 1993:3, pp. 26 and 65). Most of the loans past due in 1993 had been unserviced for at least three months (Eesti Pank Quarterly Review 1993:4, p. 62).

After the new stipulation to write off all loans which had not been serviced for at least 150 days, the past due loans amounted to 2.9 % of total loans outstanding in March 1994 (Eesti Pank information service, May 15, 1994). Thus almost half of the non-performing loans of the banks had been written off since January when the regulation took effect. By this measure all the non-performing loans inherited from the old Soviet system must also have been written off.

Since the introduction of the Estonian kroon, payments to and from Russia have mostly been carried out as advance payments in convertible currencies. Although a payments agreement was reached with Russia at the time of the currency reform, direct payments with Russia functioned poorly for many months. Cash payments in rubles, although illegal were accepted in companies which depended on their Russian trading partners. Barter transactions were also common. Eesti Pank did not quote the ruble, which increased the initial payment difficulties. Over time several banks began to specialize in trading ruble and other currencies of the former USSR republics, which has improved the flow of payments (Bennett, p.5, Hansson, p.12, Sepp, p. 23).

It can be assumed that payment arrears have probably not accumulated in Estonia after the currency reform to the same extent that they have plagued the Russian companies. High Russian inflation has also wiped out any ruble receivables that the Estonian enterprises may have had from Russia. Within Estonia there is evidence of arrears, particularly in tax payments. Tax authorities both on the level of central government as well as on the local level are coping with the problem.

There was practically no interbank money market in Estonia until the end of 1993. The budding developments in that sector received a hard blow from the bank failures in 1992. The banks had first to prove to each other that they are trustworhty partners before those markets could develop. In order to facilitate this development the Central Bank started to issue CDs in 1993.

Although the capital markets are still underdeveloped in Estonia, most of Estonian banks are developing their activities towards universal banking and plan to engage in investment banking in addition to the traditional commercial banking activities. Among the leading banks, Hansapank, has arranged a few share issues in the Tallinn stock exchange and started leasing operations.

Although until now the restructuring process of the banking system has gone relatively quickly, the banking sector is facing big problems in finding enough qualified personnel to carry out the increasingly complex banking services. This task has been helped by the small size of the country, which has made it relatively easy to invest in computer networks. However, there is a lack of qualified credit analysts who could serve the banks in identifyng the risks involved both in increased lending to local companies and in new instruments designed to manage various kinds of banking risks.

5 Foreign investments into the Estonian banking sector

Foreign investments in the Estonian banking sector became possible in 1992. The first foreign-owned bank, the American Baltic Bank, started operations in 1993. Three Finnish banks have set up representative offices in Tallinn and two of them, The Union Bank of Finland and Kansallis-Osake-Pankki, plan to open a branch in Tallinn by the end of 1994. Foreign investment in the banking sector is favoured by the central bank, which sees them as a means to increase competition and proficiency among the Estonian banks.

In addition to western banks, several Russian and Ukranian banks have expressed interest in establishing a subsidiary in Estonia, but so far no Russian bank has received a banking license. Recently a Ukranian bank has shown interest in acquiring the bankrupt Revalia Bank. There is political resistance in Estonia against the inflow of Russian capital. There are also growing fears among the Estonian bankers that the entrance of Russian banks would significantly increase the problems of money laundering and fraud which are plaguing the Russian banks.

The influence of Russian capital in the Estonian banking sector is, however, not limited to the possible entrance of new Russian owned banks into the country. The branches of the former Soviet banks were separated from their earlier parent banks and became independent joint stock companies under Estonian law. In practice a significant number of the shares of these banks was held by the former Soviet state-owned companies. These, in turn, have been corporatized and privatized, often by so-called insiders, the Russian managers of these companies. As a result there is still significant Russian ownership in some banks. As there is political resistance towards the Russian influence in the economy, these banks have also fallen victim to this attitude. Recently the Social Bank, which continued the work of the former Soviet branch of Zhilsotsbank in Tallinn, was hit hard by the decision of the government to withdraw the deposits of the state treasury from it.

6 Concluding remarks

Estonia has been praised for the speed and efficiency with which the national currency – the kroon – was introduced, and the stability of the economy since the introduction of the currency. However, there are some critics who argue that the legally regulated tie of the "hard kroon" to the German mark will be very difficult to break without creating pressures against the kroon (see for example Baltic Business Weekly, September 13, 1993). For banks the tie with the German mark has provided a natural hedge for their considerable currency positions. Breaking that tie would also introduce new risks in the banking sector. The possibilities of the banks to manage such risks would depend very much on the monetary policy of Eesti Pank and the ensuing stability of the Kroon.

The increasing minimum capital requirements for the banks will most probably cause another wave of mergers among the Estonian banks during the next few years. Nobody can say what is the "right" number of banks for Estonia, although 22 banks does seem a large number to serve 1.5 million people. Competition among the banks is also likely to increase and bring profits down.

The banks will be facing increasing challenges in developing their skills in credit analysis and management of new sophisticated instuments. Early computerization of the operations will help them in this task, but it will also require continuous training of personnel. Identifying credit risks is probably the most difficult task in an environment that is changing very fast and still characterized by non-transparent accounting practices.

To what extent could the Estonian banking sector developments be repeated in Russia and other parts of the former USSR? The closest parallels are in the other Baltic countries Latvia and Lithuania, which have both introduced national currencies of their own. Latvia in particular is facing a situation where the number of banks is most likely to decrease from the present level of about 60.

As far as Russia is concerned, the circumstances in Estonia are so different that close parallels cannot be drawn. However, the situation of Russian banks can in many ways be judged even more difficult than that of Estonian banks. Inflation in Russia has been much higher than in Estonia. The ruble has depreciated greatly since 1992, when it became convertible. The problem of interenterprise arrears is probably much larger in Russia than in Estonia and the number of banks is much greater there than in Estonia. Consequently, one could assume that there are also large problems in the Russian banking sector, which could surface if the Central Bank continues to pursue a tight monetary policy.

In the Estonian banking industry the break with the past, when the banks were an organic part of the Soviet banking system with its soft budget constraits, has proven problematic. Politically a clear break has taken place as Estonia regained her independence. However, economically the break is not so clear. There is a lot of trading going on between the countries, which is economically justified but not necessarily politically acceptable. Also, Russian economic interests in the Estonian economy and banking sector are becoming more pronounced after the initial reorientation of the Estonian economy towards the West. How the banking sector will react and develop is also going to depend on general political relations between the two countries.

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