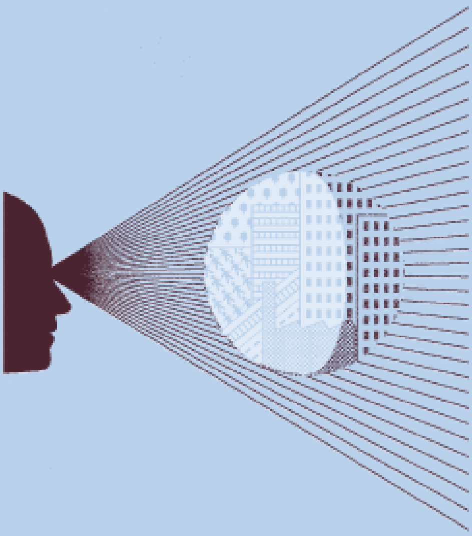
Financial services sector in Estonia

Growth opportunities and policy implications

Report prepared for
The Ministry of Economic Affairs of Estonia and the Development Fund of Estonia

November 2009



Executive summary and conclusions

Remit and objectives

The Ministry of Economic Affairs of Estonia and the Development Fund of Estonia have commissioned Oxera to conduct a study on the growth opportunities in the Estonian financial services sector. The objectives of the study are to:

– identify the parts of the financial services industry where Estonia is likely to have a competitive advantage internationally;

– propose high-level policy options to promote the growth and development of the financial services sector in Estonia in these identified parts.

The analysis investigates how Estonia might be viewed from the perspective of a financial services institution making geographic location choices for certain of its activities (ie, front office, core, and back-/middle office functions), and whether, in this context, Estonia could be seen as an attractive location for the provision of activities in different segments of the financial services sector (eg, asset management) when compared with other jurisdictions.

The focus of the study is to consider what potential there may be to increase 'exports' of financial services rather than considering the growth potential of the sector per se. In this context, exports are defined as follows.

– Sales of services to clients cross-border—for example, this could involve sales of private banking services to foreign residents, or the provision of asset management services to (foreign) private equity funds investing in the region.

– Outsourcing (external and internal) of certain activities that form part of the value chain in the provision of financial services to Estonia from another country.

  – *External outsourcing* of selected activities from another jurisdiction to an entity operating in Estonia: for example, this could involve outsourcing of back office activities by a bank to a third-party provider in Estonia.

  – *Internal outsourcing* of selected activities from another jurisdiction to Estonia within an international financial services firm—for example, this could involve consolidation of certain back office activities in Estonia to service demand in different jurisdictions by a global fund.

As part of the study Oxera carried out data and conceptual analysis, together with a review of existing research and academic and professional literature. Interviews were also undertaken for the study with leading financial institutions and regulators in Estonia and across Europe, and two workshops were held with market participants in the Estonian financial services sector.

Estonian financial services sector

Overall, Estonia has a relatively well-developed financial services sector (some segments of the sector), especially when compared with other countries in the region at a similar level of development. Moreover, although its financial services sector has been significantly hit by the financial and economic crisis[1] and suffered from at least some regional 'contagion' associated with the perception of regional vulnerabilities, to date it does not seem to have fared worse than many other European countries that have required significant state intervention in the form of bank and insurance company bail-outs, provision of state guarantees, and other measures.

Between 2000 and 2008, financial services contributed to around 4% of Estonia's gross value added (GVA). At the same time, in 2008 the share of the financial services sector of total services exports in Estonia was 2%. This contribution to GVA and exports is representative of levels observed among its Nordic and Central and Eastern European (CEE) peers in the sector.

In principle, Estonia has a basis from which to increase its exports of financial services, particularly in the segments and functions where services are 'exportable' (based on the generic characteristics of the activities involved) and where the level of development of these activities in Estonia is relatively high. The analysis identifies at least three such areas of activity.

– **Core and back office functions in asset management, particularly with respect to management of investments in the region**—these can be exported relatively easily if there is demand for these services materialises, which is likely to depend on factors such as the growth of portfolio asset allocation of international investors to the Baltic States and CEE, and changes in the degree of concentration of the core asset management function in major financial centres. The sector activities in Estonia are reasonably well developed. The sector has also experienced significant growth over the past few years (particularly since joining the European Union (EU) in 2004) and is likely to expand further, providing a basis for potential growth in exports in this sector. Although across Europe there is significant concentration of core asset management functions in major financial centres, these functions benefit from local presence, which may allow Estonia to benefit from the availability of investment know-how in relation to the Baltic States and CEE.

– **Front office, core and back office functions in private banking, particularly with respect to selected regional markets**—these can be exported if demand for these services materialises, which is likely to depend on such factors as economic and political developments in selected regional markets (particularly, Russian and other CIS countries), and, more generally, transformation of position of the offshore financial centres globally (eg, due to regulatory pressures). This sector in Estonia is being developed, with some exports specifically targeted at clients from Russia and other CIS countries. Globally, private banking is prone to significant concentration in financial centres, especially offshore ones that are well established. Nevertheless, Estonia could benefit from factors such as regional cultural links, allowing exports of private banking out of smaller centres such as Estonia which do not fall into the category of major offshore private banking centres.

– **Back office functions in banking, insurance and asset management, particularly with respect to processing functions**—these can be exported if demand for these services materialises, which is likely to depend on the overall growth of outsourcing of these activities (both internally and externally). The servicing of this function in Estonia is relatively well developed. Although these functions are still often carried out in the same

[1] This effect has mainly materialised through the indirect impact that the crisis has had on the real economy.

location as front office and core functions, or outsourced to the major outsourcing centres (including jurisdictions outside Europe, such as India), in specific circumstances (eg, where international financial services firms already have a presence in the country), smaller countries such as Estonia can have an opportunity to attract back office activity.

Other broad areas include, for example, the provision of pension savings product and technology-related services, in the contexts of both cyber-security and broader aspects of technology in financial services, including the provision of information, communications and technology (ICT) solutions to international service providers.

Importantly, these parts of the financial services satisfy *necessary* (ie, given the characteristics of these activities, they are 'exportable'; these activities are relatively well developed in Estonia), but not *sufficient conditions* for Estonia to attract a notable level of foreign demand. Further insights into Estonia's potential can be drawn from the analysis of how well it compares in terms of its critical attractiveness factors.

How attractive is Estonia as a location?

In addition to a relatively well-developed financial services sector, Estonia scores well on some important location attractiveness factors. Overall, therefore, there is a basis for increasing the export of financial services in Estonia in the medium term, although a number of challenges and obstacles remain. In particular, there are some strong alternatives, in the CEE and beyond, vying to attract an increasing level of financial services exports, although Estonia has some strong distinguishing features (eg, strong links with Nordic countries) which can provide it with some advantage.

Even if, in practice, *being an attractive location* does not guarantee significant increases in activity, this is an important pre-condition for achieving any growth in activity and positioning the country in a way that would, given the right external conditions, enable it to develop clustering of firms carrying out particular export-oriented activities, and to grow into an important small financial centre in the long run.

The key conclusions in relation to each of the attractiveness factors can be summarised as follows.

– Labour pool size and quality—in Estonia there is (a perceived or actual) scarcity of people with the relevant business education and more specific skills required for activities across different parts of the value chain of financial services.

– Regulatory regime—financial services regulation and supervision compare reasonably well against those of relevant comparators, although Estonia would benefit from more targeted effort by the regulators in terms of understanding the needs and business practices of international financial services firms.

– Tax regime—in terms of attractiveness of the tax regime, Estonia ranks midway in comparison to its peers. A number of specific issues (eg, lack of double-taxation agreements with some countries) are particularly harmful to certain segments of the financial services sector.

– Geographic and cultural proximity—Estonia is positioned favourably in terms of geographic, cultural and economic proximity to clients in the Nordic countries, CEE and CIS. It has advantages in terms of languages, familiarity, close existing links, relevant know-how, and so on.

– Technical capabilities including financial services infrastructure—in Estonia there are good (perceived or actual) technical capabilities, including ITC systems; there is also good financial services infrastructure.

– Labour and property costs—these costs are lower than the EU average, but similar to those of other countries in the Baltic and CEE regions; in terms of labour costs, even when adjusted for differences in productivity, costs in Estonia are likely to be attractive when compared with those in more developed EU countries.

– Quality of life—Estonia scores poorly on the overall quality of life metrics when compared with the more developed European countries, although the level is broadly comparable to that in other CEE countries.

– Performance and liquidity of markets—Estonian securities markets are small and significantly underdeveloped.[2]

Policy implications

In light of the findings of this study, the government, in conjunction with other independent decision centres, has a number of policy options. These options are related to the extent to which the government objectives for the economic policy more broadly would be focused on one or more sectors, the degree of intervention, and the geographical focus.

Policy option 1: 'Proactive—broad/comprehensive'
Actively promote the financial services sector with a particular focus on exports. This is the most comprehensive option and is based on the assumption that the financial services sector represents a major area of opportunity for Estonia. If successful, this option could have significant positive impacts on the Estonian economy, whereby growth in exports of financial services would contribute materially to the overall growth of exports and the overall economic activity in Estonia. Examples of other countries where global exports of financial services amount for a significant share of total exports highlight potential benefits associated with this policy options. (One example is Switzerland, whose share of financial services exports constituted 38% of total services exports in 2007.[3]) However, this option also carries potentially high costs (eg, depending on the scope of revisions to the tax code) and limited probability of success.

Policy option 2: 'Proactive—focused/niche'
Actively promote the most promising activities in the financial services sector with a particular focus on exports and emphasis on attracting demand from regional markets (Nordic and the CIS). This is a more limited version of Policy option 1. (One of the likely outcomes under Policy option 1 is the development of a strong niche focus in segments that *prove to be* particularly successful). If successful, this option could have significant positive impacts on the Estonian economy, although the precise nature and size of these benefits would depend on the size of the target market (defined in terms of geographic focus and segments/ functions that are being targeted). For example, targeting Nordic and the CIS countries–which might be an optimal approach, given Estonia's current position–would, all else equal, deliver more limited benefits than a policy option aimed at all European or global markets. Experience of successful niche centres (eg, Jersey) confirms that the financial services sector has the potential to become a major contributor to the economic growth. Overall, since the policies can be more targeted, this option might be easier to implement than Policy option 1. (This has been the option adopted by most successful small financial centres).

Policy option 3: 'Defensive'
Introduce incentives to make it less attractive for financial institutions to shift abroad the functions of the value chain in the provision of financial services for the Estonian domestic market. This policy has some overlap with the proactive policies proposed under Policy options 1 and 2, but is more focused on the domestic market. In terms of its economic

[2] It should be noted that the Tallinn Stock Exchange is part of the international Nasdaq OMX Group, one of the largest exchange groups in the world.
[3] OECD website, international trade statistics.

impact, this option is focused on maintaining the status quo in relation to exports of financial services. It is cheaper to implement than the above ‘proactive’ options, although it offers only limited gains. This option may be the most critical from a short-term perspective.

Policy option 4: ‘Neutral’
Target efforts at creating favourable economic and political conditions (eg, overall stability) more generally, without an explicit focus on the financial services sector. This involves potentially more limited changes and required investment (specific to the financial services sector), with policies and benefits considered more broadly beyond the financial services sector. In other words, take a less proactive stance without an explicit policy for the financial services sector, and be more reactive to the developments in the economy more generally. This policy option is likely to result in a level of growth of exports of financial services that is broadly in line with that observed for Estonia’s CEE peers, with a potential to outperform or underperform peers depending on specific circumstances. This option is most in line with the current policies pursued by the Estonian government.

Based on the overall evidence and analysis carried out as part of this study, and if the intention is to adopt a proactive policy, Policy option 2 looks the most attractive for Estonia. However, the decision ultimately lies with the government and other stakeholders, and needs to take into account the overall policy objectives.

Importantly, in order to develop these policy options and improve the probability of greater exports of financial services, it is important to adopt a targeted strategy aimed at improving specific aspects of the financial services industry and economy that are valued by firms when they are choosing where to locate. Although some policies may be relatively low-cost, a longer-term policy would require significant commitment by the government and other stakeholders.

The primary areas of policy focus could be defined as follows.

– Regional and international policies.
– Economic and political stability and attractiveness.
– Tax and regulatory regimes.
– Development of human capital.
– Technical capabilities (including financial services infrastructure).
– European community and other international platforms.
– General business attractiveness.

The choice of specific policies is conditional on the choice of particular policy option, and requires more detailed consideration of the costs and benefits. Nevertheless, a number of suggestions of specific policies across different policy areas are provided in the report. Notably, some of the policies could be implemented within a relatively short timescale and are comparatively low-cost. Also, the benefits associated with some of these policies (eg, promotion of Estonia) would directly benefit other sectors of the economy.

Examples of relevant policies include the following (a more detailed list of policies is provided in section 5 of the main report).

International awareness of Estonia can be increased through targeted promotional campaigns focusing on the capabilities and strengths of Estonia’s financial services sector and the country more general. Estonia may also be able to improve its standing through high-profile participation in financial services conferences. More indirectly, existing relationships with regional stakeholders (particularly large financial services firms) in Estonia’s financial industry could be used to reach out to prospective investors and financial services firms in these countries.

A coordinating body could be established (involving financial regulators, government and industry representatives) to promote cooperation between financial services stakeholders in

Estonia and their peers in Nordic (and broader EU), CEE and CIS countries. This could provide an opportunity to market Estonia more effectively, and serve as a forum to engage with foreign investors and institutions (on issues such as taxation and regulation), and better respond to their needs.

The level of skilled labour could, in the short term, be boosted by subsidising relevant academic and vocational courses and qualifications (eg, chartered financial analyst, CFA), which are of a relatively short duration. In the longer term, government grants could be provided to support the development of relevant full-time university degrees (eg, MSc Finance) and vocational programmes in Estonia. Similarly, it would be beneficial to create centres for (finance) excellence at universities, which could potentially be co-funded by financial services firms.

In relation to the attractiveness of the tax regime, it could be beneficial, as a starting point, to undertake a detailed comparison of the competitiveness of Estonia's tax system from the perspective of financial services firms relative to its Nordic and CEE peers. Furthermore, a number of specific tax and regulation issues raised during the interviews for this study (eg, lack of double taxation treaties with some countries) could be addressed within the short term. It would also be beneficial to set up systems and bodies to ensure better coordination between Estonia and the financial supervisory authorities in other countries, particularly in relation to the implementation of EU laws.

There is also a range of policies which could enhance the actual or perceived business attractiveness of a country. For example, improvement of the transport links between main European locations and Tallinn would have an immediate impact on the business environment and on the perception of the business environment.

Contents

List of tables

List of figures

1 Introduction

1.1 Objectives and remit

The Ministry of Economic Affairs of Estonia and the Development Fund of Estonia have commissioned Oxera to conduct a study on the growth opportunities in the Estonian financial services sector.

The objectives of the study are:

– identify the parts of the financial services industry where Estonia is likely to have a competitive advantage internationally;

– propose high-level policy options to promote the growth and development of the financial services sector in Estonia in these identified parts.

The specific focus of the study is to consider what potential there may be to increase 'exports' of financial services, rather than considering the growth potential of the sector per se. In this context, exports are defined in the following way.[4]

– Sales of services to clients cross-border. These could include, for example, sales of private banking services to foreign residents, or the provision of asset management services to (foreign) private equity funds investing in a region.

– Outsourcing (external and internal—see below) of certain activity constituting a part of the value chain in the provision of financial services to Estonia from another country.

  – *External outsourcing* of selected activities from another jurisdiction to an entity operating in Estonia, which could include, for example, outsourcing of back office activities by a bank to a third-party provider in Estonia.

  – *Internal outsourcing* of selected activities from another jurisdiction to Estonia within an international financial services firm, which could include, for example, consolidation of certain back office activities in Estonia to service demand in different jurisdictions by a global fund management firm.

The analysis investigates how Estonia might be viewed from the perspective of a financial services institution making geographic location choices for certain activities within its value chain. It also seeks to identify whether, in this context, Estonia could be seen as an attractive location for the provision of activities in different segments of the financial services sector (eg, asset management) when compared with other jurisdictions.

This report needs to be viewed in the context of particular challenges facing the growth of the financial services industry in Estonia and in the region more broadly.

First, exports of financial services by firms located in Central and Eastern Europe (CEE) have been limited to date. So far, the countries of CEE have provided a relatively small share of services to the market for financial services in Europe and globally. Significant investments in the financial sectors in the region have been made by foreign financial institutions largely in order to service the local markets, rather than to cater for demand in other jurisdictions. At the same time, the domestic financial institutions have had rather limited sales of their own

[4] Although other forms exist, most exports in the financial service sector fall into these categories.

financial products abroad, relative to both potential target markets and the size of the domestic financial services industry. In short, local financial services industries in CEE tend to be focused on the domestic market.

Second, over recent years there has been a progressive concentration of financial services in financial centres (particularly, global and niche ones). In other words, where parts of the value chain of firms are relocated, they have tended to be moved to one of the major financial centres or financial centres that have developed particular niche specialisation in relevant activities.

Third, this analysis is carried out against the backdrop of a global financial crisis. Over the past year or so, banks and other financial services firms globally have suffered significant losses; many have required state bail-outs and state guarantees in order to avert bankruptcies. This has led to significant turmoil in the sector (and the global economy more broadly), creating a situation whereby trends and industry developments observed before the onset of the crisis do not necessarily provide a reliable indication of the likely developments going forward. At the same time, there are reforms of the financial services sector across countries and some re-positioning of the financial centres. In the context of this study, therefore, these developments put more emphasis on assessing, at a high level, how attractive individual centres are compared with their peers, rather than the attractiveness of, or prospects for, the financial services industry as such.

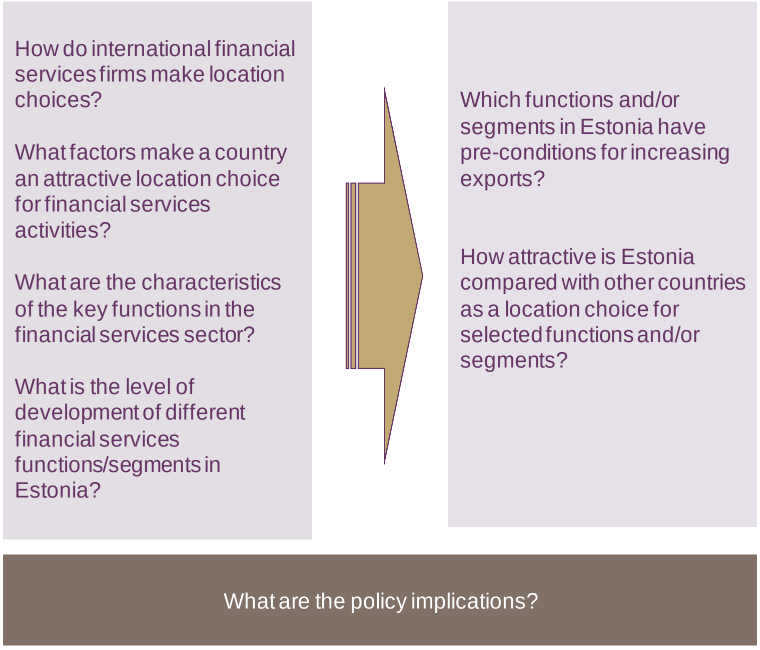
In terms of the impact of the financial crisis on Estonia, compared with other jurisdictions Estonia has been no exception. Estonian banks and other financial services firms have been severely affected, through their own losses arising mainly as a result of a significant deterioration of the Estonian real economy; and through the effect of the crisis on the operations and strategy of their parent firms. Given that a significant proportion of the financial services sector in Estonia is owned by foreign financial services firms, the effect of the crisis on these firms more generally has important ramifications for the Estonian financial services industry.

The study therefore provides an overview of the effect of the crisis on local firms and on some of the Nordic banks with presence in Estonia, providing input into the assessment of the current state of the sector.

1.2 Methodology

The analytical approach adopted in this study is summarised in Figure 1.1.

Figure 1.1 Analytical approach



Source: Oxera.

The research undertaken for this study involved the following activities:

- data collection and analysis, including statistics on the size of activities, the main players and their strategies;
- conceptual economic and financial analysis;
- a review of past research, existing studies, academic and professional literature;
- interviews with leading financial institutions and regulators in Estonia and across Europe;
- two workshops with market participants in the Estonian financial services sector.

The study has been conducted in cooperation with stakeholders of the financial services industry in Estonia.

1.3 Structure of the report

This report is structured as follows.

- Section 2 discusses how financial services firms tend to consider locations for the provision of certain activities, and identifies the major factors that determine the attractiveness of particular locations. This is presented with the help of a framework outlining the structure of key financial services sectors and the nature of the activities involved.

- Section 3 discusses the current level of development of different sub-sectors of the Estonian financial services sector, including how they have been affected by the financial crisis. This provides an insight into the starting point for the future growth of the financial services sector, as well as its position relative to other jurisdictions.

- Section 4 considers how well Estonia compares with other countries in terms of the main location attractiveness factors.

- Section 5 sets out some high-level policy implications. These implications are considered across different categories of policy options that are available to stakeholders in the Estonian financial services sector in order to meet their objectives.

Appendix 1 contains information on the interviews and two workshops held as part of this study. Appendix 2 presents an illustration of the value chain in asset management industry.

The conclusions of this study can be found in the section ‘Executive summary and conclusions’ at the beginning of this report.

2 How do financial services firms think about location choices?

2.1 Location choices for activities of financial services firms

The financial services industry is made up of many private companies pursuing individual business strategies with the aim of maximising profits in the provision of specific financial products to the global, regional and local markets.

The strategies of various financial institutions differ according to several factors, including the type of market they serve, their market position and size. On the supply side, one important consideration for firms is how to structure the value chain for the provision of their services. This structuring of the value chain includes making strategic decisions on:

– the degree to which different functions are purchased from the market for individual functions within the value chain (as opposed to being developed 'in house');

– the degree of (internal or external) outsourcing to jurisdictions other than the jurisdiction where demand is located;

– the geographic location of individual functions within the value chain for either in-house provision or outsourcing.

The degree to which Estonia can increasingly become a location of choice for functions within the value chain is the main focus of this study. In other words, the study considers the potential for Estonia to increase 'exports' of financial services, where 'exports' refer to a situation where financial services institutions locate in one country in order to serve demand for financial services products in other countries (as well as, potentially, locally).

Examples of such exports include the back office activities of a UK investment bank that are carried out in Belgium, or the core asset management functions of a pan-European fund management firm that are carried out in London (ie, exporting is done from Belgium and London respectively).

From the firm's perspective, these decisions to locate in a given country or a city have two important dimensions:

– whether and what to locate?
– where to locate, and why?

The first dimension relates to considerations about the market to be serviced. For example, when deciding whether to locate a financial institution in a given place, the geographic location of the market to be serviced may be relevant, as well as the ability to 'produce' a given financial product in a location that is potentially distinct from where customers are located.

This dimension also relates to which parts of the financial institution are to be moved or located in a given country or city. The nature of the financial institution's business and the services it offers (or plans to offer) are critical to this decision. Hence, to identify the potential for growth of the financial services sector—as driven by location choices of financial institutions—it is important to understand what the various financial products are and how they are 'produced'. In other words, for the purposes of analysing the location choices of financial institutions or their parts, it is necessary to analyse them in terms of the various functions that they perform and that form value chains of products and services.

The second dimension of the location decision relates to where to locate a financial institution or particular parts of its value chain. This decision is based mainly on how attractive a given location is for the function or functions of the financial institution under consideration. An assessment of the corporate strategies of financial institutions shows that the factors identified later in this section (labour, taxation, regulation, infrastructure, and so on) are all important for firms when choosing where to locate.

Another important consideration is the level of development of the financial services industry in general, or particular parts of the market more specifically. For example, an international firm would be unlikely to locate some of its core asset management activities in a country where the asset management industry is relatively underdeveloped.

Importantly, factors that determine the attractiveness of a location for a given function differ across the functions, or parts of the value chain, of a financial institution. Thus, one aspect of understanding the potential for export growth of the financial services sector lies in matching 'exportable' financial services functions with the factors of attractiveness of a particular location.

The remainder of this section describes the structure of the financial services sector, and outlines the main factors of attractiveness of different locations. This analysis provides a basis for the assessment of Estonia's growth potential by considering:

– which of the functions in which sectors are 'exportable', and therefore directly relevant for the analysis in this study;

– which factors are important in determining the attractiveness of Estonia as a location choice for different functions, and therefore which factors need to be considered when assessing its potential to increase exports of financial services within different functions.

