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Financial services sector in Estonia: growth opportunities and policy implications

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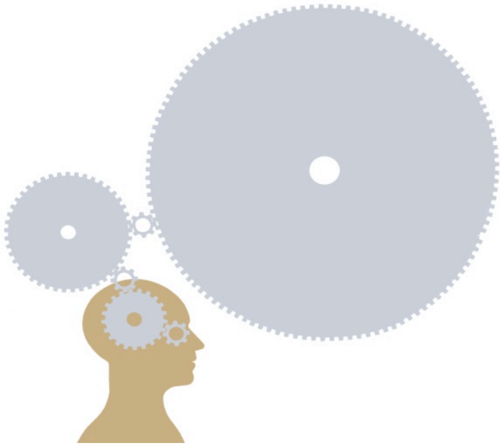

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Overview

- objectives and remit
- attractiveness of financial centres
- attractiveness of Estonia
- conclusions and policy implications

Objectives and remit

- what is the growth potential of the Estonian financial services sector?
  - different segments, parts of the value chain
- what are the policy options to facilitate growth?
  - lessons learned from other cases, timeframe, priorities
- focus on ‘exports’ of financial services
  - rather than growth potential of the sector per se

Exports of financial services:

- cross-border sales of financial services
- outsourcing of certain activities (constituting part of the value chain in the provision of financial services) to Estonia from foreign jurisdictions
  - external or internal

Background to the study
What is happening in the financial services sector?

- progressive concentration of financial services in centres
  - focus on leading international financial centres
  - niche centres with specific focus in small jurisdictions
  - regulatory and political focus on ‘offshore’ centres
- global turmoil in financial markets, global recession
  - unsustainable industry model leading to reform of the financial sector
  - some financial institutions feeling ‘less welcome’ in some jurisdictions
  - potentially some repositioning of financial centres (no revolution to date)
- limited outsourcing of financial services to Central and Eastern Europe (CEE)
  - focus on investments to service the local market
  - missed opportunity to date?
- this creates opportunities and threats
  - how to put Estonia 'on the map' for international financial institutions?

Summary of key points

- broadly positive attractiveness picture for selected areas of activity
  - Estonia might not be ready to exploit opportunities in the short term …
- not a ‘stand-out’ location for international firms
  - neither among CEE countries nor internationally
  - ‘exotic’ connotation in comparison with leading niche centres
  - economic crisis can have significant impact on perception
- strong alternatives in CEE and internationally
  - Nordic link is one of the key (positive) distinguishing factors
- potential basis for growth in exports in the medium to long term
  - providing significant demand for these services materialises
- attractiveness could be increased through targeted policies
  - significant effort necessary—policies can make a difference
  - what target? What probability of success?

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How firms think about location choice?
Need to consider functions within the value chain

- firms tend locate most activities where demand is
  - the default choice driven by convenience, customer perception, familiarity
  - many segments of financial services still less global than, eg, manufacturing
- where firms move away from this position (and export services)
  - decisions are (often) made for individual functions within the value chain
  - choice of location generally comes down to cost–benefit considerations
  - concentration is critical due to significant economies of scale
- distinguish between different functions in the value chain, across segments
  - front office
  - core functions
  - middle and back office
- not all functions/segments can be easily exported
  - for example, retail banking relatively difficult to export

Topology of the financial services sector—examples of activities

Parts of the value chain cut across different segments

Parts of value chain	BANKING			INSURANCE		ASSET MANAGEMENT				SECURITIES MARKETS		
	Retail	**Investment**	**Private**	**Life**	**Non-life**	**Investment funds**	**Pension funds**	**Hedge funds**	**VE, PE**	**Equity**	**Debt**	**Deriv-atives**
Front office functions	Sales Marketing Distribution Branch network	Origination Sales Relationship banking	Sales Customer relationship management Tax advice	Marketing Sales and distribution Claims management		Different distribution channels Marketing Sales Business development				Marketing Sales		
Core functions	Financial operations Financial intermediation Risk management Product development	Advisory Securities underwriting Trading and brokerage Custody services Research	Global custody Product sourcing Investment research and management Trust administration	Underwriting Risk management Asset management Product development		Investment research Operational and strategic asset management Buying and selling of investments Pre- and post-trade broker liaison				Order book Market making Issuance Market supervision		
Middle/back office functions	Accountancy IT systems Administration	Electronic trading support IT systems Clearing and settlement Accountancy and legal Compliance	IT systems Settlement Securities processing Accountancy	Administration Accountancy IT systems		Transaction processing and settlement Custody and stock lending Support systems (eg, IT) development and maintenance Investment and financial accounting Compliance Corporate management				Information dissemination Data and statistics IT systems		

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How firms think of location choice
What factors are key for consideration?