2.2 Structure of the financial services sector

2.2.1 Overview

Financial services institutions are set up to satisfy demand for various financial services products, such as banking, insurance, securities trading. In order to be able to supply or 'produce' financial services products, institutions must perform a variety of functions, such as sales and distribution, financial operations, risk management, administration, and others. The functions that are undertaken depend on the type of financial services product, and they form the product's value chain.

Based on the nature of the functions performed by (or for) financial institutions, these functions can be broadly grouped into three categories, corresponding to three distinct parts of the value chain:

– front office (distribution and marketing);
– core functions/activities;
– middle and back office.

This distinction recognises the intrinsically different characteristics of activities undertaken by financial institutions offering various products and services. Understanding the nature of the parts of the value chain of financial products enables factors to be identified that may be important for these financial services functions to grow and develop.

Table 2.1 summarises the structure of the financial services sector in terms of its main segments of banking, insurance, asset management and securities markets, and functions within parts of the value chain.

Table 2.1 Illustrative structure of the financial services sector—examples of activities

Parts of value chain	BANKING			INSURANCE		ASSET MANAGEMENT				SECURITIES MARKETS		
	Retail	Investment	Private	Life	Non-life	Investment funds	Pension funds	Hedge funds	VC/PE	Equity	Debt	Derivatives
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 investment Pre- and post-trade broker liaisons				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		Transactions 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		

Source: Oxera.

Front office functions include, primarily, sales and distribution, customer relations and marketing (ie, the 'customer-facing' part of a financial services institution). **Core** functions are functions performed to 'produce' the financial services product, and are largely defined by the type of product; for example, insurance products require underwriting, whereas pension funds require asset management. **Back office** functions include activities required to support the core functions and front office, such as IT systems, administration and accountancy.

While some (especially core) functions are specific to a given financial services segment, others may be common to more than one segment, such as distribution, administration, accountancy (ie, back office and some front office functions).

– **Functions common/similar across financial services segments**. Table 2.1 highlights that some functions are, by their nature, similar across financial services segments and products. For example, front office functions such as marketing, sales, and customer interface are required in all financial services segments, from banking to asset management. Back office functions, such as administration, accountancy, IT systems and other support systems, compliance and reporting, are also common across most financial services segments.

– **Functions typically specific to financial services segments**. Table 2.1 also draws attention to functions that are intrinsically different and may be specific to a given financial services product or service. For example, the core functions of insurance, such as underwriting and risk management, are distinct from the core functions of asset management, such as operational and strategic asset management.

The nature of these functions is explored below—in particular, the dimensions of the structure of the financial services sector, including considerations alongside different parts of the value chain across different segments. The key aspects examined are the following.

– What activities are undertaken within a financial services segment?

– What does the type of activity imply for:

  – the exportability of parts of the value chain?
  – geographical concentration and clustering?

– What are the implications for the required skills and other inputs?

2.2.2 Banking

Three main types of banking can be distinguished: retail, investment, and private. Many universal banks provide all types, while many others specialise.

Retail banking

Retail banking serves individuals as well as businesses, and the main types of products it offers are current accounts, deposit or savings accounts, term loans, mortgages, payment cards, credit lines, and leasing. Furthermore, retail banks are providers of the payments system in the economy and other services of financial intermediation.

Retail banking has a large front office—ie, client-facing activities, distribution, marketing—and hence proximity to the customer is important. Proximity in a broader sense, such as cultural links, familiarity with the language, customs, and economic situation, is also important for the core functions. As a result, retail banking front office and core activities are rarely provided on a cross-border basis—ie, they are not exportable—whereas at least some back office functions may be exported. For example, although European financial integration, advanced by the Financial Services Action Plan and the consequent regulations, has greatly facilitated cross-border banking within the EU, free provision of services (eg, cross-border lending) is very limited.[5]

For the same reasons which make it difficult to export the retail banking value chain (with the exception of some back office functions), there is also no particular geographical clustering of retail banking activities.

Retail banking front and back office functions are relatively undemanding in terms of skills of the employees (although back office activities require specialist skills/understanding of activities such as clearing and settlement). However, core functions, among others, require financial and quantitative skills, and the supporting services require specialised labour (eg, accountants and IT specialists). Retail banking also, for example, increasingly relies on communications and IT technologies throughout the value chain.

Investment banking

The main activities of investment banking include corporate finance and strategic advice on mergers, acquisitions, divestures, capital raising by issuing securities (ie, underwriting of equities and bonds), trading of securities, investment management, as well as structured product design. Given the sophisticated nature of these activities, investment banking tends to concentrate in large financial centres, with a relatively small front office.

In principle, the investment banking value chain is exportable; however, as indicated above, there is a tendency for the core activities to cluster in large financial centres. Back office functions may be more easily exported from locations other than these large financial centres.

In terms of the value chain, the core of the investment banks typically requires highly skilled labour and expertise (eg, to undertake research and provide strategic advice on mergers and acquisitions, securities trading, bond and equity underwriting), together with a well-developed financial infrastructure.

Private banking

Private banking is the provision of banking services to wealthy (high net worth) individuals. Its main services include tailored and sophisticated tax and investment advice, investment management, short- and long-term wealth management, trading and brokerage, custodian services, trust administration, lending and private equity.

The private banking value chain is easily exported. However, proximity to customers in a broad sense (ie, not only geographical, but also cultural) may be necessary.

Many private banks are located in offshore financial centres in order to benefit from tax and confidentiality advantages. Hence, private banking activity tends to cluster in jurisdictions that offer such advantages.

The core activities of private banks require a high degree of financial literacy and expertise in investment management, as well as knowledge of markets, in order to be able to offer clients superior investment opportunities. Private banking also relies on a stable regulatory and tax regime, although it is less important for the front- and back office activities.

2.2.3 Insurance

The main two types of insurance are life insurance and non-life insurance. Life insurance is principally concerned with the risk of death of the insured, and can also be used as a vehicle for pensions savings. Non-life insurance relates to an array of risks, the main types being medical, motor, property, liability and travel insurance.

[5] European Commission (2008), 'European Financial Integration Report 2008'.

In the insurance industry, the front office activities are marketing, distribution and sales, and some aspects of claims processing. Distribution channels may vary by type of insurance and customer (eg, personal versus business). The main ones are the branch network of an insurer, insurance brokers, financial advisers, bank branch networks, and, increasingly, the Internet. Insurance schemes may also have dedicated administrators that perform some of the front office functions and may take on some middle- and back office functions. This implies that front office functions can, and often are, exported or outsourced (eg, the distribution channel is distinct from the core and back office activities). Similarly, back office functions can be exported.

Owing to the economies of scale in the core activities of insurance companies, insurance business tends to be relatively concentrated, and there is also clustering in large financial centres, such as London.

As with retail banking, the front office represents a large part of the value chain of insurance services, and is relatively undemanding in terms of skills required. Core activities require a high degree of quantitative abilities and skills.

2.2.4 Asset management

The main segments of asset management include investment funds (collective investment schemes more generally, such as UCITS and non-UCITS funds), pension funds, hedge funds, private equity funds and venture capital. Investment vehicles can have a range of legal structures, with the role of the asset manager ranging from advice-only services to the management of clients' investments in accordance with mandated asset allocation rules, to having discretion over the clients' funds and their allocation.

In addition to the core functions, which revolve around the management of investment portfolios, asset management involves marketing, distribution and sales functions (ie, front office), as well as middle and back office activities.

Depending on the business model adopted by the asset management companies, all functions can be performed in house (eg, asset management firms that are part of large financial groups); front office and/or middle and back office functions can be outsourced; or core functions can be outsourced. Within asset management, there may also be firms that focus specifically on providing front office functions (eg, financial advisers, other distribution networks) or back office functions.[6] Thus, the value chain of asset management is relatively predisposed to exports and outsourcing.

Registration and listing tend to be concentrated in jurisdictions with advantageous tax and regulatory regimes (eg, Luxembourg, Guernsey). Core asset management tends to be concentrated in large financial centres, due to access to a large highly skilled and liquid labour pool and good financial infrastructure. However, core activities benefit from regional expertise, hence there is also considerable asset management activity outside the main financial centres.

As indicated above, core asset management activities require such factors as highly skilled labour, as well as advanced financial infrastructure. Expertise in the markets and proximity to customers in a broad sense are also important for core asset management functions.

2.2.5 Securities markets

Securities markets include primary and secondary equity and debt markets. Although the discussion in this section relates to securities markets, similar arguments apply in general to derivatives markets. The primary markets allow companies to raise equity and debt capital through initial public offerings (IPOs) and other forms of placement, while secondary markets

[6] For a detailed description of the business models adopted by companies in the asset management industry, see Oxera (2006), 'Current Trends in Asset Management', MARKT/2005/25/G, a report prepared for European Commission DG Internal Market and Services, October.

allow market participants to trade securities issued by firms (on exchanges or multilateral trading facilities, or through over-the-counter trading).

In principle, there is considerable mobility and accessibility in securities markets. Companies can list and raise equity and debt capital in foreign markets; end-investors can invest in companies that are listed in foreign markets; and brokers/dealers can generally gain direct access to trading infrastructure in other countries. Overall, therefore, there is significant scope for exporting financial services.

Although equity markets still tend to be organised on a national basis, with most companies tending to list on the domestic exchange, over recent years there has been significant integration of capital markets in the European Union (EU). In particular, there have been trends towards increased cross-border trading, greater access of brokers/dealers to foreign trading platforms, the emergence of multi-market trading platforms, and integration of central counterparty clearing houses (CCPs) and central security depositories (CSDs) across countries. All this has led to increased exports of services, although, arguably, this increase is dominated by firms located in the major financial centres, such as London, Paris and Frankfurt.

The debt markets are organised somewhat differently, and there is less activity on exchanges. In particular in relation to international bonds (Eurobonds), trading activity is especially concentrated in the major financial centres.

Activities in securities markets generally require highly skilled labour, advanced financial infrastructure and IT systems, and an attractive regulatory framework.

2.3 What factors determine the attractiveness of a given location as a financial services centre?

2.3.1 General factors determining competitiveness in financial services

Traditionally, economic theory explains the location choice of firms by making reference to the abundance of factors of production in a particular location, such as labour, raw materials and capital. The availability of these factors in a location means that they are less expensive to acquire than in another location—ie, to the competitive advantage of particular locations. This reasoning also applies to the financial services industry.

Business and economic literature has identified a number of factors that determine the competitive advantage of locations. These relate to costs, labour and skills, infrastructure, regulatory and tax regimes, and other factors, such as political and economic stability, business environment, and geographic and cultural considerations. Location choice factors are summarised in Table 2.2—notably, their importance varies across different parts of the value chain and segments.

The interviews with market participants undertaken as part of this study confirmed the importance of the factors identified in the literature, providing further insights into the differences in critical factors across different functions in the value chain.

Table 2.2 Examples of location choice factors

Costs	Labour (availability and quality)	Cultural and geographic proximity to the relevant markets	Infrastructure (availability and quality)	Taxation and regulation	Other factors
Labour Property Transport IT and communications system Financial infrastructure	Size of labour pool with relevant skills, such as: financial education and expertise; languages; supporting professional skills (management, accountancy, legal, IT) Labour flexibility Knowledge of the markets	Geographic proximity of countries Cultural links Knowledge of language	Financial infrastructure, such as trading systems Sophisticated IT systems Links to supporting services, such as accountancy Communication technologies Transport links, including air travel	Overall tax burden of the financial institution Taxation of the employees of financial institutions Taxation of investors (capital gains tax, double-taxation treaties in place) Regulation of financial services products Certainty of interpretation of the tax and regulatory regime Attitude of tax and regulatory authorities	Institutional and market framework Political and economic stability Corruption level Business environment (ease of doing business) Quality of life Clustering effects

Source: Business and economic literature, and Oxera interviews.

Costs

The success of any financial institution is driven by its ability to run a profitable business; hence a low cost base is important for financial institutions when considering how to organise their business, including where to locate parts of their value chain. The nature of financial services products means that the following costs are important:

– labour costs;
– property costs;
– transport costs;
– infrastructure, IT systems, and communications costs.

Indicators of international competitiveness developed in various studies include cost considerations. For example, in KPMG's 'Competitive Alternatives', PwC's 'Cities of Opportunity' and City of London's 'Global Financial Centres Index',[7] labour costs are shown to be particularly important in high-skill industries, such as financial services. KPMG reports that labour costs constitute around 79–88% of the location-sensitive costs of non-manufacturing operations.[8]

[7] KPMG (2008), 'Competitive Alternatives–Guide to International Business Location'. PriceWaterhouseCoopers (2008), 'Cities of Opportunity'. City of London (2009), 'The Global Financial Centres Index', prepared by Z/Yen, March.
[8] KPMG (2008), op. cit.

From the perspective of financial institutions, costs may play a role when choosing where to locate. However, costs are not a similarly important competitiveness factor for all parts of the value chain. For instance, cost considerations are less important for core asset management functions, whereas they are important for front office and, in particular, middle and back office functions.[9] This is similar across financial services segments, given the similarity of back office functions.

Labour and skills

Given that labour is one of the main inputs for 'producing' financial services products, the availability of the right set of skills is a crucial consideration. In general terms, financial institutions require the following skills and labour market characteristics:

– labour market flexibility;

– a labour pool with the relevant skills, namely:

  – financial education and expertise;
  – languages, especially when considering the export of services from a given location;
  – accountancy;
  – legal profession expertise;
  – IT skills;
  – management skills and acumen;
  – market knowledge, including macroeconomic and political aspects, market structure and functioning, and business customs and culture.

The availability of skilled labour is an important competitiveness factor, as outlined in City of London's 2003 'Global Financial Centres Index' and other studies, for example.[10] To perform certain functions within financial services, specific skills are required, such as accountancy, and IT and management skills. Language skills may enhance competitiveness and attract financial institutions from respective countries, with knowledge of English language being a prerequisite.

Core functions, such as core asset management or banking services, require a sufficiently large and flexible pool of highly financially literate and experienced workforce.[11] In several financial services industry surveys, the availability of highly skilled labour is ranked the most important factor for competitiveness of financial centres.[12] Although less important in front and back office activities, even here the availability of people with specialist knowledge (eg, understanding of clearing and settlement processes in banks) is required in order to attract activity from other countries.

Geographical and cultural proximity to the relevant markets

Proximity to the relevant markets, in terms of distance, culture and language, may be an important location factor for some financial services segments and functions. For example, geographical proximity is important for client-facing financial services segments, such as retail banking. Proximity is not important for back and middle office activities, although, for some parts of these activities, being in the same time zone as the front office/core activities can be an advantage.

[9] Oxera (2005), 'The Future of UK Asset Management: Competitive Position and Location Choice', a report prepared for the Corporation of London, May.
[10] Taylor, P.J., Beaverstock, J.V., Cook, G., Pandit, N., et al. (2003), 'Financial Services Clustering and its Significance for London', a report prepared for Corporation of London, February.
[11] Oxera (2005), op. cit.
[12] For example, a survey of City of London financial institutions indicated that the availability of skilled labour was the most important factor driving the competitiveness of financial centres. ZYen (2005), 'The Competitiveness of London as a Global Financial Centre', a report prepared for the Corporation of London, November. Similar finding s are reported in Centre for the Study of Financial Innovation (2003), 'Sizing up the City', a report prepared for the Corporation of London, June.

Similarly, language and cultural proximity are important for front office and core functions across financial services segments. For example, in private banking, cultural links between the country where clients are located and the country where a private bank (specifically, its front office) is located can be an advantage since this may facilitate better understanding of clients. At the same time, proximity can be an important factor in core functions across financial services segments. For example, in asset management, common language and better cultural understanding of a region might prove advantageous when managing an asset portfolio of investments in the region.

Regulatory and tax regime

Regulatory and tax regime can play an important role in the location choice of financial institutions, as evidenced by the success of many economies, such as offshore centres, Ireland and Jersey, in attracting a significant share of financial institutions based on a favourable tax regime. A targeted regulatory approach has also contributed to the rise of financial centres such as Switzerland.

In terms of the level of taxation, studying the impact of tax on US firms' location decisions, Devereux and Griffith (1998) found that a reduction of one percentage point in the UK average effective tax rate increased the probability of a US firm locating in the UK by approximately 1%. Morisset (2003), among others, argues that tax incentives are of varying importance to different firms, with mobile and multi-market firms, such as banks, insurance companies, as well as export-oriented firms, attaching more importance to tax levels.

In relation to the financial services industry, many studies find that tax levels, as well as the tax and regulatory regime in general, are a significant factor for financial institutions when choosing location, albeit to varying degrees. A study commissioned by the City of London, examining the importance of tax considerations in location decisions, found that, overall, they were important to financial services institutions, but not as important as the closeness of the customer base and business opportunity, availability of skilled workforce, and financial infrastructure. Furthermore, tax considerations were found to be more important when 'moves at the margin' were considered, and by smaller, more mobile firms, such as private equity and hedge fund managers.[13]

Other aspects of taxation and regulation are also considered to be important location factors by financial institutions. For example, taxation of investors and employees is important (ie, the overall tax burden), including double-taxation treaties, as are the overall stability and transparency of the tax and regulatory regime and attitude of tax authorities.[14] A study of fund domicile decisions found that the most important factors are taxation of fund, taxation of investor, and regulation, whereas location of administrative (back office) and core asset management functions were less important for these decisions.[15] Oxera research on the location choice of asset management companies found that the tax and regulatory regimes are of medium importance throughout the value chain.[16]

Thus, the principal aspects of the regulatory and tax regime that affect financial institutions' location choice are:

- the overall tax burden for the financial institution, including corporate income tax, social security contributions, VAT, property tax, and stamp duty;
- the taxation of their employees (mainly personal income tax);
- the taxation of investors, including capital gains tax, as well as any double-taxation treaties in place;

[13] CRA (2008), 'The Impact of Taxation on Financial Services Business Location Decisions', a report prepared for the City of London, February.
[14] Ibid.
[15] KPMG (2006), 'Taxation and the Competitiveness of UK Funds', October.
[16] Oxera (2005), op. cit.

– the certainty of interpretation of the tax and regulatory regime;
– the attitude of tax and regulatory authorities.

In terms of the different parts of the value chain, the tax and regulatory regimes are important for front office, core and back/middle office activities throughout different financial services segments.

Technical capabilities (including infrastructure)

The nature of the financial services sector means that, in terms of the successful functioning of financial institutions, the availability of appropriate infrastructure is paramount. Globalisation of financial services implies that the 'production' of financial services products and services by a financial institution can be done in multiple parts of the world, and provided in other parts of the world. That is, parts of the value chain can be located in different countries. Thus, the infrastructure to link the different parts of the value chain and to link the product to the consumer is an important factor for financial institutions. Furthermore, most financial services products rely increasingly on electronic solutions for the supply, execution, design and other functions within the value chain, which implies a significant role for communications and IT infrastructure. Thus, the following aspects of infrastructure in terms of their availability, price and quality are key for financial services:

– sophisticated IT systems;
– links to supporting services, such as accountancy;
– communication technologies;
– transport links, such as air travel;
– financial infrastructure, such as trading systems and account provision.

In general, good infrastructure is recognised by financial services institutions as a prerequisite for becoming a competitive financial centre. For example, studies examining the factors driving the success of Dublin as a preferred location by many financial institutions conclude that one of the factors was the strong development in telecommunications, which was the key to the financial services industry at the time.[17] Also, in the 2004 study, the Centre for Economics and Business Research report that the main factors that render London attractive to financial institutions include an efficient financial infrastructure, whereas an inadequate transport infrastructure is considered a significant drawback.[18]

IT, communications and support services are important throughout the financial services value chain, although to differing degrees. In general, they are more important for the front office and back/middle office functions, rather than the core functions. However, in securities markets, IT and communications play a critical role in core functions, while strong financial infrastructure can, for example, be an important factor in core asset management.

What other factors might play a role?

Given the comparatively sophisticated nature of financial services products and the advanced skill level required for employees within financial institutions, a number of other aspects influence the competitiveness of locations for financial services, as identified in economic research and industry surveys. Various studies and indicators of international competitiveness include these considerations, such as KPMG's 'Competitive Alternatives', PWC's 'Cities of Opportunity', and City of London's 'Global Financial Centres Index'.[19] Such considerations include the following:

– political and economic stability—low corruption rates, macroeconomic stability, political certainty, and other overall indicators of political and economic development;

[17] Burnham, J.B. (2003), 'Why Ireland Boomed', *The Independent Review*, **7**:4, Spring.
[18] Centre for Economics and Business Research (2004), 'The City's Importance to the EU Economy 2004', a report prepared for the Corporation of London, January.
[19] KPMG (2008), 'Competitive Alternatives–Guide to International Business Location'. PricewaterhouseCoopers (2008), 'Cities of Opportunity'. City of London (2009), 'The Global Financial Centres Index', prepared by Z/Yen, March.

– favourable business environment—ease of doing business and of entry and exit from the country, economic freedom, positive growth prospects, and a supportive and transparent general regulatory regime;

– quality of life—this may be an important factor, in particular in the location choices of those parts of the financial services value chain that require highly skilled labour, such as core functions. For example, a survey of asset management companies found that quality of life for employees is one of the top five factors for the location decisions of core functions, whereas it is less important for back and front office functions.[20]

2.3.2 Importance of clustering

The traditional approach to competitiveness of financial centre with reference to advantages in terms of input factors has been supplemented in recent years by an 'economics of clusters' approach. According to this, clusters are the key to the competitiveness and development of regions and countries, and the formation and success of finances centres.

The economic geography approach to financial services suggests that the following considerations may be important to financial institutions when choosing location:

– the presence of similar financial services businesses in a location, as well as strong supporting businesses and markets;

– the availability of high-quality skilled labour;

– more generally, the performance and liquidity of financial markets in a location;

– expertise in regional markets may foster the creation of a regional centre by attracting financial institutions owing to the informational benefits;

– a low cost base, attractive regulation and tax regime may attract the more 'footloose' financial activities; on the other hand, increasing costs, for example, are likely to contribute to financial institutions leaving a location.[21]

According to this economic geography approach, clusters are important to the competitiveness of regions and countries because they affect competition between firms within the cluster in a number of ways, including the following.[22]

– By increasing the productivity of companies located in a cluster, as a result of:

  – better access to employees and other specialised inputs;
  – access to specialised information, and information spillovers;
  – access to the relevant supporting institutions (legal, actuarial, accounting and IT);
  – complementarities (eg, when products complement one another in meeting customers' needs).

– By attracting, or stimulating the creation of, new businesses, which expands and strengthens the cluster. For example, when firms choose a location, the success of other firms already located in a cluster suggests to that potential entrant that it is likely to benefit from demand if it locates in that cluster.

[20] Oxera (2005), ibid.

[21] The case of Ireland demonstrates this. While several factors contributed to the creation and growth of clusters, including the Dublin financial centre, increasing costs over recent years, such as property and labour costs, are leading to companies relocating to cheaper countries, for example in CEE.

[22] Porter, M.E. (1998), 'Clusters and the New Economics of Competition', *Harvard Business Review*, November/December. Taylor et al. (2003), op. cit.

With respect to clustering in financial services, Raikes and Newton (1994) note that local concentration of financial services and supporting businesses ensures liquidity, in a broad sense, which is crucial to the success of most financial services businesses.[23] Furthermore, Taylor et al. (2003) observe the following.

– **Large and complex financial services firms**, such as investment banks, need access to large pools of specialised and highly skilled labour, and rely on shared experience and 'tacit knowledge', which is more easily exchanged when agents are geographically close. Hence, such financial services firms locate almost exclusively in major financial centres (eg, London, New York).

– **Smaller-scale financial services firms**, such as bank branches and independent insurers, are less complex and rely less on tacit knowledge or large quantities of highly specialised labour. Hence, such firms can locate also outside major financial centres.

– **Supporting services** (accounting, actuarial, legal, management consulting, IT, advertising, market research, recruitment, education, financial publishing) tend to be most prevalent in major financial centres. More generally, the co-location of associated markets leads to economies of agglomeration. This results in higher liquidity and efficiency and improved information flows.

The role of tacit knowledge and information in firms' location choices is further highlighted by Gehrig (2008), who reports that empirical evidence seems to suggest that financial activity is particularly concentrated for simple financial activities or securities, such as payment systems and currency trading ('footloose activities'). These footloose activities react more sensitively to regulatory or legal arbitrage opportunities (eg, as evidenced by the concentration of simple activities in offshore centres). On the other hand, where local information is essential, for example, for more complex securities or banking, local or regional financial centres are relevant. Gehrig concludes that financial centres could be referred to as the geographical centres of information aggregation for a given region.