Costs	Labour	Proximity	Infrastructure	Taxation and regulation	Other
Labour Property Transport IT and communications systems Financial infrastructure	Labour market flexibility Size of (skilled) labour pool Supporting professional skills (management, accountancy, legal, IT) Knowledge of the markets	Geographic proximity of countries Cultural links Knowledge of language	Financial infrastructure (eg, trading systems) Sophisticated IT systems Links to supporting services (eg, accountancy) Communication technologies Transport links (eg, air travel)	Overall tax burden Taxation of employees Taxation of investors (eg, capital gains tax, double taxation treaties) Regulation of financial services products Consistency of regulatory and tax regime	Institutional and market framework Political and economic stability Level of corruption Business environment Quality of life Clustering effects

The importance of these factors varies across segments, parts of the value chain, and according to financial institutions' considerations and perceptions

What makes centres attractive?
Drivers of success for small financial centres (I)

- attractive location (compared to alternatives)
  - scores well on those factors that firms value for particular functions
- cultural links
- relatively well-developed financial services industry
  - even if geared towards local demand
- clustering of similar financial services firms—'chicken and egg' problem
- regulation and taxation
- takes time to become a successful centre
  - external factors also play a role

What makes centres attractive?
Drivers of success for small financial centres (II)

- highly successful small centres tend to be niche markets (specialisation)
  - eg, focus on fund registration, processing, private banking
- including Dublin, Jersey, Luxembourg, Monaco and Switzerland
  - continuous repositioning across centres—eg, from Luxembourg to Dublin

Dublin

- since the 1990s Dublin has developed into a successful financial centre
- attractive location for financial services firms
  - proximity to the UK; language; low corporate, personal and other taxes; etc
  - familiarity
  - human capital already employed in the UK and US financial services sectors
- favourable 'external' factors
  - rapid advancement and adoption of IT and communications technologies globally which increased the flexibility/mobility of institutions
  - (unfavourable) changes in taxation in other countries
- proactive policies aimed at attracting financial services firms

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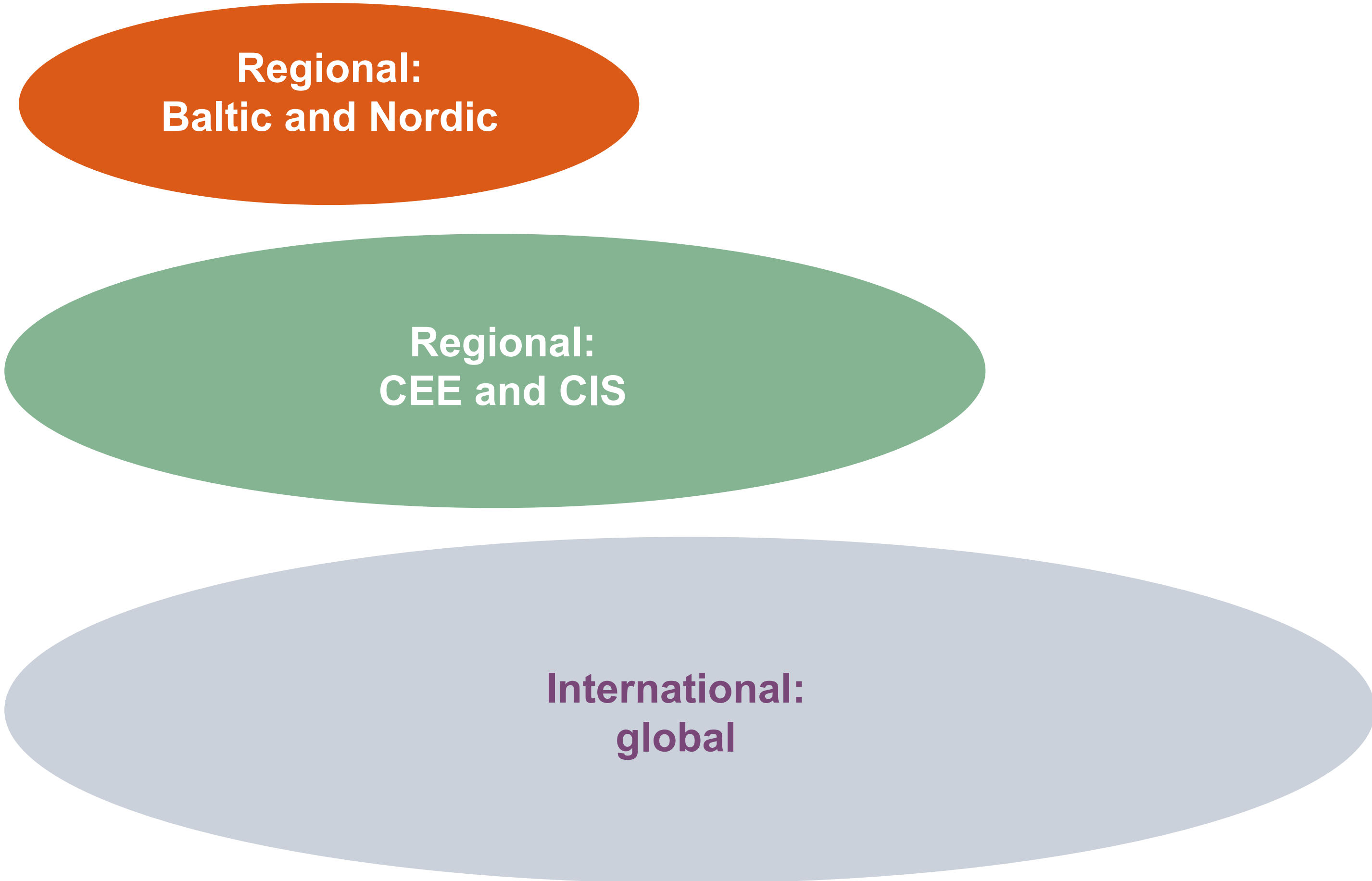
Positioning the Estonian financial services sector
Relevant geographic frame of reference (I)

- what is the relevant geographic frame of reference?
  - ie, the group of countries in which financial services firms consider Estonia to be included when they consider location
- relevant considerations include
  - geography of the potential source of demand
  - geographical considerations of financial services firms
- financial institutions consider how to service different markets efficiently
  - service the global UCITS market from Dublin
  - manage European equities from Paris
- do large countries try to position themselves as financial centres for the region—eg Poland, Turkey, Sweden?
  - but London and Dublin now coexist and exploit synergies

Positioning the Estonian financial services sector

Relevant geographic frame of reference (II)



Positioning the Estonian financial services sector
Current state of different financial services segments

- the current state of each financial services segment matters
    - sufficiently developed to facilitate export-driven growth?
- the sector in Estonia is relatively well developed (compared with peers)
    - most segments compare favourably on normalised size and sophistication
    - securities markets (and related banking activities) stand out as underdeveloped
    - this is relative to the small size of the economy
- for example, assets under management to GDP (of asset management firms) in Estonia
    - similar or higher than CEE peers
    - considerably lower than Noridic countries
- most (relevant) segments and parts of the value chain have the basis to be *sufficiently* developed for exports

Potential for growth in exports
Selected segments and functions

Three areas of activity selected based on development, exportability and geographic frame of reference

1.core functions and back office functions in asset management

- particularly with respect to management of investments in the region
- private equity and alternative investments

2.front office functions, core functions and back office functions in private banking (in niche markets)

- particularly with respect to selected regional markets (Russia and other CIS countries)

3.back office functions in banking, insurance and asset management

- particularly with respect to processing functions

Other segments and functions might be also attractive—this is not an exhaustive list

Factors driving attractiveness of location
Matching functions and segments to factors (I)

- **core functions and back office functions in *asset management***
  - labour and property costs, labour productivity
  - availability of qualified, skilled, well-educated workforce
  - geographical, cultural and economic proximity to clients, and existing relationships
  - IT and communications technology, technical capabilities supporting financial services
  - favourable regulatory and tax regime

Functions driving attractiveness of location
Matching functions and segments to factors (II)