Overall, therefore, clustering is particularly important for core functions and back office activities throughout the value chain in different financial services segments. For example, increasing the presence of financial services firms (or parts of firms) that focus on particular core or back office functions would be likely to raise the attractiveness of a particular location for other similar firms or similar functions within other firms. The clustering argument is generally less important in relation to front office activities.

2.3.3 From an attractive location to a successful financial centre

Various location choice factors discussed in this section are important determinants of attractiveness of a country as a location for financial services activities. All other things equal, a country that scores well on factors that are relevant for core asset management activities, for example, is more likely to attract international firms and increase export of this activity than a country that scores poorly. Scoring well on most of the relevant factors is an important pre-condition for increasing exports of particular financial services, but it is not a sufficient condition.

In practice, the development of successful financial centres usually takes a significant amount of time, and is often driven by external factors. With respect to the latter, for example, changes in the regulatory or tax regime in other countries (making it particularly disadvantageous to remain in these locations) can trigger switching to countries with more favourable regulatory and tax regimes. Similarly, the emergence of a new type of activity which can be easily exported globally and for which there is no natural location choice can result in the creation of a 'new' successful financial centre. In instances when these sudden

[23] Raikes, D. and Newton, A. (1994), 'Competition and Financial Centres in Europe: London as a Case Study', in Fair, D. and Raymond, R. (eds.), *The Competitiveness of Financial Institutions and Centres in Europe*, Financial and Monetary Policy Studies, 28, Kluwer Academic Publishers.

shifts take place, for a country (like Estonia) to be well positioned to capture such demand, it needs to score well on a set of factors that are relevant for this particular activity.

In the context of this study, consideration of the factors of attractiveness is critical since it allows functions/sectors of financial services industry to be identified where a country may be able to increase exports through gradual reorganisation of the international firms that are already present in Estonia, and attracting new firms to locate all or some of their activities in this country. Alternatively, in the event that some external factors result in a more significant change in location of particular activities internationally, being well placed is important to attract a significant proportion of this activity.

2.3.4 The impact of the financial crisis

The recent financial crisis and economic slowdown have had a significant impact on the financial services sector in Europe and elsewhere. Sectors such as asset management and insurance have been affected by falling asset prices. The banking sector has been particularly affected, with a number of large-scale insolvencies and an even larger extent of government support and bail-outs; furthermore, this has triggered regulatory changes.

In response to these events, financial services firms are re-evaluating their position and strategies, although to date the main focus has been on aspects such as improving solvency, de-risking of balance sheets, and improving risk management practices. This process has not had a significant effect on the overall approach to outsourcing of activities, although there are examples where large international financial services firms have increased centralisation of activities in their main locations and retreated from non-core markets.

The interviews with market participants undertaken as part of this study confirmed that firms have not in the main significantly altered their outsourcing policies (including those related to the CEE and Estonia) in direct response to the crisis. One of the financial services firms interviewed, however, has increased centralisation of their key activities (such as core asset management) in the home market, with a corresponding reduction in the level of outsourcing to the CEE, although this does not appear to be representative of the general trend observed in the sector.

In the longer term, the main impact of the crisis is likely to depend on how it affects various location attractiveness factors—in particular, the regulatory regime and (perceived) economic stability. In relation to the former, the main effect to date has materialised in terms of changes in ‘regulatory attitudes’. In particular, regulators across most countries are adopting a more stringent approach to the design and application of various rules and regulations. These changes are affecting different jurisdictions differently, thereby altering their relative attractiveness.

The interviews with market participants identified changes in regulatory attitudes as one of the most important immediate effects of the crisis. In particular, some of the firms confirmed that there had been a very significant change in the attitude of regulators in some of the European jurisdictions.

2.4 Examples of small, successful financial centres

There are a small number of leading international financial centres where, across different segments of the financial services sector, many major financial institutions are based, or at least have a presence. These centres have a highly developed financial services industry and infrastructure for ancillary services. This category includes established centres such as London, New York, Tokyo and Frankfurt. See Box 2.1.

Box 2.1 International financial centres

The International Monetary Fund defines international financial centres as:

> large international full-service centres with advanced settlement and payments systems, supporting large domestic economies, with deep and liquid markets where both the sources and uses of funds are diverse, and where legal and regulatory frameworks are adequate to safeguard the integrity of principal-agent relationships and supervisory functions. IFCs generally borrow short-term from non-residents and lend long-term to non-residents.

Source: IMF (2000), 'Offshore Financial Centers, IMF Background Paper', prepared by the Monetary and Exchange Affairs Department, June 23rd.

There are also many other jurisdictions, which, while they may not be classified as full-service international centres, are nonetheless seen to have developed regional and niche expertise in particular financial services segments and functions. This category of specialist/regional financial centres includes Switzerland, Luxembourg, Dublin, Jersey, Guernsey, Cyprus, Singapore and Monaco.

The centres considered here have focused on providing specific services; namely, private banking, wealth management and fund registration services. Some of these centres have also developed strong core asset management and back/middle office functions. For example, Switzerland has a well-developed core asset management cluster providing support to the private banking segment, as well as producing products that are sold independently of that segment.

An overview of some of the strengths of selected specialist/regional financial centres is provided below. This analysis is intended as an illustration of some of the main aspects of what made selected financial centres attractive.

Switzerland

The Swiss financial sector has considerable pre-eminence in private banking, and well-developed private banking services. Zurich ranks 15th and Geneva 40th in the MasterCard Worldwide Centres of Commerce Index along a number of dimensions.[24] Aside from historical reasons, such as its traditional 'neutral' role attracting capital in turbulent times such as the Second World War, a few main factors are cited as having led to its success: its taxation and secrecy laws, human capital, and the presence of established institutions.

On taxation, according to a City of London (2008) study, Switzerland has tended to attract companies and individuals with attractive, tailored tax proposals, and has recently been targeting UK-based hedge funds and private equity firms that are dissatisfied with developments in UK taxation[25] and prospective regulatory developments.[26] These developments are likely to strengthen further the core asset management cluster in Switzerland.

Another important aspect of Swiss predominance in banking is the secrecy laws, and, to some extent, there may be a policy trade-off between secrecy and taxation that has become more prominent in recent years. In 2005 Switzerland's attractive taxation regime was affected by a new tax on the savings of non-resident EU citizens, as part of a complex compromise with the EU to preserve bank secrecy. Nevertheless, this appears to have had

[24] MasterCard Worldwide (2008), 'Worldwide Centers of Commerce Index'; Dimensions: legal and political framework, economic stability, ease of doing business, financial flow, business centre, knowledge creation and information flow, and 'liveability'.

[25] City of London (2008), 'The impact of taxation on financial services business location decisions', research by CRA International.

[26] For example, the European Commission's proposed Directive on Alternative Investment Fund Managers.

limited impact on client behaviour to date, not least because of potential loopholes in the regulations, whether in terms of assets covered or parties liable to tax.[27]

The quality of the human capital and the established expertise of institutions in the Swiss financial centres (Zurich and Geneva) are other factors behind the sustained success of the sector. Not only does this presence of established institutions attract further institutions and human capital to the sector (ie, clustering), but this expertise is increasingly being leveraged to tap into new markets. Established Swiss banks have, at least until the current downturn, been opening branches in Asia and the Middle East to access new areas of affluence, and have been hiring tailored staff (eg, Russian-speaking) to strengthen Switzerland-based regional teams.[28]

Luxembourg

Luxembourg is the second-largest investment fund centre in the world behind the USA, and has a dominant role in reinsurance and the private banking sector in Europe.[29] As a financial centre, Luxembourg was primarily a Eurobond domicile in the 1960s, and then developed as a private banking centre before gaining ground as an investment fund centre in the 1980s. Its strengths in developing as a financial centre have stemmed primarily from its stability, quality of human capital, and regulatory regime.

Specifically, the factors behind its success have centred on Luxembourg's social and political stability, the openness of the economy, a competent regulatory authority, a multilingual and multicultural workforce, and, importantly, a legal and regulatory framework which is continuously updated to take into account the needs of the financial centre. According to Luxembourg for Finance (LFF), the agency for the development of its financial centre:

> over the years, specific regulatory frameworks have been created for alternative investment funds, venture capital companies, international pension funds, the Specialised Investment Fund for institutional and informed investors, covered bonds and the banks that specialise in issuing them, securitisation vehicles and a dedicated vehicle for managing family wealth.[30]

Dublin

Ireland has a well-developed investment funds sector, which has focused on attracting UK-based financial institutions, with the Irish Development Authority (IDA) actively seeking inward investment from UK-based institutions.[31] Dublin ranks 31st in MasterCard's Worldwide Centres of Commerce Index[32] along a number of dimensions, including the legal and political framework, ease of doing business and 'liveability'.[33]

The development of the Irish financial sector interacts closely with the Irish boom of the 1990s—the boom facilitated the development of the financial industry, while the industry's development in turn fed into the economic boom. The strongest growth at the end of the 1980s and at the beginning of the 1990s was in insurance, finance and business services; driven largely by back office work for major international banks that viewed Ireland as an excellent location for pan-European operations due to its human resources, communications

[27] Financial Times (2007), Private Banking, 'Profile: Switzerland: Much to smile about in climate of growth', June 20th, and Financial Times (2008), Private Banking, 'Switzerland: Clouds disturb sunny outlook', June 17th.

[28] Ibid.

[29] Luxembourg for Finance (2009), 'Key Facts', The Luxembourg Financial Centre.

[30] Ibid.

[31] City of London (2008), 'The impact of taxation on financial services business location decisions', research by CRA International

[32] MasterCard Worldwide (2008), 'Worldwide Centers of Commerce Index'. Dimensions: legal and political framework, economic stability, ease of doing business, financial flow, business centre, knowledge creation and information flow, and liveability.

[33] Although the Irish financial services sector has been significantly affected by the current financial and economic crisis, these effects have materialised in its domestic financial services, and not the export-oriented operations.

infrastructure and tax regime office.[34] The factors behind Ireland's success fall into three categories:

– **inherited factors**: these include demographics (eg, a large base of young workers to sustain economic growth). Also, factors such as openness to foreign investment, language and the common law legal system have played a role;

– **policy factors**: Ireland was quick to adopt low corporate profit tax rates and to reduce the effective tax rates on individuals. Development was also helped by educational reforms and the restructuring of the telecommunications system. Also, focused marketing efforts by Ireland highlighted to investors the following:

> In the early 1990s, IDA and Telecom Eireann established joint marketing programs, focused on the United States, to point out to investors the happy coincidence of a young, literate, English-speaking (in many cases multilingual), technically trained labour force in a low-tax environment with a technically advanced and relatively inexpensive telecommunications infrastructure—a place where many multinational firms already were established comfortably.

– **external events**: the rapid advancement and adoption of IT and communication technologies, globally, has had a disproportionately favourable impact on Ireland because the country was well situated and well prepared to take full advantage of it.

Jersey

The main activities of the Jersey financial industry are banking, private wealth management, and fund administration, and the key drivers of its success can be classified as inherited and policy factors.

In terms of inherited factors, the financial centre has been advantaged first of all by the inherent stability of Jersey, which has not suffered from political or economic instability. As an offshore regime, Jersey has also been advantaged in attracting UK-based institutions due to historical links and a common language. The States of Jersey also offers useful expertise in ancillary services (law, accountancy, and professional administration firms).

In terms of policy factors, Jersey offers an attractive and flexible tax regime and significant flexibility in terms of accounting requirements and incorporation of company requirements, relative to the requirements that characterise mainland jurisdictions in the EU. Jersey also has a strong confidentiality regime. It is appropriate to emphasise Jersey's tax regime as this is particularly relevant in attracting financial services institutions, workers and investors. In establishing Jersey's financial centre, zero rates of corporate tax and tax neutrality[35] have been achievable by 'exempt' companies. Currently, corporate tax rates tend to be 10% on the income from banking business, 10% for companies regulated by the Financial Services Commission, and 20% from Jersey property. The personal income tax is non-progressive at a 20% flat rate.[36]

Guernsey

Guernsey has an established deposit-taking, and to some extent private banking, base and has also developed a private equity niche in fund administration.[37] Its financial centre initially focused on attracting clients and firms with a connection to mainland UK, and this is still an area of specialism. The main factors underpinning the strength of the financial centre are its taxation and regulatory regimes.

[34] Burnham, J.B. (2003), 'Why Ireland Boomed', *The Independent Review*, **7**:4, Spring, 537–56.

[35] Tax neutrality is the ability to undertake a transaction or establish a structure whereby there is no additional tax, over and above the tax liability of participants in their home jurisdictions. By precluding additional layers of taxation, a tax-neutral offshore entity is tax-efficient for investors and creates a level playing field for investors from across the world.

[36] HM Treasury (2009), 'Progress Report of the Independent Review of British Offshore Financial Centres', April, p. 24.

[37] Financial Times (2008), 'Financial services: Holding its own against bigger rivals', Doing Business in Guernsey 2008, September 18th.

Regarding its taxation regime, one of Guernsey's main attractions, as with its Channel Island counterpart, Jersey, is the offer of tax neutrality. The 'zero 10' structure means that most companies, whether Guernsey-owned or owned by overseas shareholders, pay 0% corporate tax.[38] Banks and other companies providing credit facilities are taxed at 10%. There is a zero capital gains tax, and a 20% flat rate for income taxes.

The regulatory regime also plays a role in the strength of Guernsey's financial centre. Since Guernsey is not part of the EU, its financial sector is not necessarily constrained by the same regulation as its mainland counterparts. Guernsey's policy-makers facilitate the development of particular financial services segments with tailored legislation and regulation. For example, a registered fund regime introduced in 2007 eliminated drawn-out processes of obtaining regulatory consents by allowing licensed fund administrators to self-certificate new applications once they had collected all the necessary compliance details. With this tailored package submitted to the authorities, it allowed a fund to be approved for launch within 72 hours.[39]

Cyprus

Cyprus has an established presence in private banking and in registering foreign investment vehicles. The main factors behind the success of its financial sector are regulatory factors, and, most importantly, the taxation regime.

Regarding regulatory factors, the financial sector in Cyprus received a substantial boost from a government policy to lift all restrictions on foreign direct investment from the EU (since 2000) and from non-EU countries (since 2004). Also, the confidentiality regime is strong and facilitates the incorporation of companies—eg, a company can be registered by appointed nominees who hold shares on behalf of the owners, while the owners' identity remains secret.

One of the most favourable aspects of the financial centre in Cyprus is the taxation regime. In a KPMG survey in 2008 which compared tax regimes across Europe, Cyprus was ranked the best in Europe across dimensions such as consistency in interpreting tax legislation, stability in resisting frequent changes to tax laws, as well as low tax rates.[40]

Singapore

Singapore has a reputation as a premier asset management centre in Asia, and as an active trading centre, in OTC and commodity derivatives, and foreign exchange trading.[41] Aside from inherent factors such as Singapore's time zone, the main factors behind its success have been its foreign-oriented fiscal and regulatory incentives.

In the 1960s Singapore adopted 'an outward-looking financial development strategy, with the aim of transforming into a regional financial centre'.[42] Then, in the 1970s, to attract foreign banking groups, it implemented a two-tier banking system with two types of financial institution: domestic banking units (DBU) and Asian currency units (ACU), which focused on domestic and international banking activities respectively. The foreign institutions operating as ACUs enjoyed considerable fiscal and regulatory incentives.

Building on the success in attracting foreign financial institutions in targeting the development of its fund industry, Singapore has also offered a number of regulatory and fiscal incentives. For example, the Government of Singapore Investment Corporation (GIC) and the Monetary

[38] Financial Times (2008), 'Taxation: Authorities may cap a year of change', Doing Business in Guernsey 2008, September 18th.

[39] Gilligan, K. (2009), 'Guernsey: At the Forefront of the Fund Sector', HFM Week Guernsey Report, May.

[40] KPMG (2008), 'Cyprus, Ireland and Switzerland have most attractive corporate tax regimes in Europe, finds KPMG International Poll', Press Release, January 18th.

[41] Monetary Authority of Singapore (2009), 'Singapore International Financial Centre, Gateway to opportunities in Asia and beyond', available at www.mas.gov.sg.

[42] Hew, D. (2002), 'Singapore as a regional financial centre', AT10 Research Conference, March 7th–8th.

Authority of Singapore targeted external funds, giving mandates worth more than $20 billion between 1998 and 2001.[43] The government liberalised the CPF Investment Scheme, and fund managers, alongside other institutions, have benefited from one of the lowest corporate tax rates in Asia-Pacific, as well as a comprehensive network of double-taxation and free trade agreements.[44]

Monaco

Monaco specialises in offering private banking and wealth management services. The patronage of French financial institutions and clients has been important in the development of Monaco as a financial centre. The Monaco private banking association, Association Monégasque des Banques,[45] emphasises two principal factors behind Monaco's attractiveness: its strict confidentiality laws and favourable taxation regime.

In particular, the taxation regime in Monaco is highly attractive. It is characterised by an almost complete absence of direct taxation.[46] There are no corporate taxes, except for a 33.33% tax on profits for companies earning more than 25% of their turnover outside of the Principality (or which earn revenues from patents and literary or artistic property rights). There are no income taxes.[47]

What do these examples infer for Estonia?

The above examples of how some small financial centres have developed provide a number of insights for the development of Estonia as a financial services centre. One such insight stems from the fact that the centres considered here have focused on providing specific services, namely private banking and wealth management and fund registration services. Also, for example, in the case of Ireland, the beginnings of its international financial centre were largely due to international financial institutions locating their back office functions in Ireland, attracted by the high level of development in telecommunications and information technology, attractive costs and tax regime, skilled labour, and government policies. Nonetheless, for the smaller centres which have attracted investment in niche segments from financial services institutions in established financial centres, there is the more generalised prospect of attracting services across the value chain. Each of the financial centres considered has relied on several key aspects which have made the jurisdiction particularly attractive, such as a low overall tax rate and tailored taxation policies, proactive regulation which adapts to the needs of the financial services segments, and marketing efforts to attract skilled workers and financial services institutions. Given Estonia's proximity to Nordic countries, another factor which may be relevant for the development of Estonia's financial industry is that several of the niche financial centres considered have leveraged their proximity to established financial centres (eg, Ireland, Jersey and Guernsey to London's financial centre) to develop their financial sector.

In addition to the specific factors discussed above, all the jurisdictions reviewed above are characterised by broadly attractive lifestyles and a number of geographical and/or historical advantages in terms of cultural and political links to major business centres in Europe that attract the presence of foreign businesses and individuals, thereby facilitating growth of the local financial services industry. These potentially less tangible considerations should not be dismissed as irrelevant when considering the attractions of these locations as financial services centres.

[43] Ibid.

[44] Monetary Authority of Singapore (2009), op. cit.

[45] Association Monégasque des Banques (2009), http://www.monaco-privatebanking.com/en/banking-sector.html

[46] Association Monégasque des Banques (2009), 'An Unique Fiscal System', http://www.monaco-privatebanking.com/en/banking-sector.html

[47] The only income taxes payable are by French nationals who are unable to prove that they were resident in the Principality before October 31st 1962 for at least five years.

Thus, the nature and the development of these small financial centres highlight several factors that may be important for export-driven growth of the Estonian financial services sector and supporting activities. First, it might be important to focus on providing specific services or providing services to specific institutions, such as the Nordic financial services firms (ie, becoming a ‘niche’ player). Second, an effective regulatory and favourable tax regime is likely to contribute significantly to the attractiveness of a location. Third, the importance of other factors, such as geographical and cultural proximity, language, and the availability of an appropriately skilled labour force cannot be underestimated. Finally, at least to some extent, opportunities might arise due to exogenous reasons, and an appropriate response to these may play a significant role. Thus, based on the cases of some of the small financial centres, targeted and well-timed policies and actions (by the government and regulatory authorities, as well as the financial and non-financial businesses) are likely to increase Estonia’s opportunities for growing its export of financial services and related services.

2.5 Summary

The way in which a financial services firm structures its activities geographically typically forms an integral part of its corporate strategy. This strategy involves identifying the activities for which a firm has flexibility in relation to their location (relative to the location of demand), and then assessing which of the locations is most attractive for these activities.

In practical terms, it is important to distinguish between different financial services sectors (banking, insurance, asset management and securities markets), and different functions within these sectors. With respect to the latter, different functions across sectors can be classified into the following three categories:

– front office;
– core functions;
– back and middle office.

This classification provides a useful frame of reference for this study. In particular, factors that determine the most attractive location are likely to vary across these different functions, even within the same financial services sector. At the same time, there are often considerable similarities in the nature of activities within these functions across different financial services sectors. Therefore, factors that make a country an attractive location for back office activities in the financial services sector are also likely to make it more attractive for back office activities in other sectors.

Broadly speaking, the following factors are important determinants of attractiveness of location for different parts of the value chain:

– labour and property costs—especially important for front office and middle/back office functions;
– labour pool size, skills and flexibility—especially important for front office, core and middle/back office functions;
– proximity to clients and markets—especially important for front office and core functions;
– technical capabilities—especially important for front office, core and middle/back office;
– regulatory regime—especially important for front office and core functions;
– tax regime—especially important for front office, core, and middle/ back office;
– quality of life for employees—especially important for core functions;
– performance and liquidity of markets—especially important for core functions.

A consideration of the structure of the financial services industry and the distinct parts of the value chain indicate that some functions of some financial services segments may not be (or are less likely to be) exportable, and hence may be less relevant in the context of this study. Principally, functions and sectors that are generally more difficult to export include front office and distribution across financial services sectors and retail banking across functions. At the same time, functions that are generally more easily exportable are core functions in asset management and investment banking, and back/middle office activities across financial services sectors.

When considering the export growth potential of financial centres, the focus should be on the functions that can be exported relatively easily. Clearly, if the functions cannot be exported—for example, because there is a need to be in physical proximity to customers—it is more difficult (or impossible) for Estonia to increase export of these activities. On the other hand, for functions that can be easily exported, the combination of a well-developed industry and high attractiveness on the key location factors provides a solid basis for gradual growth in exports. In addition, idiosyncratic external factors (such as significant negative changes in the tax regimes of some relevant countries) play an important role in allowing countries to grow from providing 'some exports' to become successful (small) financial centres (such as Luxembourg, Jersey).

3 Positioning the Estonian financial services sector

3.1 Overview

The ability to support the export of financial services depends, to a large degree, on the level of development of the country's financial services industry. In other words, a reasonable degree of development of a given financial services sector or function—even if it is currently structured to service local demand exclusively—is an important factor determining potential for growth of exports. In the context of this study, it is therefore important to assess the level of development of different financial services sectors and functions in Estonia, even if this development can be considered as a necessary rather than a sufficient condition for the future growth of the export-oriented financial services industry.

This section examines the status quo of the financial services industry in Estonia to understand whether different sectors/functions are currently developed to a sufficient degree to provide some basis for future growth in exports of financial services. The analysis considers:

– whether the financial services sector in Estonia is reasonably well developed both overall and when compared with other countries in the region as well as more developed countries;[48]

– what impact the financial crisis has had on the Estonian financial services sector, and what lessons can be drawn from this about the resilience of the financial services industry in Estonia?

Another important aspect of the Estonian financial services sector is the relevant geographic frame of reference, which can be defined in terms of a group of countries in which Estonia is included by financial services firms when they consider location choices. For example, firms might choose location for a given function from a regional perspective whereby they select a country from a region such as CEE or the Baltic States.

The choice of the frame of reference depends on factors such as the characteristics of activities in different sectors/functions (eg, are there any advantages in being located in the same region), the nature of demand that is being serviced (eg, where does the demand originate), or the structure of the current operations of firms (eg, where does the firm currently have offices), among other factors. This frame of reference is particularly important when examining where the increases of financial services exports might come from and what the main 'competing' locations may be.

Overall, the analysis in this section—combined with the assessment in section 2 of the characteristics of activities in different sectors/functions—allows several sectors/functions to be identified where Estonia may have an opportunity to increase the level of exports in future, subject to demand for these services from abroad. This assessment is based on past research, business and academic literature, and Oxera interviews with market participants undertaken for this study.

[48] In line with the approach of the International Monetary Fund, the size of a sector relative to its gross domestic product (GDP) is a useful and comparable measure here. See International Monetary Fund and World Bank (2005), *Financial Sector Assessment: A Handbook*, Chapter 2.

3.2 Geographic frame of reference

Export-driven growth of the financial services sector and activities in Estonia requires consideration of the geography of the potential source of demand, as well as the geographic considerations of the financial institutions. In this context, it is useful to distinguish three geographic frames of reference:

– regional—the Baltic and Nordic region;
– regional—CEE and CIS;
– international—global.

3.2.1 Regional—Baltic and Nordic region

The other two Baltic States (Latvia and Lithuania) and the Nordic countries (Finland, Sweden, Denmark, and Norway) are likely to be an important source of demand for Estonian financial services or activities. In particular, the current state of development and the considerations by financial institutions indicate a regional perspective on financial services sectors, especially with regard to banking and securities markets.

Historically, financial institutions have largely viewed the three Baltic States together rather than separately. For example, one common reason for investing in the Baltic States cited by Swedbank, and other international financial institutions operating in the region, appears to be the scope for achieving economies of scale via cross-border synergies:

> Due to the similarity of the three Baltic countries, the top priority is to capture these synergies within the Baltic region. The goal is to build a regional banking organisation which leverages cross-border capabilities and whose value is greater than the associated increase in complexity.[49]

Thus, the general perspective appears to be that the Baltic States form a 'common market' for financial services. This view has been enhanced by the effects of the financial crisis being similar across the three Baltic States but different from most other CEE countries, such as Poland and the Czech Republic.[50]

Moreover, the current structure and ownership of the financial services industry in Estonia–where a significant proportion of services is provided by firms with presence in both Nordic and Baltic countries (see section 3.3 for more detail)—have direct implications for a relevant reference frame. In particular, for financial services firms with presence in the Baltic and Nordic States, choice from these countries becomes a natural frame of reference when deciding how to structure their operations internally. Therefore, in this context, Nordic countries represent target markets for Estonia.

At the same time, the significant presence of Nordic financial services firms in the Baltic States may also affect the location decisions of other Nordic financial services firms without any current presence in the Baltic States. In particular, when deciding the best location for particular functions, these firms may more naturally choose between Nordic and Baltic countries before considering other locations in CEE, other parts of Europe or globally.

3.2.2 Regional—CEE and CIS

While the geographic frame of reference based on the current structure and ownership of financial services industry in Estonia is largely regional in terms of the Baltic States and the Nordic countries, other aspects of the financial services industry may have a broader regional relevance for Estonia. In particular, when considering location choices for their activities, international financial services firms often include Estonia in the CEE region, which is viewed as an 'emerging' market within the enlarged EU. Therefore, if the decision to

[49] Swedbank (2008), 'Annual Report'.

[50] Standard & Poor's (2009), 'Market Dislocation Exposes Vulnerability of Eastern European Economies', RatingsDirect, February 23rd.

relocate some activity to the CEE region is considered, Estonia may be viewed as a potential option, and other CEE countries represent alternative locations against which Estonia is compared.

The regional perspective in relation to the Commonwealth of Independent States (CIS) is somewhat different. In particular, when choosing where to locate particular activities, Estonia is unlikely to be considered together with the CIS countries, although it may be considered as a potential location from which to service demand originating in the CIS (eg, dealing with the CIS clients). In other words, the CIS represents a possible target market for Estonia.

3.2.3 International—global

The geographic perspective could also be broadened to include global demand for financial services. Although Estonia is not, at present, likely to be considered in the circumstances where financial services firms have a genuine choice of locating particular functions globally, it is useful to consider this broader geographic frame of reference (at least in the longer run) in addition to the regional considerations described above.

3.2.4 Implications for the analysis

The relevant geographic frames of reference in the case of Estonia yield a number of observations. First, part of the growth in exports may come from the Nordic countries, from both firms which already have a presence in Estonia and other Nordic firms, for which Estonia may be a more attractive proposition than other CEE countries. However, this also results in reliance on the Nordic financial services sector, and more specifically on the decisions of large financial services firms. For example, a decision by one of the large Nordic banks to centralise as many functions as possible would have a potentially significant negative effect on Estonian exports of financial services. Second, to the extent that Estonia may be considered as part of the CEE, in order to attract activity (in this context) it needs to compare favourably with locations such as Latvia, Lithuania and Poland.

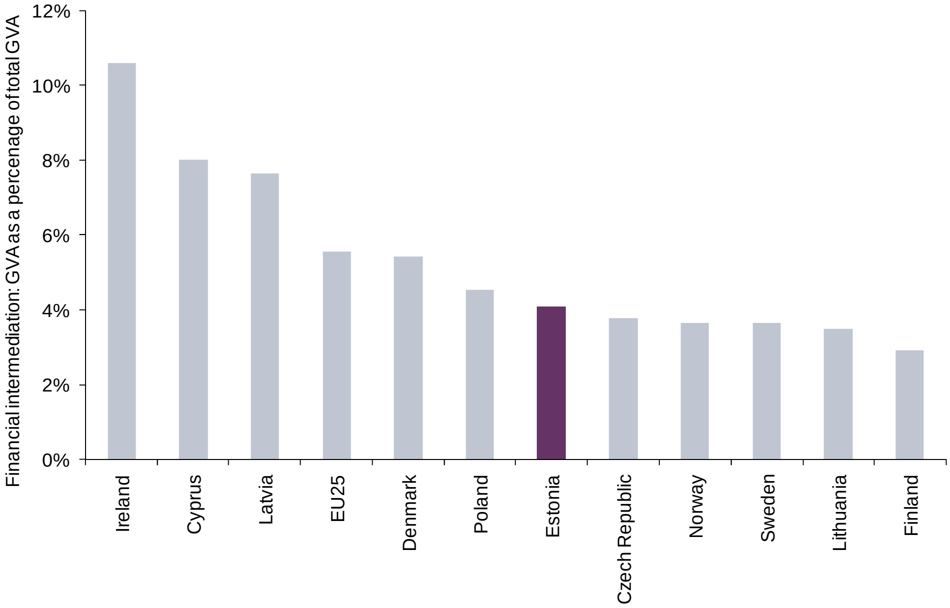
Overall, when considering the ability of Estonia to increase exports of financial services, it is therefore important to assess how well it compares—on the main location choice drivers—with its Baltic and Nordic peers, and peers in the CEE. (Section 4 provides insights into how well Estonia compares on these factors.)

3.3 Level of development of the Estonian financial services sector

Financial services contributed to around 4% of Estonia’s gross value added (GVA) between 2000 and 2008,[51] which is somewhat lower than the EU25 average (see Figure 3.1). In terms of more direct comparators, this share is considerably lower than that in Latvia, but comparable to that in Poland, the Czech Republic and Lithuania. Similarly, in terms of financial services employment, the level in Estonia (at 1%) is lower than in the EU25; and, in relation to comparator countries, it is lower than that in Latvia (2%), but comparable to that in Poland (1.2%), the Czech Republic (1.3%) and Lithuania (1.1%).

[51] Data on the share of financial intermediation in value added at current prices taken from Statistics Estonia.

Figure 3.1 Financial intermediation as a percentage of GVA, 2007

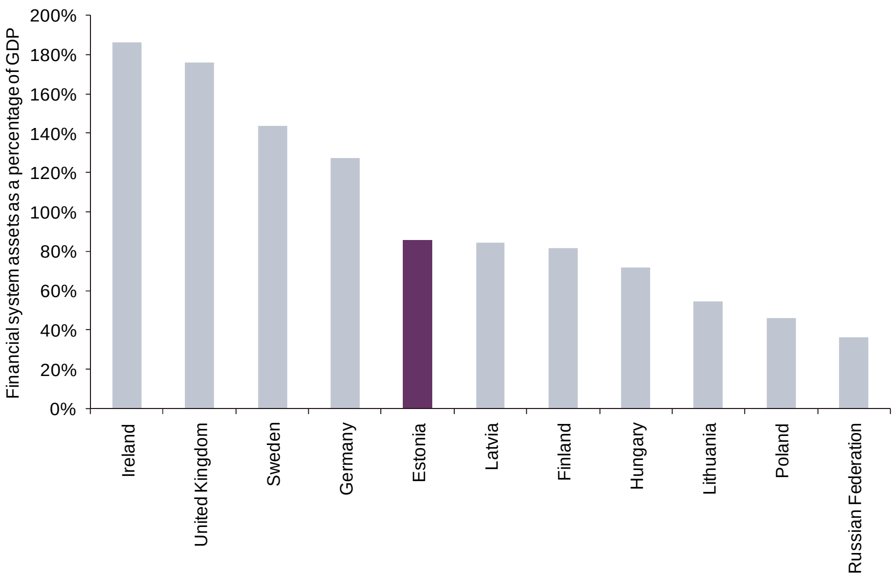


Note: 2007 data except for Poland, which refers to 2006.
Source: Oxera analysis, Eurostat

At the same time, in 2008 financial services share of services exports in Estonia was 2%, which is comparable to Poland (2.1%), higher than in Lithuania (1.2%) and considerable lower than in Latvia (6.9%). In relation to Nordic countries, the picture is more mixed, whereby, for example, the level in Sweden was higher (3.8%), while the level in Denmark was lower (0.9%) than in Estonia.

In comparison to other countries in the region, Estonia's financial services industry is one of the largest in relative terms—ie, in terms of financial system assets relative to GDP (see Figure 3.2), while it still lags behind the more advanced European economies. In particular, in 2007 Estonia had the highest ratio (86%) among the Baltic countries, as well as among the CEE countries shown in the figure and Russia. (In this sample, the Baltic, CEE and CIS average is 63%.) According to this measure (relative to GDP), Estonia's financial system assets slightly exceeded those of Finland (81%), but were significantly below those of other developed European countries.

Figure 3.2 Financial system assets as a percentage of GDP, 2007



Note: Financial system assets are calculated as the sum of central bank assets, deposit money bank assets and other financial institutions assets.
Source: World Bank (2009), 'Financial Structure Dataset', January, and Oxera analysis.

A significant share of total FDI coming into Estonia has gone into the financial services sector. In particular, in 2006, as much as 28.3% of total FDI in the country was comprised of financial intermediation FDI. This is a bigger share than that observed in Latvia (24.1%), Poland (18.7%) and Lithuania (15.9%). In relation to Nordic countries, the share of Estonia was similar to that in Finland (29.7%), and higher than in Sweden (22.7%), Denmark (16.7%) and Norway (11.7%). At the same time, the level of financial services sector ODI as a share of total ODI from Estonia in 2006 was 38.3%, compared with 20.8% in Latvia and 8.1% in Lithuania. In relation to Nordic countries, the share in Estonia was lower than in Sweden (45.6%) and higher than in Denmark (15.9%), Finland (4.0%) and Norway (1.9%).

In terms of assessing the Estonian financial services industry, it is useful to look at relative sizes of each of the financial services segments in order to understand the overall size of the industry and its high-level composition (see Table 3.1). As in many countries in the region, the banking industry is by far the largest, with assets of 138% relative to GDP. Pension and investment funds' net assets to GDP were 8.3%, whereas insurance gross premiums to GDP were 2.2%. Equity market capitalisation relative to GDP was 8.8% at the end of 2008 (down from 27% at the end of 2007).

Although Estonia's financial services industry has experienced significant growth and development over the past decade, the economic crisis has reduced the relative size of a number of segments within financial services.

Table 3.1 Relative size of the Estonian financial services segment at end 2008 (% of GDP)

Segment	Basis of calculation	Relative size (% of GDP)
Banking	Volume of assets	138
Pension funds	Volume of net assets	3.4
Investment funds (excl. pension funds)	Volume of net assets	4.9
Non-life insurance	Total gross premiums	1.7
Life insurance	Total gross premiums	0.5
Investment firms	Total assets	0.3
Equity market capitalisation	Market capitalisation	8.8

Source: Estonian Banking Association, Estonian Financial System Authority (EFSA), Estonia Statistics, NASDAQ OMX Baltic market statistics, and Datastream.

Thus, overall, the current size of the financial services sector in Estonia compares well with that of other countries in the region, and all of the main financial services segments are currently present in Estonia in some form.

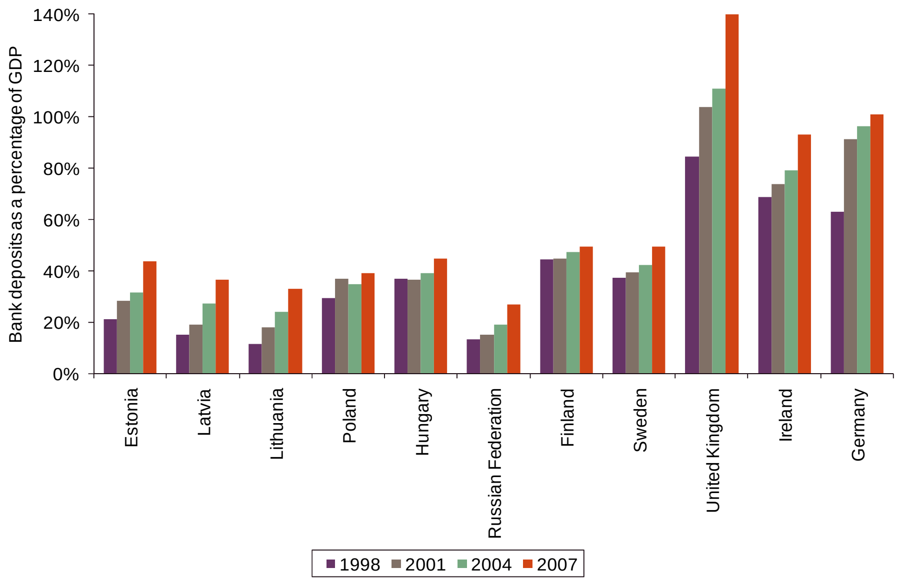
The level of development and growth of specific segments within the financial services sector in Estonia is discussed in more detail below in order to consider whether the key financial services segments in Estonia are sufficiently developed to be considered for export-driven growth.

3.3.1 Banking

Commercial banking

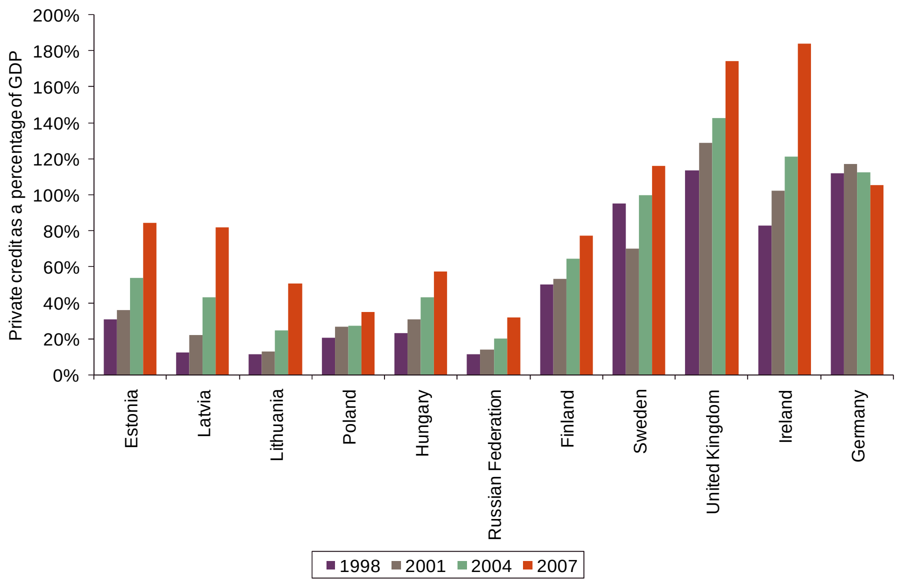
According to the Estonian Financial System Authority (EFSA), total deposits in Estonia in April 2009 had reached EEK117 billion (€7.48 billion).[52] Figures 3.3 and 3.4 below show bank deposits and credit to the private sector as a percentage of GDP, and compare Estonia against other countries. Both deposits and credit have grown rapidly in Estonia over the past decade—deposits increased from 21% of GDP to 44% between 1998 and 2007, whereas relative credit to the private sector increased from 31% to 84% of GDP over the same period.

Figure 3.3 Bank deposits as a percentage of GDP



Source: World Bank (2009), 'Financial Structure Dataset', January, and Oxera analysis.

Figure 3.4 Credit to the private sector as a percentage of GDP



Note: Credit to the private sector is measured as private credit by deposit money banks and other financial institutions.
Source: World Bank (2009), 'Financial Structure Dataset', January, and Oxera analysis.

[52] EEK to EUR exchange rate is fixed at EEK 15.6466:€1.

The relative size of the Estonian deposits market is similar to that of Finland and Sweden, and larger than that of its Baltic peers and other countries in CEE and CIS, but lags behind other European countries. Estonia has the largest credit market relative to GDP among the Baltic, CEE countries and Russia, exceeding also that of Finland. Thus, in terms of the size of the banking market, Estonia shows a high degree of development, especially when compared with other countries in the Baltic and CEE region. In terms of different elements of the value chain, activities across the front, core and middle/back office functions all are reasonably well developed, with some having a particularly high level of development (eg, electronic channels of distribution such as e-banking and m-banking). The interviews undertaken for this study indicated that exports of this segment are small at present.

The main players in Estonian commercial banking are foreign (Nordic) banks, which also have significant operations in the other Baltic States. Table 3.2 shows the main credit institutions in Estonia, together with their ownership and market shares as at the end of 2008. It is evident that the banking sector is mainly foreign-owned, with foreign-owned banks accounting for around 95% of the market, and highly concentrated, with the largest three banks accounting for 82% of the market.[53]

The Nordic ownership of the largest banks—which is also reflected in similar patterns in other types of banking, insurance and asset management—is a critical consideration in the context of this study. In particular, it has contributed to the level of development of technology, know-how and other operational aspects. At the same time, it introduces a particular geographic frame of reference whereby, from these firms' perspective, internal location choices for activities are often made between the Nordic and Baltic countries.

[53] According to the European Commission's report on retail banking, the average CR3 (the combined market share of the three largest banks in a country) across the EU is 49% and for new Member States it is 58%. The highest retail bank concentration, with CR3 larger than 80%, is in Finland, the Netherlands, Lithuania and Sweden, while the lowest concentration (CR3 at or lower than 50%) is in Poland, Latvia, Ireland, Italy, Spain and Germany. European Commission (2006), 'Interim Report II Current Accounts and Related Services', Sector Inquiry under Article 17 Regulation 1/2003 on retail banking', July.

Table 3.2 Credit institutions in Estonia—market shares and ownership

Bank	Market share	Owner (country)	Other branches
Swedbank	49%	Swedbank (Sweden)	Sweden, Estonia, Latvia and Lithuania; representations in Luxembourg, Russia and Ukraine
SEB Bank	21%	Skandinaviska Enskilda Banken (Sweden)	Sweden, Denmark, Norway, Finland, Latvia, Lithuania, Poland, UK, Germany, France, Singapore, Russia, Luxembourg, Switzerland, USA, China
Sampo	12%	Danske Bank (Denmark)	Finland, Sweden, Norway, Ireland, Latvia, Lithuania, and other
Nordea	11%	Nordea Bank (Finland)	Sweden, Poland, Denmark, Latvia, Lithuania, Norway, and other
BigBank[1]	n/a	BigBank (Estonia)	Estonia, Latvia, Lithuania, Finland
Eesti Krediidipank[1]	n/a	85% owned by Latvian Business Bank, the parent of which is Bank of Moscow Group (Russia)	Multiple jurisdictions
LHV Pank[1]	n/a	LHV Group (Estonia)	Estonia, Latvia and Lithuania
Marfin Pank Eesti (formerly SBM Bank)[1]	n/a	53% owned by Marfin Popular Bank Public Company (Cyprus)	Parent has 400 branches in 13 countries
Tallinna Äripanga[1]	n/a	Tallina Aripanga (Estonia)	A subsidiary in Moscow

Note: Market shares are as at end December 2008, and are calculated on the basis of total assets according to the Estonia Banking Association. Nordea is classified by EFSA as a branch of a foreign credit institution. Sampo is the Estonian branch of Danske Bank. These credit institutions are taken from EFSA's list of supervised entities as at June 22nd 2009. [1] For the banks whose market shares are labelled 'n/a', the cumulative market share is 7%.
Source: Company websites, and Estonia Banking Association.

Investment banking

In terms of financial institutions registered locally with the EFSA, investment banking services in Estonia appear to be offered by institutions classified as investment firms by the EFSA. That is, investment firms sell investment services, comprising mainly corporate finance advisory services, securities brokerage, and portfolio and asset management.[54]

At the end of June 2009, there were seven licensed investment firms in Estonia, as well as one foreign investment firm branch (Privanet Eesti) and 950 cross-border providers. Table 3.3 below shows the 2008 market shares of the authorised investment firms,[55] and suggests that investment banking activities in Estonia are covered by a relatively high number of firms, showing a mixture of Estonian (or firms originally established in Estonia, such as GILD and LHV) and Nordic firms.

[54] EFSA (2008), 'Financial Supervisory Authority Yearbook 2008'.

[55] According to EFSA, investment firms earned income primarily from the sale of mediation and advisory services which do not require acceptance of major balance sheet risks.

Table 3.3 Authorised investment firms in Estonia and their market shares, 2008

Firm	Market share by sales volume of investment services (%)	Market share by advisory services (%)
GILD Financial Advisory Services	34	57
LHV[1]	16	2
KIT Finance Europe	14	3
Evli Securities	13	2
Trigon Securities	12	-
SEB Enskilda	10	36
Cresco Väärtpaberite	1	-
Admiral Markets	-	-

Note: [1] LHV's licence of an investment firm expired on May 6th 2009.
Source: EFSA website and EFSA (2008), 'Financial Supervisory Authority Yearbook 2008'.

There is also some degree of export of investment banking services. For example, GILD, one of the leading Baltic investment banks (founded in Estonia in 1999), has activities and investments extending to the CEE, CIS and Nordic region. In 2008, GILD Investment Banking completed 12 transactions with a total value of around €200m (five capital raisings and seven mergers and acquisitions), and arranged an IPO in the Baltic and Nordic region (in Lithuania).[56] In 2008, the investment banking net fee and commission income of the group was €3.6m (36% of the total).[57]

Overall, based on the above and the interviews undertaken for this study, the investment banking sector in Estonia appears to be relatively small. Also, in terms of activities across the value chain in investment banking, front office, core, and back/middle office activities are generally undertaken in Estonia and, as discussed above, are limited by the small size and are not highly developed.

Private banking

The nature of the private banking business makes it difficult to assess the size and the structure of the market. Private banking appears to be offered by the largest banks in Estonia (for example, Swedbank, SEB and Nordea all have some private banking operations in Estonia), as well as by smaller independent institutions (such as GILD Bankers Group).

The growth in this activity has been driven largely by the growth in wealth (and number of wealthy individuals) in Estonia, and in neighbouring countries. Importantly, clients from the CIS constitute a significant proportion of private banking clients in some of the major institutions providing this service in Estonia—ie, the Estonian operations of large Nordic banks are managing to attract private client money from the former CIS countries. Moreover, the banks are increasingly providing higher value-added services to these clients.

Overall, based on the above and the interviews carried out as part of the study, the private banking sector currently appears to be reasonably well developed, and in terms of the front office activities of marketing and distribution, appears to have created a niche in servicing clients from the CIS. Core and middle/back office activities are also carried out in Estonia, and the overall level of industry development is generally representative of the development of each element of the value chain in private banking.

[56] AS GILD Financial Advisory Services, '2008 Annual Report of the Group'.
[57] GILD Bankers Group (2009), 'GILD Bankers Annual Review 2008'.

Impact of recent events on banking

Banks in Estonia, and in the Baltic States more generally, have suffered significant losses as a result of the global financial crisis. The situation in the Baltic States has had an impact on the parent companies of Estonian banks, although, overall, the parent companies remain sound. Table 3.4 shows the credit ratings of Nordic banks with large exposures in Estonia and other countries in the region. Although the financial strength and outlook for some banks is rated negatively when compared with previous positions, there have been no bankruptcies or large-scale government intervention in the form of state aid.[58]

Table 3.4 Credit ratings of Nordic banks, as at July 10th 2009

	Standard & Poor's		Moody's			Fitch	
Bank	Long-term	Outlook	Long-term	Outlook	Financial strength	Long-term	Outlook
Nordea Bank	AA-	Stable	Aa1	Stable	B	AA-	Stable
Danske Bank	A+	Neg	Aa3	Stable	C	A+	Stable
Svenska Handelsbanken	AA-	Stable	Aa1	Stable	B	AA-	Stable
DnB NORD	AA-	Neg	Aa1	Neg	B-	A+	Stable
SEB Bank	A-2 [1]	-	Aa1	Neg	C-	A+	Stable
Swedbank	A	Neg	Aa1	Watch	C-	A	Stable

Note: [1] Standard &Poor's rating for SEB Bank is short-term.
Source: Standard &Poor's, Moody's and Fitch websites.