- **front office functions, core functions and back office functions in *private banking***
  - availability of qualified, skilled, well-educated workforce
  - proximity to markets and clients
  - geographical, cultural and economic proximity to clients, and existing relationships
  - favourable regulatory and tax regime

- ***back office functions* in banking, insurance and asset management**
  - labour and property costs, labour productivity
  - size of labour pool with appropriate skills, labour flexibility
  - information technology and communications systems
  - inexpensive and efficient regulatory and tax regime

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Attractiveness of Estonia as a location
Critical factors (I)

- **labour and property costs, productivity**
  - labour costs and property significantly lower than EU27 average, but similar to those of other countries in the Baltic and CEE regions
  - however, costs need to be weighted against the lower productivity of labour and potentially lower perceived attractiveness of Estonia when compared with more developed countries

  - **labour pool size and quality**
  - generally relatively well-educated workforce compared with the EU27 average
  - however, (perceived or actual) scarcity of people with relevant business education and skills
  - although mixed evidence on this, there appears to be a small but critical mass of workers already employed in wealth management who could facilitate growth of niches
  - mixed evidence on general labour market flexibility

- **geographic and cultural proximity**
  - Estonia is favourably positioned in terms of geographic, cultural and economic proximity to Nordic, CEE and CIS clients
    - advantages in terms of languages, familiarity, close existing links, relevant know-how
  - but other countries in the region may be similarly or better positioned
  - furthermore, some links may be undermined by political relationships or practical obstacles

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Attractiveness of Estonia as a location

Critical factors (II)

- **technical capabilities**
- good technical capabilities including IT and communications systems, low technological barriers —Estonia mostly scores better than other countries in the Baltics and CEE
- good financial services infrastructure

- **regulatory regime**
- the regulatory regime in particular, and financial services regulation and supervision more generally, compare well against relevant comparators

- **tax regime**
- some favourable aspects, such as flat -rate income tax, which may be important for high-value-added services
- but: mixed evidence, since the overall tax burden is not as low as some comparators
- some specific issues—eg, lack of double taxation agreements with some countries

- **quality of life**
- Estonia scores poorly overall

- **performance and liquidity of markets**
- securities markets are significantly underdeveloped and very ‘thin’

What are the main strengths and weaknesses?

- **strengths**: geographic and cultural proximity to selected markets; ‘attitude’ of regulatory and supervisory authorities; perception in the region (at least before crisis); level of costs; technical capability; perceived or real technical skills (eg, IT)
- **weaknesses**: perception in the global markets/business community; potentially insufficient pool of labour with the relevant skills and education; quality of life; (some aspects of) the tax regime; low development of securities markets
- not all weaknesses need to be addressed, but some are critical
- examples of main obstacles across functions
- recognition among international financial services firms, investors
- adequately skilled and educated labour force
- need to improve certain ‘links’—eg, transport, political
- political and economic stability

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Conclusions and implications

- starting point: how to put Estonia ‘on the map’ for the financial services industry?
  - what is realistic? Which segments? How to target?
- potential objective: relatively small, regional financial centre for selected activities, with further growth potential for the wider market
- significant, long-term effort and investment required
  - understand marketplace, target policies, cater for financial institutions
  - large investment decisions are made with great caution—many elements need to ‘fall into place’
- strong alternatives in CEE and internationally
  - Nordic link is one of the key (positive) distinguishing factors
- planning, coordination, long-term commitment

Policy implications
Preliminary suggestions and issues for discussion (I)

- time frame is important for
  - initiating policies
  - (expected) improvement in attractiveness
  - increasing financial services exports
- potential areas for proactive policies
  - strengthening (and using more effectively) links with Nordic countries?
  - improving the tax and regulatory regime?
  - increasing awareness of Estonia among financial institutions?
  - building expertise and a skilled human capital base?
  - improving infrastructure and general business attractiveness?

Policy implications
Preliminary suggestions and issues for discussion (II)

- what other high-level policy areas should be targeted?
- what specific policies in each policy area could be implemented?
  - what would be the expected effects?
- which policy areas and specific policies are most critical?
- what time frame should be adopted for each policy area and specific policy?
  - initiate immediately/initiate within the next three years/initiate within the next five years
- what can firms and other stakeholders do to contribute?

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