As an example, the effect of the crisis on Swedbank, the largest banking group in Estonia (and the Baltic countries overall), is outlined below.

– In mid-2008, Moody's lowered Swedbank's financial strength rating to B– from B, noting that the bank's Tier 1 capital ratio, at 6.5%, was low relative to similarly rated peers given its Baltic exposure and expansion in emerging markets. Also, the Fitch downgrade of the outlook on Swedbank to negative from stable and the cut of its individual rating to B/C from B reflected its relatively large exposure to the Baltic States, which accounted for 16% of its total lending at the end of June 2008 and 27% of group operating profit.[59]

– Swedbank Baltic Banking division reported an operating loss of SEK2.9 billion (€0.3 billion) in Q1 2009, down from a profit of SEK1.2 billion (€125m) in the equivalent period of 2008. The decrease was due primarily to a substantial increase in loan loss provisions, which were SEK4.2 billion (€437m) in Q1 2009, up from SEK173m (€18m) in Q1 2008.[60] The loan losses of Swedbank's Estonian unit totalled €7m due to the growth in the number of clients in repayment arrears; moreover, the bank set aside €61m to cover potential loan losses.[61] Swedbank is considering placing the toxic assets with a special unit within the existing bank in 2009.[62]

[58] Although the Swedish government has borrowed from the European Central Bank in order to be prepared to make capital injections in case of unfavourable outcomes of its banks in the Baltic States.
[59] Reuters News (2008), 'Fitch cuts Swedbank outlook due to Baltic worries', October 7th.
[60] IPR Strategic Business Information Database (2009), 'Moody's reviews Swedbank AS'S BAA2/D/P-2 Ratings for Downgrade', April 28th.
[61] Baltic Business News (2009), 'Estonia: Swedbank makes €19 min loss in Q1', April 26th.
[62] Dow Jones Newswires (2009), 'Swedbank: To Implement Baltic Bad-Bank Structure In 1H-09', March 29th.

SEB Bank was affected by the crisis, taking a hit of EEK293m (€18.7m) due to bad loans in Q1 2008, compared with just EEK20m (€1.28m) in the same period for 2007. Quarterly profit fell to EEK57m (€3.64m) as a result.[63]

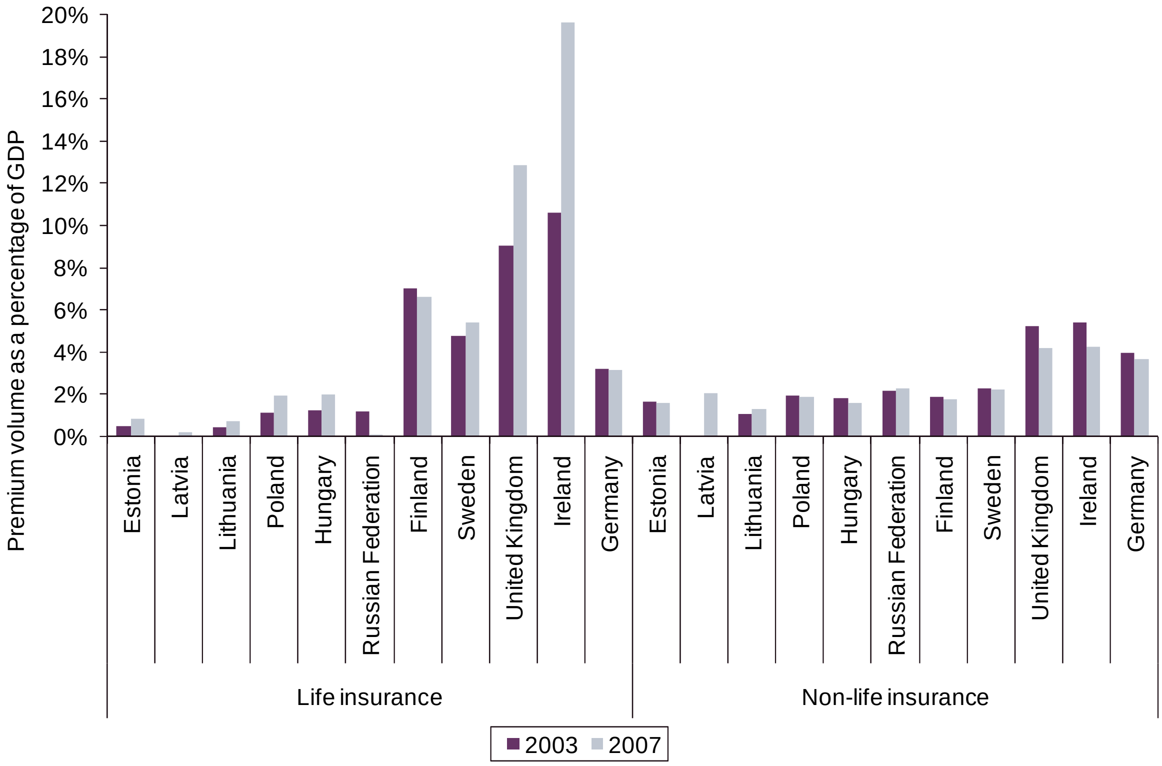
Overall, therefore, although Baltic banks suffered significant losses, the banking sector remains sound, particularly when compared with other countries where banks required state bail-outs and guarantees (eg, the UK, Germany and Belgium).

3.3.2 Insurance

Size of the Estonian insurance market

The insurance market in Estonia is relatively underdeveloped, as illustrated in Figure 3.5, which shows the size of the life and non-life insurance market relative to GDP in Estonia and in comparator countries.

Figure 3.5 Life and non-life insurance premium volume as a percentage of GDP



Source: World Bank (2009), 'Financial Structure Dataset', January, and Oxera analysis.

Non-life gross premiums amounted to nearly EEK1 billion during Q1 2009, or 1.9% of GDP. Motor insurance (by individuals and legal persons) is by far the most prevalent type of non-life insurance, with gross premiums accounting for nearly 70% of the total in 2008. Property insurance is the second most prevalent type of insurance, accounting for 22% of non-life gross premiums in 2008.

Life gross premiums amounted to EEK238m during Q1 2009, or 0.5% of GDP. Nearly half of the life insurance is unit-linked (in 2008), with endowment insurance being the second most prevalent type in Estonia (with 37% of gross premiums in 2008).[64]

When compared with other countries in the region (based on 2007 indicators), the Estonian life insurance market is slightly larger than that of its Baltic peers, whereas the non-life

[63] Baltic Times (2008), 'REPORT: SEB sends in Debt Collectors', June 11th.

[64] Insurance premium data is taken from Estonia Statistics, and quarterly GDP data is from Datastream.

insurance market is slightly smaller than that of Latvia. The market size of non-life insurance in Estonia is comparable to that of other CEE countries, and only slightly lower than that of Finland.

As such, the insurance industry in Estonia is relatively underdeveloped, and exports of insurance services appear to be small (0.07% of GDP in 2007). Activities across the value chain of insurance (front office, core and back/middle office) are accordingly small. While there is significant potential for further growth in local markets, the level of development does not appear to provide a good basis for increasing exports in the short run.

Main providers of insurance in Estonia

As in the banking sector, the insurance sector in Estonia is also dominated by foreign financial institutions. Table 3.5 shows the main insurance providers in Estonia, their ownership and market shares in 2008. While the large Nordic banks have a significant share of the insurance market, insurers from Finland, Austria, Germany, Luxembourg, Latvia, and the UK also are important market participants (particularly in the non-life segment).

Table 3.5 Market shares and ownership of insurance companies in Estonia

Insurance company	Market share (%)	Owner
Life insurance		
Swedbank Elukindlustus	40	Swedbank (Sweden)
SEB Elu-ja Pensionikindlustus	34	SEB (Sweden)
Sampo Life Insurance Baltic	12	Mandatum Life Insurance Company (Finland)
Compensa Life Vienna Insurance Group SE	8	Wiener Stadtische Versicherung AG Vienna Insurance Group (Austria)
ERGO Elukindlustuse	6	ERGO Insurance Group, owned by Munich Re Grupp (Germany)
Main non-life insurance companies		
If P&C Insurance AS	28.7	P&C Insurance Holding, part of Sampo Group (Finland)
ERGO Kindlustuse	21.8	Ergo International (Germany)
Swedbank Varakindlustus	14.5	Swedbank (Sweden)
Seesam Rahvusvaheline Kindlustuse	11.7	Pohjola Bank plc (Finland)
Salva Kindlustuse	8.2	ING (Luxembourg)
BTA apdrosinasanas akciju sabiedriba*	4.2	BTA apdrosinasanas akciju sabiedriba (Latvia)
QBE Insurance*	3.2	QBE Insurance Group Europe Operations (UK)
Inges Kindlustus	2.7	Ingosur, Ou Unix-V (Netherlands, Finland)
AAS Gjensidige Baltic in Estonia*	2.7	Gjensidige Forsikring (Norway)

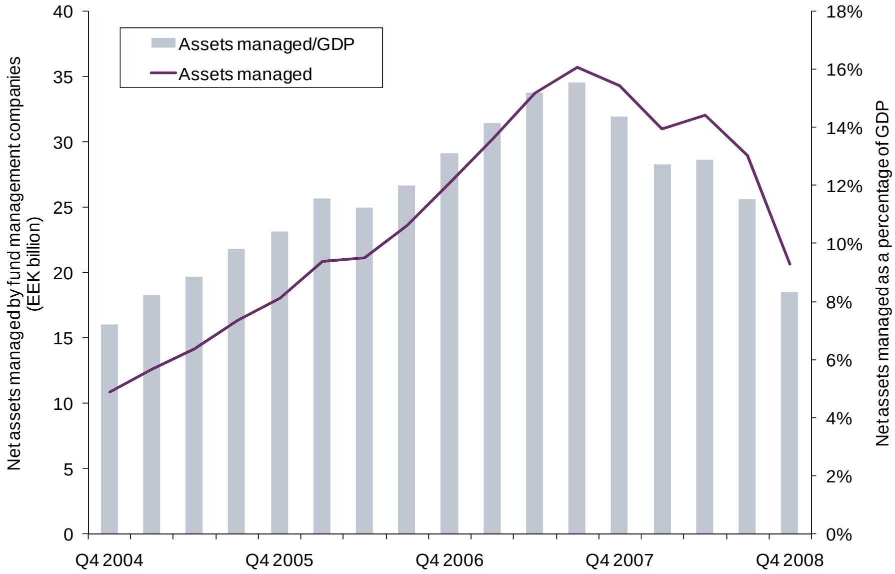
Note: Insurance companies marked with * are affiliated branches in Estonia; others are licensed institutions according to EFSA's classification. Five other non-life insurance companies, not shown here, operate in Estonia, with a combined market share of 2% in 2008: Codan Forsikring; Euler Hermes Kreditversicherungs-Aktiengesellschaft; Estonian Traffic Insurance Fund; D.A.S. Õigusabikulude Kindlustuse AS; and Fennia Mutual Insurance Company. The market shares are calculated on the basis of gross premium volumes for each company, using 2008 data.
Source: Company websites, Statistics Estonia, EFSA, and Oxera analysis.

3.3.3 Asset management

Size of the market

The asset management industry in Estonia is reasonably well developed given the size and development of the Estonian economy as a whole. Although net assets managed by asset management companies in Estonia reached over EEK35 billion (€2.24 billion) in Q3 2007, this fell to EEK20 billion (€1.28 billion) by the end of 2008. Net assets managed relative to GDP were 8% at the end of 2008, nearly half their level one-and-a-half years earlier. This rapid fall in the size of the industry in terms of net assets managed is largely a consequence of the financial crisis, as asset values have been falling worldwide.

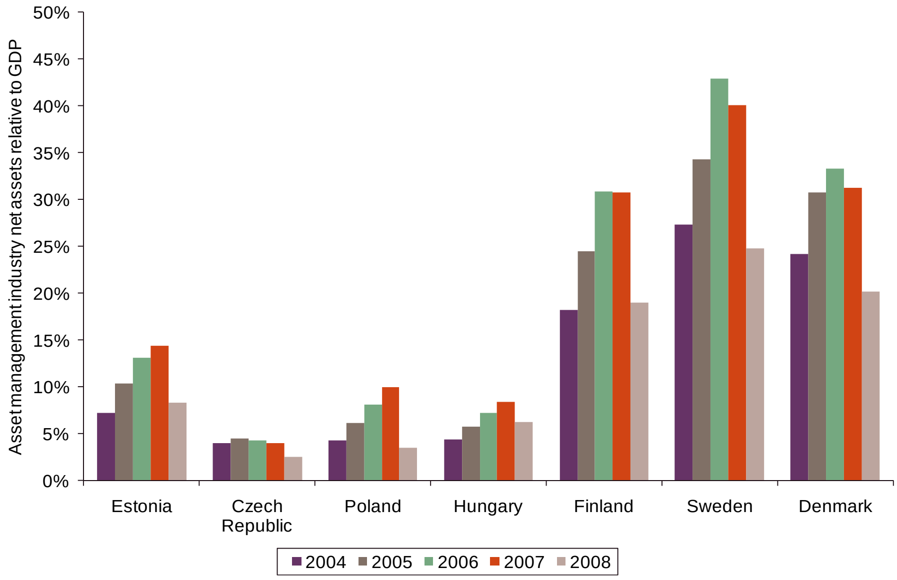
Figure 3.6 Net assets managed by asset management companies in Estonia



Note: Quarterly GDP data is taken from Datastream, and the rolling total over four quarters is calculated. Assets managed are as at the end of the period.
Source: EFSA, and Datastream.

Estonia's asset management industry is relatively small and represents a very small proportion of the total European industry. At the same time, although, the size of assets in Estonia relative to the economy is small when compared with the developed countries, it compares relatively positively in relation to the CEE countries (see Figure 3.7 below).

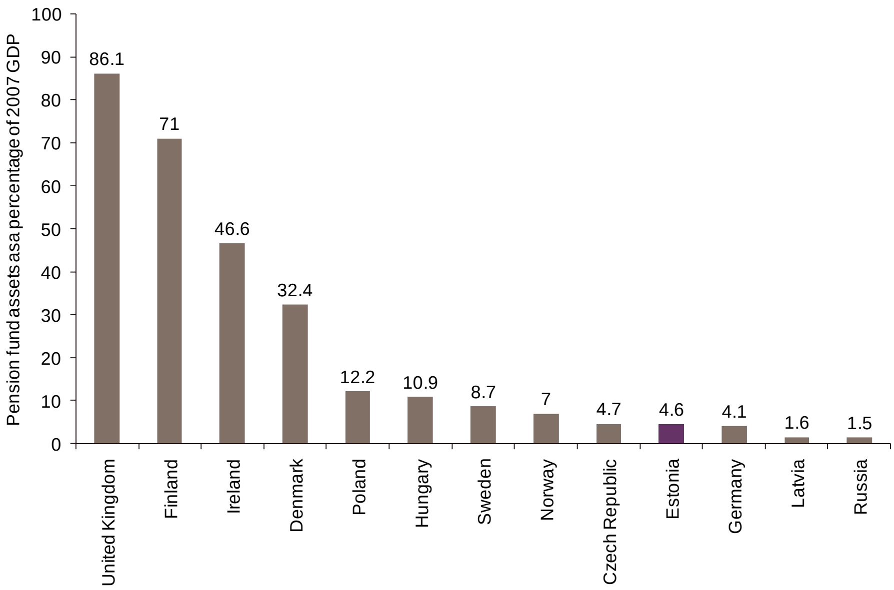
Figure 3.7 Asset management industry net assets relative to GDP



Note: Estonia data shows the net assets of investment funds at the end of the period (data obtained from EFSA). Data for the other countries is based on international statistical releases of EFAMA, and represents net assets at the end of the period.
Source: Oxera calculations based on data from EFAMA, EFSA, Eurostat.

Another indication is provided by the size of pension fund assets relative to GDP. Figure 3.8 shows that the level in Estonia is similar to that of some of the comparators (such as Latvia), and lower than others (such as Poland).

Figure 3.8 Pension fund assets relative to GDP—Estonia and selected comparators



Note: The figures for Latvia and Russia refer to 2006 data.
Source: OECD (2008), 'Pension Markets in Focus', Issue 5, December.

Structure of the industry

Estonian asset management industry participants are registered fund management companies and investment firms, as well as cross-border providers. Table 3.6 details the fund management companies and investment funds in Estonia.

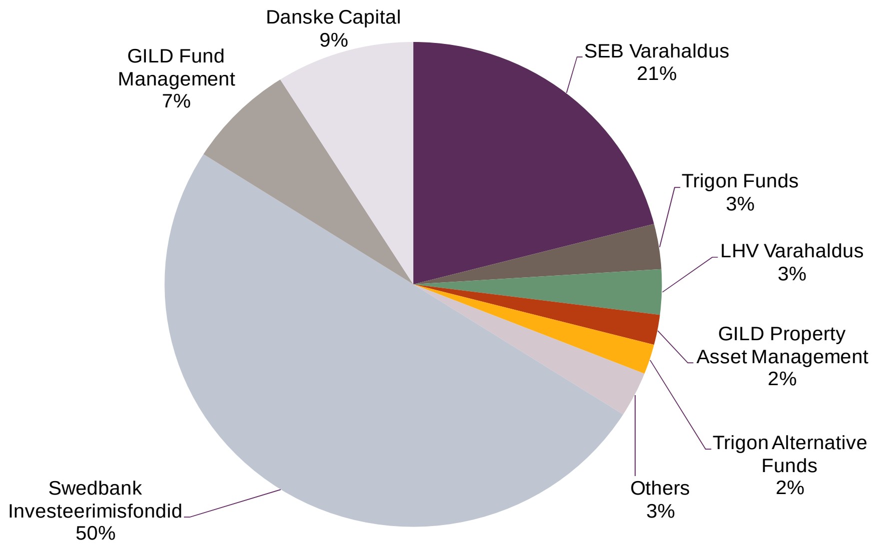
Table 3.6 Number of asset managers and investment funds in Estonia

Fund management	
Fund management companies	16
Cross-border fund management companies	11
Investment funds	
Investment funds (contractual)	46
Pension funds (mandatory)	20
Pension funds (voluntary)	12
Registered foreign investment funds	63

Source: Taken from the EFSA's list of supervised entities, as at the end of June 2009.

Figure 3.9 shows the market shares of the major players in the asset management industry. Based on the market shares of asset management companies in terms of funds under management, the market is dominated by Nordic asset managers and is highly concentrated (the three largest players account for 80% of the market share). None of the investment firms had a large actively managed trading portfolio, with securities forming only around 9% of firms' assets.[65]

Figure 3.9 Market shares of main players in asset management industry, 2008



Note: The market shares of asset management companies are based on their volume of investment funds.
Source: EFSA (2008), 'Financial Supervisory Authority Yearbook 2008'.

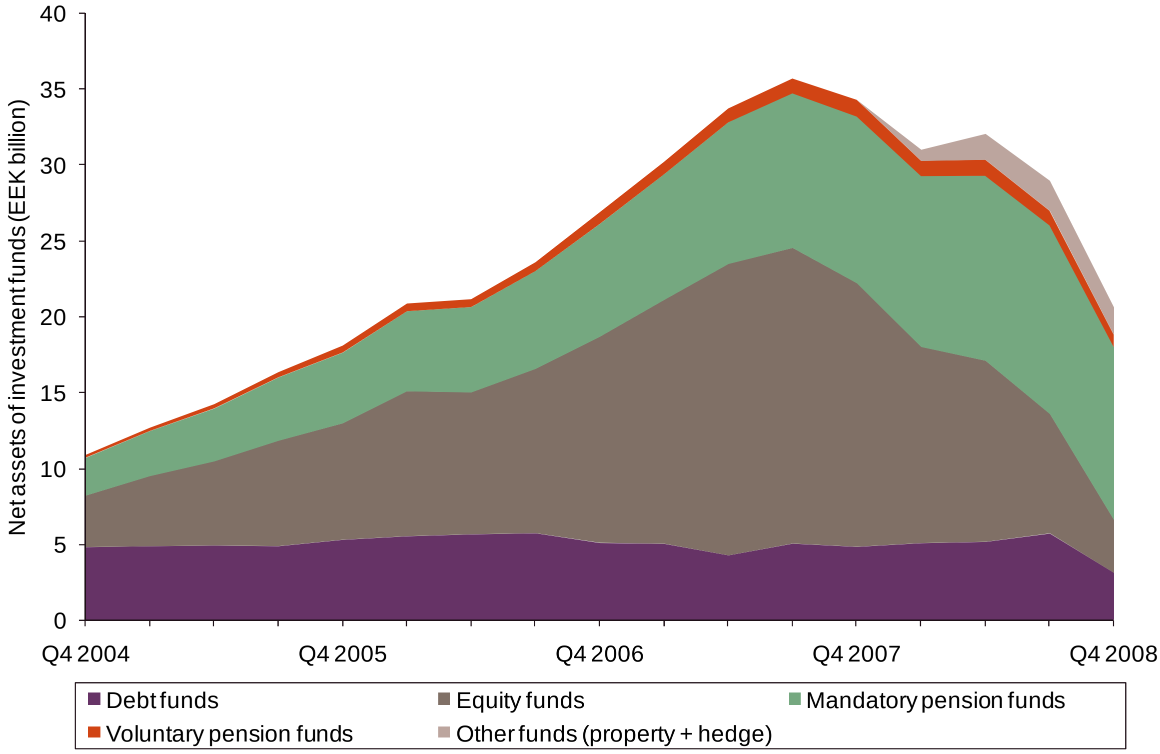
As the figure shows, similar to the banking and insurance industry, the asset management sector is dominated by large Nordic firms. This provides a certain geographic frame of reference for the analysis of exports, whereby one important aspect of the export of asset management services is the way in which activities (particularly core and back office activities) are allocated across geographic locations within these firms. For example, re-locating all of the CEE core investment to Tallinn, all else equal, increases the export asset management services from Estonia.

At the same time, it is worth noting the presence of some of the independent asset management firms, including firms with presence in other CEE countries. The attractiveness of Estonia from the perspective of such firms is likely to be driven (at least partly) by different considerations to those of the large Nordic firms. For example, they are unlikely to have a Nordic/Baltic regional view when choosing location of different activities, and instead are more likely to adopt either a CEE regional or pan-European frame of reference.

The Estonian fund market is mainly dominated by equity funds and mandatory pension funds, as Figure 3.10 shows. However, due to the financial crisis, falling equity prices have significantly dented the net assets of equity funds, with pension funds accounting for 55% of the industry at the end of 2008. Property and hedge funds have a very recent history in Estonia, but their share at the end of 2008 was 9%. Therefore, the Estonian asset management industry covers all main asset classes.

[65] EFSA (2008), 'Financial Supervisory Authority Yearbook 2008'.

Figure 3.10 Investment fund assets by fund type



Source: EFSA.

The geographic scope of the Estonian investment fund portfolios provides an important indication of the potential niche of the asset management industry going forward. In particular, Figure 3.11 below shows that, at the end of Q1 2009, a disproportionately large[66] proportion of funds' assets were invested in Latvia/Lithuania and CEE. In particular, investments in CEE (including Latvia and Lithuania) accounted for around 11% of the investment fund portfolio. However, the geographical distribution has changed significantly over the past year—in comparison, at the end of Q1 2008, CEE (including Latvia and Lithuania) accounted for 22%.

Estonian funds have a relatively low home bias in asset allocation, which may be due to the legislative framework:[67]

> pension fund regulation in Estonia differs from other CEE countries. There are no minimum guarantees and almost no restrictions on international investment and providing funds with different risk/return profiles.[68]

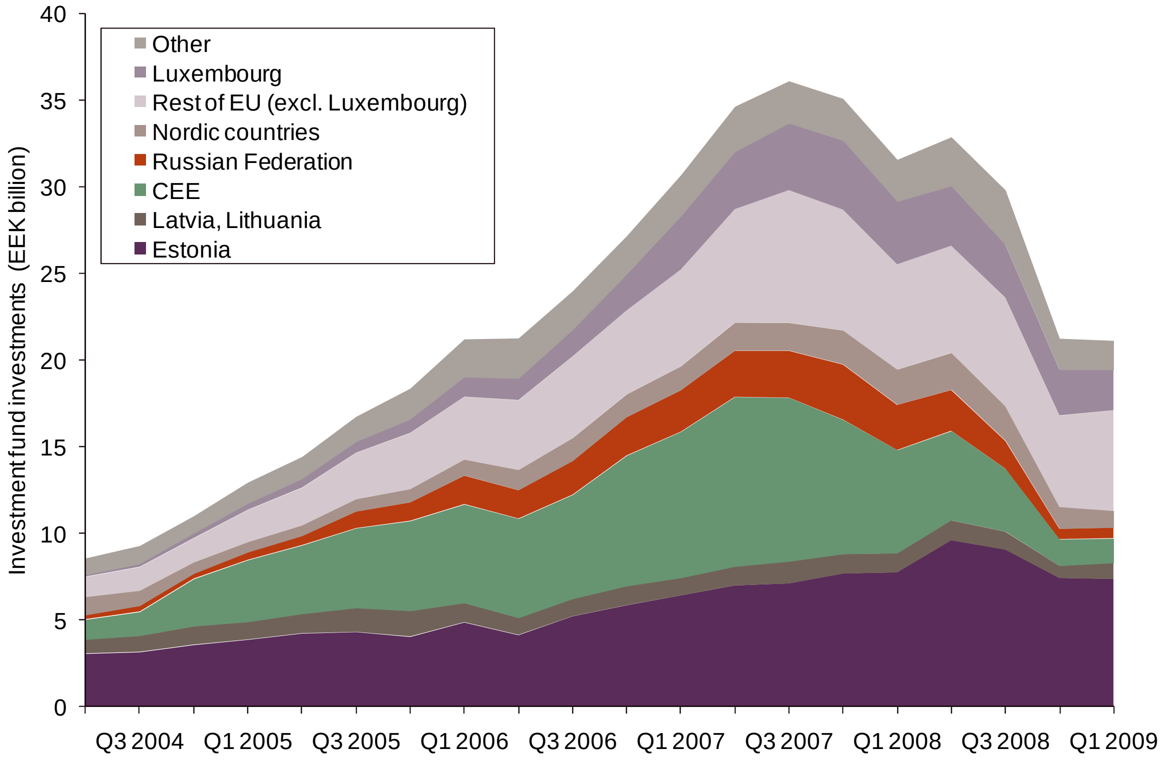
Overall, this evidence (notwithstanding that there has been a reduction in the CEE investments), combined with observations from the interviews undertaken for this study, suggests that there is regional (Baltic States /CEE) investment know-how in Estonia, which could be leveraged as one of the factors attracting core asset management activity to the country.

[66] Disproportionate relative to a 'fully diversified' pan-European or global portfolio.

[67] Indirectly related to the Estonian situation, Swinkels et al. (2005) question why Latvian funds pursue limited international diversification, noting that these pension funds invest about 85% in domestic assets. They speculate that the domestic orientation can be explained partly by legislation and cultural investment attitudes. Latvian pension law has traditionally been strict on international diversification, while both fund managers and investors are arguably more comfortable with investing in Latvian companies with which they are familiar. Swinkels, L., Vejina, D., and Vilans, R. (2005), 'Why don't Latvian pension funds diversify more internationally?' Stockholm School of Economics in Riga, Working Papers 2005, 1 (69).

[68] Aviva Investors (2009), 'Estonia Country Profile'.

Figure 3.11 Breakdown of funds investments by residence of issuer



Source: EFSA.

Thus, the Estonian asset management industry shows a reasonable level of development across the entire value chain (front office, core and back/middle office activities) and there are positive trends in international focus and CEE investment know-how in the industry. This includes, for example, management of the CEE mandates for distribution to investors outside Estonia. However, with the exception of core activities (particularly investment management), the level of development of each of these activities has generally been constrained by the overall size of the market. Although, on their own, these factors are not sufficient to drive growth in exports in asset management industry in Estonia, they are important pre-conditions.

3.3.4 Securities markets

Founded in 1996, the Tallinn Stock Exchange (TSE) is the only regulated securities market in Estonia. At present, TSE is part of the Nasdaq OMX Group, along with stock exchanges in the other Baltic States and Stockholm, Helsinki, Copenhagen and Iceland.

The stock markets of the three Baltic States are closely integrated, based on Nasdaq OMX Baltic, which combines products from Nasdaq OMX Tallinn, Riga and Vilnius into common lists and trades them in the same market segment. That is, cross-border trading and settlement are provided by the common trading system for the three Baltic stock exchanges. There are three lists on Nasdaq OMX Baltic: the Baltic equity list (main and secondary), the Baltic bond list, and the Baltic fund list.[69]

Table 3.7 shows the evolution and size of the TSE equity list. While market capitalisation and trading turnover grew steadily during the first half of the decade, there has been a decline in recent years, partly driven by the financial crisis and worsening economic situation in Estonia.

[69] In the first half of 2009, there were no securities listed on the secondary market of the TSE.

Table 3.7 Size of equity market on the Tallinn Stock Exchange

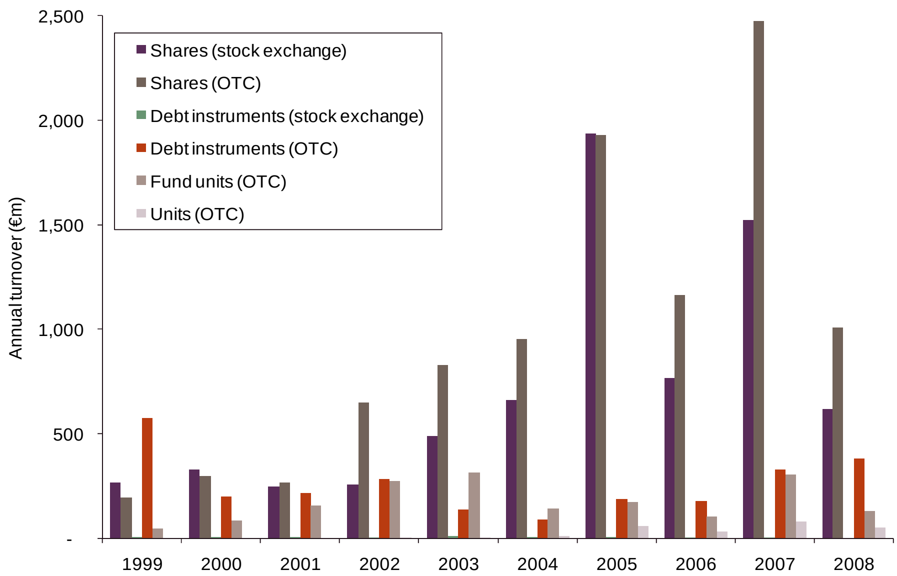
	Market cap (€m)	Market cap (% GDP)	Market turnover (% of GDP)	Number of companies	Number of IPOs
2000	1,923	31.5	5.7	21	-
2001	1,666	24.1	3.7	18	-
2002	2,316	29.9	3.4	15	-
2003	3,005	35.4	5.8	15	-
2004	4,627	49.4	7.1	14	-
2005	3,022	27.3	17.5	16	3
2006	4,578	35.0	5.9	16	2
2007	4,105	26.4	9.8	18	2
2008	1,403	9	3.9	18	-
2009 H1	1,382	-	-	17	-

Note: Data for 2008 and the first half of 2009 is shown as at the end of the period.
Source: Nasdaq OMX Baltic (2008), 'Guide to Nasdaq OMX Baltic Securities Market', and market statistics from Nasdaq OMX Baltic.

The bonds market on the TSE is of negligible size: at June 30th 2009 six bonds were listed on it, out of 135 listed on Nasdaq OMX Baltic, with market cap of only €6.77m (less than 1% of the Baltic total). The Baltic funds list comprised 186 funds on June 30th 2009, of which 34 were domiciled in Estonia.

Figure 3.12 below, which presents the evolution of turnover by security type, including the OTC market, shows that trading by value is dominated by on-exchange and OTC share trading, followed by OTC trading in debt instruments. Overall, however, the activity in securities markets in 2008 declined compared with 2007.

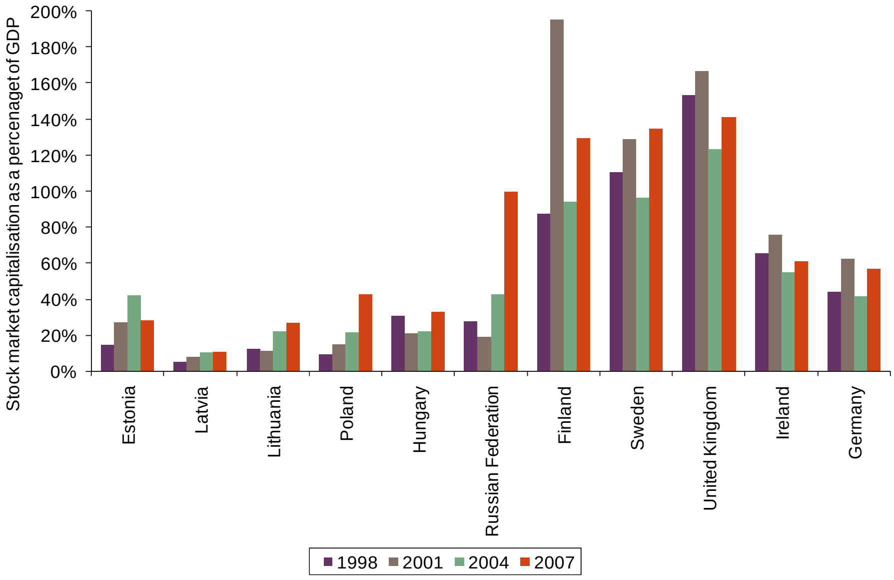
Figure 3.12 Annual turnover by security type and transaction method



Source: Estonian Central Register of Securities.

Importantly, the Estonian securities market is very small. Figure 3.13 shows that the market is underdeveloped relative to other countries. Although the ratio of Estonia's stock exchange market capitalisation value to GDP was higher in 2004 than those of its Baltic peers and CEE comparators this was no longer the case in 2007, with Estonia's stock market cap falling below CEE and developed country comparators, while still having the being above that of other Baltic States. Moreover, in terms of the absolute size of markets, Estonia falls considerably short of its CEE and western European peers.

Figure 3.13 Stock market capitalisation relative to GDP—Estonia and comparators



Source: World Bank, 'Financial Structure Dataset', January 2009, and Oxera analysis.

While there may be potential for further growth of the Estonian securities market based on local or regional (Baltic countries) developments, such as further integration, it is unlikely that securities market services may be exported in the short or medium term. It is, however, also important to consider the role of securities markets in the wider context of the attractiveness of Estonia as a location for financial services activities. The development of securities markets—even in the local or Baltic context—can have an important indirect impact on Estonia's attractiveness (even if this is not a critical attractiveness factor). In particular, as markets develop in size and sophistication, from the perspective of both investors and companies raising capital, this creates demand for support services, resulting in greater scope and quality of services and expertise available to support the export of financial services activity more generally.[70]

3.4 Summary

Overall, Estonia has a relatively well-developed financial services sector, especially when compared with other countries in the region at a similar level of development. Moreover, although its financial services industry has been significantly hit by the financial crisis (and suffered from at least some regional 'contagion' associated with the perception of regional vulnerabilities), to date it does not seem to have fared worse than many other European countries that have required significant state intervention in the form of bank and insurance company bail-outs, provision of state guarantees, and other measures.

In principle, Estonia has a potential to develop a strong financial services sector and increase its exports of financial services, given an overall relatively well-developed financial services sector, even if the activity is currently geared towards servicing local demand. However, it is important to bear in mind that this potential should be viewed relative to the size of the Estonian economy rather than in absolute terms.

[70] Notably, there are many examples of small and medium-sized financial centres that have developed strong niche markets without having well-developed securities markets.

The analysis in sections 2 and 3 above provides insights into the sectors and functions in which Estonia may be well placed to service foreign demand compared with other financial services sectors in Estonia. This analysis has focused on two aspects relevant to assessing the ability of Estonia to increase exports in different segments/functions: the ‘exportability’ of services (based on the generic characteristics of the activities involved); and the level of development of these activities in Estonia. Therefore this analysis provides insights into which segments/functions have *a basis* for increasing exports. Section 4 below provides a more detailed analysis of how well Estonia compares with other locations on the main attractiveness factors relevant to the various segments and functions.

This assessment has identified *at least* three relevant areas.

– **Core functions and back office functions in asset management, particularly with respect to the management of investments in the region**—these can be relatively easily exported if demand for these services materialises. The sector activities in Estonia are reasonably well developed. The sector has also experienced significant growth over the past few years and is likely to expand further, providing a basis for potential growth in exports in this sector. Although across Europe there is significant concentration of core asset management functions in major financial centres, these functions benefit from local presence (which may allow Estonia to take advantage of its investment know-how in relation to the Baltic States and CEE more generally). In relation to back office activities, international firms also increasingly decide on their location independently of the location of front office and core functions, which may allow Estonia to attract back office functions of those international firms that already have a presence in Estonia.

– **Front office, core and back office functions in private banking, particularly with respect to selected regional markets**—these can be exported if demand for these services materialises. This sector is being developed in Estonia, with some exports targeted at clients from Russia and other CIS countries. Globally, private banking is prone to significant concentration in well-established financial centres, especially offshore ones. Nevertheless, Estonia could benefit from factors such as changes in attitudes towards the offshore financial centres, and regional cultural links, allowing exports of private banking out of smaller centres such as Estonia which do not fall into the category of major offshore private banking centres.

– **Back office functions in banking, insurance and asset management, particularly with respect to processing functions**—these can be exported if demand for these services materialises, which is likely to depend on the overall growth of outsourcing of these activities (both internally and externally—see section 1). The servicing of this function in Estonia is relatively well developed. Although these functions are still often carried out in the same location as front office and core functions, or outsourced to the major outsourcing centres (including jurisdictions outside Europe, such as India), in specific circumstances (eg, where international financial services firms already have a presence in the country), smaller countries such as Estonia can have the opportunity to attract back office activity, provided that this process is facilitated by the local market characteristics.

In addition to these three areas, Estonia may be in position to increase exports of pension products, for example. In particular, the core functions in this segment are ‘exportable’ and also relatively well developed in Estonia, owing to a growing funded (contributions-based) pension system. This may provide a basis from which to increase exports of core pension products, particularly in a regional context, as well as more generally to contribute to the competitiveness of Estonia’s financial services sector (for example, through the impact of an effective defined-contributions pension system on the development of the country’s asset management segment).

Another broad area is technology-related services, both in the context of cyber-security and broader aspects of technology in financial services, including the provision of communications solutions. This could build on Estonia's strengths in this area more generally, across a number of industries not limited to the financial services sector. Growth of these services in the Nordic region more generally offers additional opportunities from know-how transfer, clustering, and regional development.

Importantly, these parts of the financial services satisfy *necessary* conditions (ie, given characteristics of these activities they are 'exportable'; these activities are relatively well developed in Estonia) but not *sufficient conditions* for Estonia to develop a notable level of export activities. Section 4 below considers how well Estonia compares on critical attractiveness factors—such as cost and knowledge—allowing further insights to be drawn about the export growth potential in the three areas identified above.

4 Attractiveness of Estonia as a location for export of activities

4.1 Overview

For Estonia to be able to attract demand for the export of certain activities in the segments and functions identified in section 3, it is not sufficient to have a relatively well-developed financial services sector; it also needs to compare positively with other relevant countries on the critical location attractiveness factors. Scoring highly on the relevant attractiveness factors is more likely to induce financial services firms to locate particular activities in Estonia, while a low score on (even one or two) critical factors might deter them from locating these activities in Estonia.

Even if, in practice, *being an attractive location* does not guarantee significant increases in activity, this is an important pre-condition for achieving any growth in activity and positioning the country in a way that would, given the right external conditions, enable it to grow into an important small financial centre in the long run. For example, if there are changes in the perceived attractiveness of other locations or if regulations in other countries trigger switching, for Estonia to be well positioned to capture such demand it should score well on a set of factors that are relevant to this particular activity.

This section considers in more detail to what extent Estonia might be seen as an attractive location for export of the activities identified in section 3. The analysis considers how Estonia compares with other countries on location choice factors. In particular, the report considers Estonia's standing on labour pool size, skills and flexibility, regulatory regime, tax regime, geographic and cultural proximity to clients, labour and property costs, technical capabilities, quality of life of employees, and liquidity of markets.

The assessment of Estonia on these attractiveness factors is undertaken by considering relevant indicators for Estonia and a number of comparator countries. This benchmarking analysis is carried out in relation to two groups of countries. (The relevant geographic frame of reference is discussed in more detail in section 3.1 above).

– Alternative locations—when deciding on the location of a financial institution or particular parts of its value chain, firms make a choice between financial centres that could be suitable for this purpose. Broadly speaking, most comparable alternative location choices in the case of Estonia are the other Baltic countries and CEE countries. The analysis therefore covers Latvia, Lithuania and selected CEE countries.

– Target markets—although Estonia could attract firms from various global jurisdictions, it is most likely to succeed in attracting institutions and parts of their activities from Nordic countries, and to a lesser extent from other EU countries. The benchmarking analysis therefore focuses on Sweden, Finland, Denmark and Norway, with more limited inference for EU. (In principle, countries from other Baltic and potentially CEE countries may fall into this category).

This analysis also forms an important part of the assessment of the policy options that the government (and other stakeholders) might have for increasing the attractiveness of Estonia as a location choice (see section 5). In particular, although many drivers of growth are arguably beyond the control of policy-makers, most of the attractiveness factors discussed in this section can be improved through targeted policies by the state as well as other stakeholders.

In this context, it is also important to recognise the nature of interaction between Estonia and countries that may be perceived as alternative locations. In particular, the 'competition' between different locations does not take place across the full range of functions. Furthermore, while there are some locations (eg, Poland) that may be able to develop into a regional financial centre in CEE across a broad range of segments and functions, Estonia is unlikely to be able to do so, but could instead develop its attractiveness as a location choice for selected functions and segments.

The objective of this analysis, however, is not to carry out a detailed analysis of each topic or a cost–benefit analysis of changing particular characteristics, but to provide a high-level overview of how well Estonia compares on relevant metrics and to identify areas where more analysis might be required to design specific policy interventions.

4.2 Location choices of foreign financial services firms in Estonia

The importance of individual factors in firms' location choices is likely to differ by function and segment of the financial services sector, as discussed below. This is an important consideration even if some factors are likely to improve Estonia's attractiveness in general.

4.2.1 Labour pool size, skills and flexibility (important for front office, core and middle/back office)

The size and qualifications of the labour pool, together with its flexibility, are very important for financial services firms when choosing where to locate their activities, although there are clearly differences between the nature of skills required for front office, core and back/middle office functions. For example, core functions generally require both strong finance and business administration education as well as expertise in the particular area of activity (eg, investment expertise). On the other hand, skills required for some back/middle office functions, while critical, can often be obtained through work experience and vocational trading, and may not require specific business and finance education.

Labour pool size and quality

This is important for every function in the financial services sector which cannot be automated via standardisation and mass retail processes. Access to a qualified workforce is especially important in providing higher value-added front office and core services, such as private banking and asset management, although middle/back office activities also require high level of specific skills and understanding of these processes.

Estonia's labour force is relatively well educated in terms of tertiary education, with a greater proportion of workers educated to this level than the EU average. For example, 35% of Estonians aged 25–34 have achieved a tertiary education qualification compared with the EU27 average of 30%. While Estonia compares favourably to other countries in the Baltic and CEE region, it lags behind all the Nordic countries, where 40% or more of the population is educated to tertiary level. Estonia is comparatively well educated for older cohorts, although this is arguably less important when considering attractiveness as a location choice.[71]

In assessing the size of the pool of workers with tailored capabilities or who would be predisposed to working in the financial services industry, research shows that the number of Estonian graduates in finance-related disciplines has been rising steadily. This increase in human capital with the potential to work for financial services institutions is a positive sign for the Estonian financial services industry. However, the number of students in Estonia (as a proportion of the total population) graduating with business administration degrees in 2007 was considerably lower than in other Baltic and CEE comparator countries. In particular, in 2007 the ratio of graduates with business administration degrees to total population in

[71] Eurostat News Release (2009), '30% of 25-34 year-olds in the EU27 are graduates from higher education', April 28th.

Estonia was 0.16% compared with 0.26%, 0.30% and 0.19% in Latvia, Lithuania and Poland respectively.[72]

The circumstances in other subjects of relevance when considering the financial services sector was more mixed. For example, in mathematics and statistics the number of graduates in Estonia (as a proportion of the total population) was considerably lower than in Lithuania and Poland, but comparable to that in Latvia, while the number of graduates in computer sciences in Estonia (as a proportion of the total population) was higher than in Latvia, Lithuania and Poland.

Data on the number of graduates is, however, an important but incomplete indicator of whether the workforce has the requisite skills to work in the various segments of the financial services industry. Not all graduates are suitable for the functions considered in this study; for example, even business graduates have not necessarily achieved the level of education and expertise required for sophisticated financial services activities such as core asset management.

In particular, there are indications that the Estonian workforce may be insufficiently well educated for the more sophisticated financial services activities. Although the quality of mathematics and science teaching is highly rated, that of management schools is rated comparatively poorly. For example, the World Economic Forum notes that, according to an executive opinion survey, the second most significant obstacle for doing business in Estonia is an inadequately educated workforce.[73]

Interviews with market participants carried out as part of this study also suggest that the business education graduates often do not have the necessary (quality of) skills, and that there is a general lack of graduate finance degrees at Estonia universities.

Overall, there appears to be a critical mass of skilled financial services workers located in Tallinn (eg, working in asset management and banking), albeit on a relatively small scale. If the crisis leads to a reduction in the capacity of existing institutions, the human capital that is freed up could be redeployed, but may also migrate or move to another industry. The supply of new skilled workforce, however, is arguably not sufficient to provide a strong basis for growth in financial services activities going forward. This might therefore represent an obstacle for establishing Estonia as an attractive location choice.

Flexibility of labour market

The relative rigidity of the labour market is relevant across the financial services segments and functions because it limits the extent to which financial services workers can be redeployed to growth areas. In particular, if firms cannot redeploy human resources efficiently, this will pose a barrier in developing the sector.

Looking at Estonian labour market flexibility, this is ranked lower than most comparator economies in the World Bank's 'Doing Business 2009' report. While Estonia is estimated to have a lower rigidity of employment index than the Eastern Europe and Central Asia average (in 2008, around 40 compared with 60), the costs of redundancy are higher in comparison.[74] Also World Economic Forum data indicates that Estonia ranks worse than the other two Baltic states, CEE and western European countries in terms of rigidity of employment. (Estonia is ranked 116 out of 134 countries).[75]

Other indicators assess Estonia relatively positively on labour market flexibility. The IMF notes that Estonia has a liberal legislative framework with respect to employment,

72 Source: Oxera calculations and Eurostat.

73 World Economic Forum (2008), 'The Global Competitiveness Report 2008–2009'.

74 World Bank (2009), 'Doing Business 2009, Country Profile for Estonia'.

75 World Economic Forum (2008), op. cit., Table 7.09.

decentralised wage setting, and a widespread use of performance-related bonuses (65% of enterprises overall, 15% of the wage bill). Furthermore, the overall labour market flexibility of Estonia is rated at or above countries such as Lithuania, Poland, Norway, Finland and Ireland.[76]

4.2.2 Regulatory regime

The financial services regulatory regime in Estonia is regarded as relatively effective, with the EFSA widely perceived to exercise adequate regulatory control. The regulation staff are perceived to avoid a tendency to over-regulate, and are seen to be quite pro-business. This is affirmed by the IMF:

> The Estonian authorities have made significant progress since the 2000 FSAP in improving financial sector supervision…The creation of the Estonian Financial System Authority (EFSA) has improved supervision in Estonia. Its organizational structure has been designed in a manner to effectively address the unique features of the Estonian financial sector.[77]

For example, banking supervision appears to be well organised:

> There are no serious weaknesses in bank supervision. The EFSA appears to be conducting prudential supervision in an independent and professional manner in close cooperation with the BoE and MoF as well as home (especially Sweden) supervision authorities. Estonian financial and supervision regulations have been harmonized with EU rules. The systemically important banking groups seem to be closely monitored and continuously supervised by the EFSA.[78]

However, parts of the regulatory framework are regarded by some industry participants as somewhat less well-developed. For example, certain aspects of the non-UCITS funds legislative framework established in 2004 are regarded by the industry in Estonia as in need of improvement.

More generally, Estonia compares favourably to the other Baltic countries and other countries in CEE in terms of various broader risk ratings, as shown in Table 4.1 below. Overall assessment by the Economist Intelligence Unit rates Estonia above the other two Baltic States and CEE countries in the sample, as well as Russia. This holds also for government effectiveness risk and legal and regulatory risks. This is an important indication of the reliability of the regulatory regime in Estonia, placing it at an advantage when considering location choices of financial institutions for functions throughout the value chain.

[76] International Monetary Fund (2009), 'Republic of Estonia: 2008 Article IV Consultation: Staff Report', March.
[77] International Monetary Fund (2009), 'Republic of Estonia: Financial Stability Assessment', February 13th.
[78] Ibid.

Table 4.1 Economist Intelligence Unit risk rating scores, July 2009

Overall assessment	Government effectiveness risk	Legal and regulatory risk	Tax policy risk
Sweden (13)	Sweden (11)	Ireland (5)	Finland (12)
Finland (14)	Finland (14)	Sweden (8)	Sweden (12)
Ireland (25)	Ireland (21)	Finland (10)	Estonia (12)
Estonia (26)	Estonia (36)	Estonia (18)	Latvia (19)
Czech Republic (32)	Latvia (39)	Latvia (22)	Lithuania (19)
Latvia (33)	Lithuania (43)	Czech Republic (25)	Poland (19)
Poland (33)	Poland (43)	Lithuania (28)	Czech Republic (25)
Lithuania (34)	Czech Republic (46)	Poland (35)	Ireland (25)
Russia (61)	Russia (82)	Russia (70)	Russia (50)

Note: Scores are shown in parenthesis, with lower scores indicating a better risk rating.
Source: Economist Intelligence Unit.

Thus, the regulatory regime in particular and financial services regulation and supervision more generally are a strength of Estonia, although it is not a stand-out location that would currently be able to attract the activities of financial services firms due to its regulatory regime as a main driver. However, given the significant amount of regulations coming from the European Commission, it will be important that Estonia transposes these regulations in an efficient manner without creating undue disadvantages to firms—a factor raised by the industry participants interviewed for this study. There are also a number of specific aspects of the regulatory regime that are outdated and could become an obstacle for attracting financial services activity to Estonia.

Finally, although the Estonian regulators cooperate with international regulators, it might be beneficial to seek to engage more with international financial groups and understand developments in the financial industry outside Estonia. Although the lack of such engagement is not a weakness per se, improvement in this respect would strengthen Estonia's financial services growth and export potential.

4.2.3 Tax regime (important for front office, core, and middle/back office)

The main features of the Estonian tax regime are the following:[79]

- corporate income tax—distributed profit is subject to a tax of 26.6% and there is a 0% tax on retained earnings;[80]
- personal income tax—21% flat rate;
- social tax—33% (payable by employers);
- unemployment insurance payment—2.8 % payable by employees and 1.4% by employers;[81]
- VAT—20% (standard rate) and 9% (reduced rate)
- taxation of capital gains—there is no capital gains tax on institutions; individuals are taxed at a flat rate of 21%.

Looking at the general tax regime in Estonia shows that, although the country has a more convenient tax regime (in terms of administrative burden), its total tax rate is not, in general, as attractive as that of its target markets and alternative locations (Table 4.2).

[79] Estonia Ministry of Finance (2009), 'Estonian taxes and tax structure', presentation, July.
[80] The corporate income tax rate is 21%, which is the same as the personal income tax rate. In terms of distributable profit, the rate is equal to 26.6% or 21%/(100% – 21%).
[81] As at August 1st 2009.

In a 2008 KPMG survey, the Estonian tax system was among the top five European tax regimes according to an international poll carried out among businesses across Europe. The system's stability over time and the total tax rate were highly rated, and Estonian companies were also positive about relations with tax authorities and the consistency of the tax system. Areas identified for improvement included the volume of tax legislation, the explicitness in interpreting tax regulations, and the practice of providing sufficient prior information about significant changes.[82] The table also shows the tax policy risk ratings for Estonia and comparators, with Estonia rated significantly above the other Baltic and CEE countries.

Table 4.2 Tax regime in Estonia relative to selected economies

	Number of payments[1]	Time (hours)[2]	Total tax rate (% profit)[3]
Estonia	**10**	**81**	**48.6**
Denmark	9	135	29.9
Finland	20	269	47.8
Latvia	7	279	33.0
Lithuania	15	166	46.4
Norway	4	87	41.6
Poland	40	418	40.2
Sweden	2	122	54.5
Average (excl. Estonia)	13.9	210.9	41.9

Note:[1] This takes into account the method and frequency of payments, and the number of agencies involved. This measures the number of hours necessary per year to prepare and file tax returns and to pay the corporate income tax, VAT, sales tax, or goods and service tax, labour tax and mandatory contributions. [3] This measures the amount of taxes and mandatory contributions payable by the company during the second year of operation. Expressed as a percentage of commercial profit, this is the sum of all the taxes payable after accounting for various deductions and exemptions.
Source: Oxera analysis, and Doing Business (2009), Paying taxes, http://www.doingbusiness.org/ExploreTopics/PayingTaxes/.

The attractiveness of the overall tax regime in the country is directly relevant for the financial services firms. A more convenient tax regime with lower overall tax rates will be attractive to firms when choosing where to locate their activities. At the same time, some of the activities in financial services industry attract specific tax (eg, withholding tax). A review of how specific financial services taxes in Estonia compare against those in other jurisdictions is beyond the scope of this study; however, interviews with market participants have identified some specific issues that may be reducing the attractiveness of Estonia as a location choice.

For example, double-taxation treaties are important for financial services functions, such as asset management. Double-taxation agreements protect individuals and firms from being taxed twice where the same income is taxable in two states; as such, they are an important consideration when financial services firms are structuring their activities across countries. In the case of Estonia, there are a number of relevant countries with which it does not have double-taxation treaties. In particular, it currently has double-tax avoidance treaties (for income and capital tax) with all of the other EU countries, and other European countries, such as Iceland, Switzerland and Norway. However, of the CIS countries, Estonia has such treaties in place only with Ukraine, Belarus, Moldova, Kazakhstan, Armenia, Georgia, and Azerbaijan.[83]

[82] KPMG (2008), 'KPMG survey: Estonian tax system among the top five European tax regimes', Press Release, January 28th.
[83] As of July 2009. Estonian Tax and Customs Board, http://www.emta.ee/index.php?id=1830&highlight=double,tax.

4.2.4 Proximity to clients and markets (important for front office and core functions)

Geographic, cultural and economic proximity to clients, and familiarity and existing links more generally, tend to be an important factor when financial institutions consider location for parts of the value chain of their businesses.

Geographic proximity

The proximity of clients and markets is especially relevant in offering higher value-added services such as asset management and private banking. This is because proximity to clients is especially important where client relationship management is a key activity of the front office, as it is for the private banking and asset management industries. Also, proximity to clients is important for marketing and distribution functions across all sectors, including retail banking and distribution channels in insurance.

Estonia's geographic position close to the Nordic countries, CEE and CIS may give it an advantage in serving clients in these markets. Overall, Estonia is well positioned to serve the Baltic and CEE market, as well as Nordic and CIS clients. However, particularly in relation to the CEE markets, its geographic location may be similar or even inferior to other countries in the region (eg, Poland).

Economic proximity

Estonia's main trading partners are its Baltic neighbours, Nordic countries, Germany, CEE countries, and Russia.[84] These existing links can be advantageous when considering exporting financial services to these markets. Furthermore, the presence of large Nordic financial institutions in Estonia (eg, Swedbank, SEB, Nordea) implies strong financial services-related links. While this may be in favour of Estonia, other countries in the region also have similar economic proximity (eg, Latvia, Lithuania). At the same time, some CEE countries have considerably stronger links with western European countries such as Germany and Austria.

Cultural and language proximity

In terms of languages spoken, Estonia is reasonably well positioned, with Russian and English, and to a lesser degree German and Finnish widely spoken and understood. The most widely spoken foreign language in Estonia is Russian, spoken by 42% of the total population; English is spoken by 25% of the total population (see Table 4.3). There is also some variation across age cohorts, implying that there is an increased learning of English and reduced learning of Russian among young people. This is a positive trend when, for example, considering servicing clients in Nordic or other European countries, while a negative trend when considering CIS markets. Nevertheless, considering the 0–24 and 25–49 cohorts, which are most relevant in the context of this study, both Russian and English languages are spoken by a very significant proportion of the population.

[84] According to the IMF International Financial Statistics database, Estonia's main export partners in 2008 were Finland (18.3% of Estonia's exports), Sweden (13.8%), Russia (10.3%), Latvia (10.0%), and Lithuania (5.7%). Estonia's main import partners were Finland (14.2% of Estonia's imports), Germany (13.4%), Sweden (10.0%), Lithuania (9.0%), Latvia (8.9%), Russia (7.4%), and Poland (4.6%).

Table 4.3 Proportion of population speaking each language (as % of cohort)

	Russian	English	German	Finnish
Total	42.2	25.2	10.2	10.1
Age cohort 0–24	23.0	36.7	11.4	6.6
Age cohort 25–49	57.3	30.1	10.7	17.2
Age cohort 50–79	47.6	9.0	8.2	6.4
Others	20.1	4.1	12.8	1.4

Note: Taken from the 2000 census data.
Source: Statistics Estonia.

In the international context, an indication of the language skills is provided by the relative levels on foreign language learning (see Table 4.4). The uptake of English is comparable to some of the main CEE countries (eg, Poland), although it lags that in the Baltic peers and selected Nordic countries. At the same time, Estonia (together with the other two Baltic countries) has a significantly higher uptake of Russian language than the CEE peers or Nordic countries.

Table 4.4 Language learning, relative to population aged under 50, 2006 (%)

	English	French	German	Russian	Finnish	Swedish
Estonia	6.28	0.31	2.51	4.13	0.29	0.06
Latvia	9.62	0.20	1.66	4.76	0.01	0.01
Lithuania	11.90	0.51	3.04	7.67	0.00	0.00
Poland	6.19	0.60	4.75	1.26	0.00	0.00
Finland	7.75	0.41	0.85	0.05	–	5.56
Sweden	8.74	1.13	1.64	0.01	0.01	–
EU27	5.48	1.55	1.01	0.19	0.01	0.06

Note: The table shows the maximum number of individuals studying a given foreign language at levels ISCED 1–3, relative to the size of population aged under 50 years.
Source: Oxera analysis, and Eurostat.

Notably, while cultural and language skills with Russia are close, they may be undermined by political relationships, including practical aspects such as the visa regime.

Overall, taking a broader view of proximity in considering not only geographic distance but also cultural proximity, Estonia is reasonably well positioned (particularly when compared with the other CEE countries) to serve the Baltic, Scandinavian and at least part of the Russian markets. Estonians arguably have the requisite know-how in terms of cultural, investment, attitudes and knowledge of languages, and Estonia can act as a bridge between the East and West precisely because of this cultural proximity.

At the same time, the cultural and historical background provides some basis for developing particularly strong investment know-how in the Baltics, CIS and CEE. However, on its own (with exception of the Baltic markets), there are arguably countries that are, a priori, better positioned in relation to this aspect. For example, Poland is likely to be better positioned in terms of its understanding of the CEE culture, business practices, etc; while those working in the CIS countries (particularly Russia) are likely to have a better basis for developing CIS market know-how.

4.2.5 Labour and property costs (important for front office and middle/back office functions)

Low labour costs will affect firms' ability to establish all functions across the financial services industry in Estonia. However, low labour costs are given greater weight by institutions in making their location choices for front and middle/back office functions since, when looking at core activities, considerations other than cost, such as established expertise, may dominate.

Labour costs and productivity

Estonia is well positioned as far as total labour costs are concerned. On a total labour cost measure, Table 4.5 shows that Estonia's labour costs, while not being as low as in its Baltic neighbours, are still considerably lower than the EU27 average (notwithstanding rapid wage inflation since 2000).[85]

For the financial services sector specifically, the table suggests that average earnings in Estonia are much lower than in the Scandinavian comparators, at about €12,000 a year as opposed to an average of more than €50,000 in Sweden. Estonian earnings in financial intermediation are not, however, as low as in Latvia and Lithuania, which are lower by almost a third. In other words, the level of labour costs compares favourably to those observed in target markets, while results are more mixed when compared with the alternative locations. It should also be noted that in the medium term there is likely to be some convergence between the labour costs in Estonia and other more developed countries.

Table 4.5 Monthly labour costs and labour productivity

	Overall (2006)			Financial services-related	
	Labour costs (€ per month)	Labour productivity per hour worked (index)	Labour productivity per employee (index)	Average earnings in financial intermediation, 2005 (€ per year)	Productivity in finance, lease, real estate, business services, 2006[1] (index)
Estonia	840	46	61	12,220	100
Latvia	532	n/a	50	9,986	79
Lithuania	646	45	56	9,810	74
Sweden	4,518	103	111	51,951[2]	238
Denmark	4,481	100	106	60,550[2]	244
Finland	3,682	96	110	n/a	244
Poland	889	53	61	n/a	76
EU27	2711	89	100	n/a	n/a

Note: [1] This shows productivity (value added per employee index) relative to Estonia. [2] Data for Sweden and Denmark refers to 2007.
Source: Oxera analysis, Eurostat, and Estonian Development Fund (2008), 'The Estonian Economy Current Status of Competitiveness and Future Outlooks', Annex 3.

The absolute level of earnings, however, does not provide a complete picture—earnings need to be considered alongside productivity differentials. As Table 4.5 shows, while the labour productivity of Estonia compares favourably to its Baltic peers and other countries in CEE, it is significantly below some of the more developed countries. In particular, with respect to productivity in financial services, the Estonian financial sector has higher productivity than Baltic and CEE comparators such as Latvia, Lithuania and Poland. However, it is considerably lower than productivity in the Scandinavian comparators, Sweden, Denmark and Finland.

[85] The Statistical Office of the European Communities looks at the evolution of total labour costs in Estonia relative to comparators where labour costs are: 'the total expenditure borne by employers for the purpose of employing staff. They include employee compensation, with wages and salaries in cash and in kind, employers' social security contributions; vocational training costs, other expenditure, such as recruitment costs and expenses on working clothes, and employment taxes regarded as labour costs minus any subsidies received.' Source: Eurostat (2009), 'Annual Labour Cost data, Eurostat Metadata in SDDS format: Summary Methodology'.

This evidence suggests that in Estonia labour costs, in general, and in the financial services sector, in particular, are significantly lower than in the more developed countries, and broadly comparable with its Baltic States and CEE peers.

Although more detailed evidence is not readily available, qualitatively similar patterns are likely to exist in the individual segments and functions across the financial services value chain. This general pattern of a more favourable level of wages is also likely to persist after adjusting for differences in productivity across countries, although Estonia's advantage compared with Nordic and other more developed countries on this attractiveness metric is likely to be somewhat reduced.

Overall, therefore, the level of labour costs is a factor that, all else equal, provides Estonia with an advantage over its Nordic peers and other more developed countries, although it does not constitute an advantage over potential alternatives in the Baltic region or CEE.

Property costs

While generally less important for financial services than labour costs, the cost of purchasing or renting property is another factor contributing to the attractiveness of a location. This might be particularly important for the parts of the value chain where property costs constitute a significant proportion of total costs.

Overall, there is evidence to suggest that rental costs in Estonia compare favourably with Nordic countries, and to a lesser extent its Baltic and CEE peers. For example, class A office rents are marginally lower in Tallinn than in the other two Baltic capitals (just under €15/m^2 per month in 2009).[86] Rentals in Tallinn also compare favourably to other CEE countries and Nordic comparators. For example, prime office rents per month in Warsaw were €24/m^2 and €22/m^2 in Prague.[87] In the Nordic countries, office monthly rents for Q2 2009 were €31/m^2 in Stockholm, €28/m^2 in Oslo and €20/m^2 in Copenhagen.[88]

Similar patterns are observed for residential property costs (a metric which is less relevant in the context of this study). For example, the average per square metre price of apartments[89] in Estonia is €2,840 compared with €2,860, €3,540 and €3,350 in Latvia, Lithuania and Poland respectively.[90]

Overall, therefore Estonia compares well with Nordic and other more developed peers (ie, target markets), as well as, to a much lesser extent, with alternative locations in the Baltic States and CEE. On the other hand, low property costs might reflect Estonia being perceived as less attractive. It is worth noting that some of the leading financial centres in Europe typically have high property costs, reflecting significant demand from a variety of businesses and individuals.

4.2.6 Technical capabilities (important for front office, core and middle/back office)

Industry participants in Estonia interviewed for this study generally believe that the technical capabilities which support the financial system in Estonia are of good quality. Technical capabilities in Estonia include low technology barriers, the requisite technology for account provision, well-developed payment systems, clearing and settlement services, and high-quality services by banks for asset valuation. These supporting capabilities strengthen the financial system and the firms that work across the Estonian financial services sector. The technical capabilities of Estonia have been especially fostered by the presence of Nordic banks in the region, and the Nordic investment in the financial sector more generally.

[86] Oberhaus (2009), 'Real Estate Market Report 2009: Baltic States Capitals'.

[87] CB Richard Ellis (2009), 'MarketView CEE Office Investment H1 2009'

[88] CB Richard Ellis (2009), 'MarketView EMEA Rents and Yields Q2 2009 V2'

[89] This is the average per square metre price in € for 120m^2 apartments located in the centre of the main city of each country.

[90] Global Property Guide, Residential Property Data, Square Metre Prices – Estonia Compared with Continent.

Furthermore, World Economic Forum research shows that Estonia compares well on broader financial sophistication indices (notably, technical capabilities are only one aspect determining the level of financial market sophistication).[91] The research shows that Estonia is ranked lower (at 25th) than some of its main target markets including Sweden (5th) and Finland (18th), but higher than the main alternative locations, including the Czech Republic (49th), Latvia (55th), Lithuania (66th), and Poland (78th).

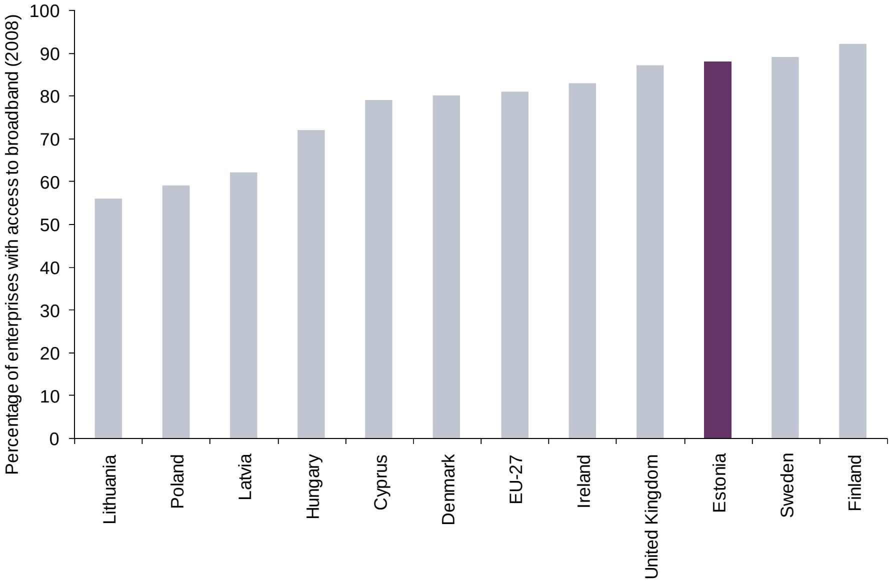
Evidence on the quality of the financial system's technical capabilities is, by its very nature, difficult to obtain. However, in interviews with industry participants, it has been affirmed that these capabilities are very strong in Estonia relative to comparators, and on some indicators even comparable to the technical capabilities of international financial centres. More specifically, although this aspect is not likely to provide an advantage in particular over the more developed countries, the quality of specific financial services technology would not be likely to be an obstacle for attracting financial services activity to Estonia.

Information technology and communications systems

The use of IT and communications systems—which is also a vital component of the development of functions for the back/middle office functions in banking, insurance and asset management—is perceived to be quite sophisticated in Estonia. While far from exhaustive, this sub-section looks at a number of metrics, such as the proportion of firms with access to the Internet, international Internet bandwidth per inhabitant and expenditure on IT systems, which illustrate the state of development of IT and communications systems in Estonia compared with other countries.

In terms of connectivity, a higher proportion of enterprises have access to broadband Internet in Estonia than the EU27 average, CEE comparators, and even some relatively advanced countries such as the UK and Denmark:

Figure 4.1 Enterprises with access to broadband, 2008



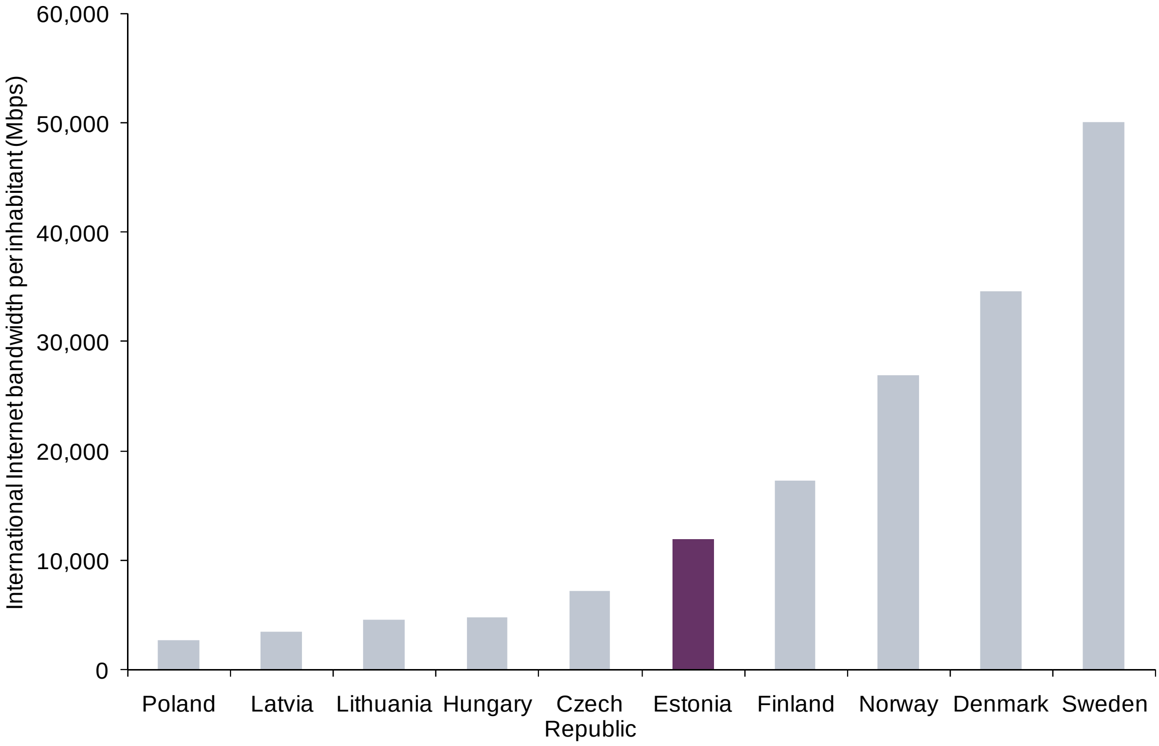
Note: The availability of broadband is measured by the percentage of enterprises that are connectable to an exchange that has been converted to support xDSL-technology, to a cable network upgraded for Internet traffic, or to other broadband technologies. It consists of enterprises with ten or more full-time employees.
Source: Eurostat (2009).

Estonia appears relatively well positioned in terms of Internet speed. For example, there are plans for a new fibre-optic network, which will make it possible to exploit the real data

[91] World Economic Forum (2008), 'The Global Competitiveness Report 2008-2009'.

exchange speed of 100MB per second in most of Estonia (ie, 90% of territory) by 2012 and across all the country by 2015.[92] This compares favourably with a much less ambitious UK government target of establishing a broadband universal service commitment of 2MB per second by 2012.[93] Similarly, Estonia compares well in terms of international links. For example, it is doing well relative to CEE and Baltic comparators in providing a high level of international Internet bandwidth, although this is still lower than the level observed in Nordic countries.

Figure 4.2 International Internet bandwidth per inhabitant



Note: 2007 data. This measures the total capacity of international Internet bandwidth in megabits per second (Mbps). If capacity is asymmetric (ie, there is more outgoing than incoming traffic, or more incoming than outgoing), the outgoing capacity is provided.
Source: International Telecommunications Union.

Table 4.6 shows that Estonia compares favourably to the other CEE countries and an EU average in terms of other indicators related to cost and expenditure on IT and communications systems (although Latvia has somewhat higher communications expenditure). Estonia also compares well on telecommunications costs: based on the cost of international calls to the USA, it scores better than other Baltic countries, although somewhat worse than Poland.

Separately, Estonia is ranked 24th in the Economist Intelligence Unit e-readiness rankings in 2009, above any of the other Baltic and CEE countries, but below Sweden, Finland and Denmark.[94]

[92] The Baltic Course (2009), 'Plan to build an ultra-fast internet network in Estonia approved', July 31st.

[93] Ofcom (2009), 'Westminster eForum: Broadband for all? Broadband and the Universal Service' Speeches and Presentations, July 16th.

[94] Economist Intelligence Unit (2009), 'E-readiness rankings 2009: The Usage Imperative'.

Table 4.6 Expenditure and cost of IT and communications systems, 2006

	IT expenditure as a % of GDP	Communications expenditure as a % of GDP	Cost of international calls to the USA (€/10 minutes)
Estonia	**2.9**	**6.8**	**2.13**
Latvia	2.3	7.6	5.94
Lithuania	1.8	5.0	4.07
Poland	2.6	5.0	1.23
Hungary	2.5	5.0	2.88
Sweden	3.8	3.5	1.18
Finland	3.2	2.8	4.90
EU27	**2.7**	**3.0**	**1.79**

Source: Eurostat.

There is evidence that technological progress has already played a role in developing the Estonian financial services industry locally, which may also have implications for the role of IT in export-driven development. For example, Kirikal (2004) conducted a study on the efficiency and productivity of the Estonian banking sector.[95] Measuring productivity differences between six Estonian domestic commercial banks from 1999 to 2002, Kirikal found that the highest productivity growth rate across all Estonian banks was from 1999 to 2000, with Estonian banks experiencing an average of a 25.6% annual productivity growth rate during 1999–2002, mainly owing to technological progress.

Overall, compared with the alternative locations (other Baltic and CEE countries), Estonia appears to have a relatively well-developed communications technology infrastructure, although its infrastructure is somewhat less developed than that of its main target markets (ie, the Nordic countries). Communications technology is therefore one of the aspects that make Estonia relatively attractive, particularly when compared with its Baltic and CEE peers.

Security of data

Security of data is important for financial services segments across the value chain, and may be a financial services export in its own right. The evidence suggests that, in 2007, a high proportion of enterprises in Estonia used security measures: nearly 60% have firewalls, and one-fifth use secure servers, while more than 85% use virus checking or control software.[96]

Also, in terms of efficacy of security measures, Estonia is a frontrunner in building defences against cyber warfare. In 2007, Estonia’s government websites, as well as those of its financial institutions, came under cyber-attack. Coordinating efforts with those of Estonia's Computer Emergency Response Team (CERT), firms such as Swedbank managed to keep their infrastructure intact, suffering only minor losses.

Overall, therefore, having a comparatively developed knowledge base in relation to data security can be a positive factor, increasing Estonia’s attractiveness as a location choice, although the main effect would materialise in activities directly involving this activity.

4.2.7 Quality of life for employees (important for core functions)

Many financial institutions will consider the quality of life for their employees in a country as one of the factors that guides their location choices, as it is important in attracting and retaining a skilled workforce in the financial services industry.

[95] Kirikal, L. (2004), ‘Malmquist Indexes of Productivity Change in Estonian Banking’, Tallinn Technical University.
[96] Oxera analysis and Estonia Statistical Database.

Notably, various indices used to measure quality of life across countries are based on a number of indicators, but these are not exhaustive, or specific to the financial services sector (or skilled labour more generally). They also do not capture the subjective perceptions of each country's population in assessing the quality of their own lives, as do some indicators which are discussed subsequently. Therefore, the relative quality of life in Estonia as measured by these indicators has only partial relevance when assessing the attractiveness of Estonia in the context of this study.

In the Economist Intelligence Unit's Quality of Life index (2005), Estonia ranks 68th out of 111 countries. This is broadly comparable to its main CEE comparators, but considerably lower than the ranking of Nordic countries (see Table 4.7). This index is based on indicators to represent factors such as material wellbeing, political stability and security, community life, climate and geography (latitude, to distinguish between warmer and colder climes), and political freedom.

Table 4.7 Quality of life index, 2005

	Rank	Score out of 10
Norway	3	8.1
Denmark	9	7.8
Finland	12	7.6
Poland	48	6.3
Lithuania	63	6.0
Latvia	66	6.0
Estonia	**68**	**5.9**

Source: The Economist Intelligence Unit's Quality of Life index, 2005.

Overall, on composite measures of quality of life, Estonia appears to score poorly relative to Nordic and western European countries, although it is broadly comparable to its CEE peers. This may pose a challenge in attracting financial services functions which require highly skilled and high value-added employees, such as core functions of asset management and private banking.

4.2.8 Performance and liquidity of markets (especially important for core functions)

Currently, the securities market in Estonia is underdeveloped and very small. More details were provided in section 3 about the performance of the TSE and the limited liquidity it offers (eg, there were only 18 registered companies on the TSE in 2007).

Although the lack of a developed securities market might not be an obstacle for building up the export of financial services per se, a strong local market can be a source of exports, and can also facilitate development of the know-how and expertise required for services that are related to the securities markets. With respect to the latter, this lack of a developed market therefore puts Estonia somewhat at a disadvantage compared with the CEE countries with more developed securities market (eg, Poland).

4.3 Summary

The analysis of the relevant location attractiveness factors of Estonia yields a mixed picture. For international firms choosing a location among CEE countries or internationally, Estonia does not stand out as a clear location of choice. A combination of positive factors that exist in Estonia may in future provide a sufficient basis for gradual growth in exports in selected areas of activity, provided that significant demand for these services materialises.

Box 4.1 Relevant functions and sectors in the value chain

In terms of attractiveness factors, Estonia scores well on some of the key attractiveness factors for the front office, core, and middle/back office functions in the selected sectors, although there are a number of important factors on which it scores poorly:

– **front office**: private banking;

– **core**: asset management and private banking;

– **middle/back office**: banking, insurance and asset management.

4.3.1 Core functions and back office functions in asset management

In terms of the relevant attractiveness factors, particularly with respect to the management of investments in the CEE,[97] Estonia:

– scores well on proximity to clients and markets, regulatory regime, technical capabilities, regional investment expertise/know-how (to a degree), labour, and property costs;

– scores poorly on perception in the global markets/business community (some aspects of) the tax regime, labour pool size and skills, quality of life, and performance and liquidity of markets.

Although Estonia scores reasonably well on some important factors, for financial services firms that are considering locating their activities in CEE, there are some strong alternatives. In particular, countries such as Poland compare well on the attractiveness factors for both core and back office activities, and have experienced significant growth in their financial services sectors over recent years. At the same time, even in the context of managing investments in CEE, these activities are often carried out from operations of asset management firms in international financial centres such as London.

Going forward, in terms of ensuring attractiveness, it is important for Estonia to maintain its relatively good standing on the key factors for core functions (such as the availability of investment know-how in relation to the CEE) and back office functions (such as technical capabilities). At the same time, it seems important to maintain close links with Nordic markets, as this is one of Estonia's distinguishing factors (compared with most other CEE countries); and to improve the particularly important attractiveness factors (such as perception of the global markets/business community). In addition to improving general attractiveness, this may allow Estonia to attract an increasing share of the operations of firms that already have a presence in both the Nordic countries and Estonia, and to attract the activities of Nordic firms that do not currently have a presence in Estonia.

4.3.2 Front office functions, core functions and back office functions in private banking

In terms of the relevant attractiveness factors (particularly in the context of servicing clients from the CIS), Estonia:

– scores well on proximity to clients and markets (particularly language and cultural proximity to CIS), regulatory regime, technical capabilities, labour, and property costs;

– scores poorly on perception in the global markets/business community, political risks (in particular, relationships between Estonia and Russia), (some aspects of) the tax regime, labour pool size and skills, and quality of life.

[97] Most of the attractiveness factors on which Estonia scores well are also relevant for the management of investments outside the CEE. However, since it scores poorly (particularly compared with the major financial centres) on the investment know-how in relation to European/global investments and their scale of activity, there is currently no basis for attracting a significant volume of European/global investment mandates.

Although Estonia scores reasonably well on some important factors, it is not considered by clients (including those from the CIS) as one of the prime private banking locations. In particular, established centres, such as Switzerland and Luxembourg, still remain the location of choice. At the same time, over recent years new alternative centres such as Cyprus have started to develop private banking industry, including attracting significant inflow of the client money from the CIS.

Going forward, in terms of ensuring attractiveness, it is important for Estonia to maintain and improve its attractiveness factors. The risk element in this context lies in external factors, particularly the political relations with significant markets in close proximity, such as Russia.

4.3.3 Back office functions in banking, insurance and asset management

In terms of the relevant attractiveness factors, Estonia:

- scores well on links with regional financial services institutions, technical capabilities, labour, and property costs;
- scores poorly on perception in the global markets/business community, labour pool size and skills, (some aspects of) the tax regime, and quality of life.

Estonia scores well on important factors compared with the Nordic and Baltic countries. In the context of Nordic/Baltic markets (eg, Nordic firms choosing between a domestic and Estonian location), therefore, Estonia appears to offer specific advantages to firms choosing between these countries. At the same time, in a broader CEE context, there are some more direct (and strong) alternatives, including Warsaw. These cities compare well on the attractiveness factors for back office activities, and have also experienced significant growth in their financial services sectors over recent years.

Going forward, in terms of ensuring and improving attractiveness, it is important for Estonia to maintain and build upon its relatively good standing on the key factors (such as the level of costs, technical capabilities, and so on). At the same time, it would seem critical for Estonia to maintain close links with Nordic markets, which is one of Estonia's distinguishing factor (compared with the most other CEE countries); and to improve the particularly important attractiveness factors (such as the skills base). In addition to improving general attractiveness, this may allow it to attract an increasing share of operations of firms that already have presence in both Nordics and Estonia, and to attract activities of other Nordic firms.

5 Policy implications

5.1 Policy implications in the current economic and market context

The objective of this study is to consider what potential there may be for Estonia to increase 'exports' of financial services, and to propose high-level policy options to promote the growth and development of the financial services sector in the country. This section focuses on the latter, setting out possible strategic policy objectives and providing examples of specific policies that could be adopted.

The analysis presented in this study of Estonia's attractiveness as a location for the activities of financial services firms yields a mixed picture. While Estonia scores well on some critical location attractiveness factors, a number of obstacles to attracting increased levels of exports of financial services remain.

Estonia has made good progress over recent years before the crisis in its development and economic growth, and, as demonstrated in the analysis presented in section 3, has a well-developed financial services sector, at least in some activities. The sector has shown strong resilience to the crisis—to a large extent owing to the foreign ownership of institutions.

The ongoing financial crisis is also affecting the financial services sector globally, creating both opportunities and threats to countries that are seeking to attract increased activity of international financial services firms. Although Estonia may not be able to position itself quickly enough to take advantage of potential reallocations of activities, repercussions of the crisis are expected to continue for several years. As the new financial services architecture takes shape, Estonia can take advantage of some emerging opportunities.

In addition to a relatively well-developed financial services sector, Estonia scores well on some important location attractiveness factors. Overall, therefore, there is a basis in Estonia for increasing the export of financial services in the medium term, although a number of challenges remain. In particular, there are some strong alternatives, in CEE and beyond, vying to attract an increasing level of financial services exports, although Estonia has some strong distinguishing features (eg, strong links with Nordic countries) which could provide it with some advantage.

There are also some specific indirect factors that may make it more difficult for Estonia to succeed. In particular, the country is in recession. Although the economic contraction is not dissimilar to that observed in the other countries in the region, this does pose a threat to the perception and attractiveness of the country in the eyes of international financial services firms. The economic conditions also directly affect the (actual and perceived) economic stability of the country, which is an important consideration of the financial institutions making location choices. Therefore policies aimed at ensuring economic stability—although not necessarily specific to financial services sector—form an important part for improving attractiveness of Estonia as a location choice.

Clustering of firms focusing on particular export-oriented activities is another important determinant of attractiveness of a given location. From a perspective of Estonia, it is therefore important to attract several significant export-oriented investments from international financial services firms in a shorter-term, which would form a basis for establishing a broader cluster of firms in the longer-term. In other words, attracting even a small number of such investments in the first place could provide a significant boost for attracting larger number of firms thereafter.

The analysis in this study also has to be set within the context of the overall situation in CEE. In particular, exports of financial services by firms located in CEE have been limited, and to date local financial services sectors in CEE have tended to focus on the domestic market rather than exports of services. This suggests that there is comparatively high threshold that needs to be crossed by Estonia to achieve significant growth in exports.

5.2 Defining policy objectives

There is a broad spectrum of policies that could strengthen the financial services sector in Estonia, and improve its potential to increase exports of financial services. In order to devise an efficient and effective set of specific policies, however, it is important first to make a strategic choice (explicitly or implicitly) and adopt a specific policy option in relation to the export of financial services sector in Estonia (eg, becoming a niche financial services centre). Specific policies can then be devised in a way that is targeted at achieving this specific policy objective, allowing more appropriate planning and considerations. For example, a set of policies aimed at increasing Estonia's attractiveness across all financial services functions and segments, and achieving a global reach would be different from a set of policies targeted at attracting increased back and middle office activities of Nordic firms.

The potential policy options facing Estonia can, among others, be defined in terms of financial services segments and functions (ie, niche activities). In principle, Estonia could adopt either a broad functional and segmental approach focusing on increasing export activity across all activities, or it focus on niche segments and functions. Notably, as it is illustrated in section 2 of this report, most small successful financial centres (eg, Dublin, Jersey) have been quite focused in providing specific services (eg, private banking, wealth management, fund registration services).

At the same time, policy options can be defined in terms of the geographic focus. In the case of Estonia, it could adopt either a global or a regional approach (in terms 'alternative locations'—including Baltic and CEE countries; and/or 'target markets'—including Nordic and CIS, as well as Baltic and CEE countries). The analysis in this study shows that any potential policy should focus on the regional and local context in the first instance—rather than global considerations—with a potentially broader focus in the medium term. This approach would also be consistent with that adopted by several existing successful small financial centres (eg, Dublin) that have taken advantage of their (geographical, cultural, and political) proximity to established major financial centres in Europe.

A choice also needs to be made about whether to adopt aggressive expansionary strategies, or a more defensive approach. If the objective is to (significantly) increase exports of financial services then Estonia would require a set of policies targeted at improving its attractiveness on the key drivers of location choice. On the other hand, threats from other locations in relation to services that are currently carried out in Estonia (including those for the local market) cannot be neglected. In particular, even maintaining the status quo in the sector will require a set of engagement strategies aimed at improving the attractiveness of Estonia as a location choice.

A policy aimed at promoting the export of financial services cannot be considered in isolation from the domestic financial sector servicing the local market. As discussed in section 3, having a strong financial services sector—even if targeted at local demand—is an important precondition for increasing the export of services. Therefore, when designing policies aimed at increasing exports, it is important to take into account existing policy initiatives that seek to improve the domestic financial services sector more generally (eg, specific legislative and regulatory developments).

Overall, this two-stage approach—first, make a strategic choice, and, second, develop specific policies—allows more effective and efficient policies to be designed, together with an appropriate timeframe for implementation. In particular, this approach facilitates identification of policies that need to be followed in the short term and those that need to be introduced in the medium term. Also, it informs the timeframe in which the results of these policies can (should) be expected to materialise, and, more generally, when the increases in exports of financial services might be expected to arise.

5.3 High-level policy options

In light of the opportunities and challenges described above, and the analysis in sections 3 and 4, the government, in conjunction with other independent decision centres, has a number of policy options. These are related to the extent to which the government objectives for the industrial policy more broadly would be focused on one or more sectors, the degree of intervention, and geographic focus.

Policy option 1: 'Proactive—broad/comprehensive'
Actively promote the financial services sector with a particular focus on exports. This is the most comprehensive option and is based on the assumption that the financial services sector represents a major area of opportunity for Estonia. If successful, this option could have significant positive impacts on the Estonian economy; however, it also requires significant investment and carries potentially high costs (eg, depending on the scope of revisions to the tax code) and limited probability of success.

Policy option 2: 'Proactive—focused/niche'
Actively promote the most promising financial services sector with a particular focus on exports, potentially with emphasis on attracting demand from regional markets (Nordic and the CIS). This is a more limited version of Policy option 1. Since the policies can be more targeted this option could potentially be easier to implement and could overcome the hurdles.

Policy option 3: 'Defensive'
Create incentives to make it less attractive for financial institutions to shift abroad the functions of the value chain in the provision of financial services for the Estonian domestic market. This policy has some overlap with proactive policies, but is more focused on the domestic market. It is cheaper to implement than the above 'proactive' options, although it offers only limited gains. This option may be most critical in the short term.

Policy option 4: 'Neutral'
Focus efforts on creating favourable economic and political conditions (eg, overall stability) more generally, without an explicit focus on the financial services sector. This involves potentially more limited changes and required investment (specific to the financial services sector), with policies and benefits considered more broadly beyond the financial services sector. In other words, take a less proactive stance without explicit policy for the financial services sector, and be more reactive to the developments in the economy more generally.

Based on the overall evidence and analysis carried out as part of this study, and if the intention is to adopt a proactive policy, Policy option 2 looks the most attractive for Estonia. The decision, however, ultimately lies with the government and other stakeholders, and needs to take into account the overall policy objectives.

In order to develop this advantage and improve the probability of greater exports of financial services, it is important to adopt a targeted strategy aimed at improving specific aspects of the financial services industry and economy that firms value when making location choices. Although some policies may be relatively low-cost, longer-term policy would require significant commitment by the government and other stakeholders.

The benefits that would arise if Estonia achieves competitiveness and demand materialises could be significant. Direct benefits would include increased economic activity in the sector, all else equal, leading to more employment, higher tax revenues, and other effects. Moreover, production of financial services creates significant positive spillovers to other sectors (eg, professional services sector), bringing further benefits to the economy.

These potential benefits, however, need to be offset against significant uncertainty that surrounds the ability to increase the exports of financial services. In other words, even if a country becomes an attractive location for financial services activities, there is still a possibility that this might not lead to a significant increase in financial services activity (for example, if there emerges a general trend towards reducing the exports of financial services due to some external factors). Such uncertainty is not specific to financial services sector, however, but is a general feature of sectors with highly mobile and 'exportable' activities.

5.4 Policy areas

There are a number of high-level policy areas that can be considered by the Estonian government and regulators (with support from other stakeholders in the sector) to improve the export growth potential in the identified parts of the financial services sector. Importantly, these policy objectives need to be considered in the right context with realistic targets of achieving growth in exports of financial services, and depending on the strategic choices that are made by the government and other stakeholders (section 5.3).

The primary areas of policy focus could be defined as follows.

– **Regional and international policies.** This requires cooperation with countries that could be seen as the most relevant foreign markets for the financial services industry. In the Estonian context, the most relevant markets at present are the Baltic/Nordic and Russian/CIS countries, with the Nordic region not only serving as a source of potential demand, but also being the home of parent financial institutions of many of the current financial services firms in Estonia. The potential tools for achieving regional and international cooperation are many and varied, including diplomatic links, taxation treaties, free trade areas, and cross-country industry engagement forums. Such policies are relevant in promoting the home financial industry by making it easier for it to access and market to foreign jurisdictions and cooperate with foreign financial institutional counterparts, often to mutual benefit.

– **Economic and political stability and attractiveness.** One factor frequently cited in the development of financial centres has been the general stability of a jurisdiction—including economic, political, and regulatory stability. The economic and political stability of a region is important in attracting foreign investors, and in permitting the development and growth of the domestic financial services industry. Initially, the economic growth of an emerging economy is relevant, as has been the case in Estonia, in attracting foreign financial institutions which hasten to service local demand. As the economy matures, sustained economic growth facilitates, among others, the ongoing foreign and domestic investment needed to develop exports. Regulatory and policy stability also plays an important role in the sustained growth of the financial industry.

– **Tax and regulatory regimes**. The tax and regulatory regimes are important factors influencing foreign institutions' assessment of a country's competitiveness when choosing location. In particular, elements of the general tax regime, such as corporate and personal income tax rates, are relevant in increasing the attractiveness of a country as a location choice. At the same time, certain aspects of the financial services tax regime, such as tax incentives for foreign financial services firms and withholding tax, can be important for specific segments and functions in the sector. Similarly, the level of duties levied on financial services firms (eg, financial supervisory fees) can also play a role. As for the regulatory regime, the financial services industry benefits from a predictable and flexible regulatory framework exercised by a competent regulator with good understanding of the firms' activities.

– **Development of human capital**. Developing a financial services industry relies on the presence of a pool of human capital with expertise in financial services activities, including both strong university-level education and the specific skills (eg, understanding of the back office processes) required for different parts of the financial services value chain. The availability of skilled labour can be improved through policies such as expanding the programme of relevant finance and business administration degrees (as well as mathematics, and other related subjects) at universities in Estonia, attract foreign help or send best professors overseas for three months to a year.

– **Technical capability (including infrastructure)**. The availability of good financial services infrastructure plays an important role in the development of the industry. This includes payment and clearing systems, and more generally the infrastructure to link the different parts of the value chain and to link the product to the consumer in financial services. Both the quality and cost of the financial services infrastructure are relevant in attracting and supporting firms. Therefore, policies to enhance the quality and efficiency of financial infrastructure would facilitate industry development.

– **European Community and other international platforms**. Another relevant policy area is for Estonian financial institutions and policy-makers to participate actively in European financial industry bodies (eg, European Fund and Asset Management Association). From the institutions' perspective, this should enable better cooperation with foreign counterparts, affording them a chance for reputational enhancement and the opportunity for cross-border marketing. From the perspective of policy-makers, not only would active membership of European financial industry bodies allow for lobbying efforts on behalf of the Estonian industry, but would also make the regulators aware of international developments and best practice, which could be incorporated into Estonian policy frameworks in order to enhance the attractiveness of the Estonian financial industry to international financial institutions.

– **General business attractiveness**. Policies to enhance business attractiveness are many and varied since the term 'general business attractiveness' can refer to a wide range of factors within the regulatory, economic, social and technical characteristics of an economy. Within general business attractiveness there are factors such as transport links, the quality of life for workers in Estonia, the openness of the economy, the ease of doing business (eg, the ease of registering property or obtaining credit), and so on. Perceptions of the environment play a part too; for example, the perception that Estonia's policy-makers are pro-business, flexible and responsive. As such, marketing policies play a role in enhancing the perception of general business attractiveness.

Examples of particular policies that could be adopted are outlined below, although the specific design of policies would require more detailed analysis (eg, cost–benefit assessment of the specific changes, market analysis, and so on), which is outside the scope of this study.

5.5 Suggestions and illustrations of specific policies across different policy areas

The choice of specific policies is conditional on the choice of particular policy option, and requires more detailed consideration of the costs and benefits. Nevertheless, a number of suggestions are provided below, together with illustrations of specific policies across different policy areas that could be adopted to achieve the set policy objectives.

Generally, distinction is made between policies that could be implemented in the short run and in the medium-run respectively. Also, while some of these policies are relatively costly, others can be effectively implemented with comparatively low cost. Moreover, it should be noted that some of the policies outlined here (eg, advertising campaigns promoting Estonia) would directly benefit other sectors of the economy.

5.5.1 General awareness, information and perception of Estonia and regional and international policies

To develop Estonia's financial services sector, and enhance opportunities for exports, efforts could be geared towards improving the general awareness of, and information about, Estonia's strengths and the opportunities it offers to investors. In particular, policies could be targeted towards improving the perception of Estonia's financial services industry and enhancing cooperation between Estonian financial service institutions and institutions and investors in the relevant markets.

Short-term options

In the short term, the priorities could include policies aimed at marketing Estonia's financial services industry and promoting cooperation between Estonia and the regions which can offer a source of demand for Estonia's financial services exports. The policies falling into this category can generally be undertaken with relatively low monetary cost. Examples of these policies include the following.

– A coordinating body could be established to promote cooperation between Nordic (and broader EU), CEE and CIS financial institutions and investors and the Estonian financial services stakeholders. This would provide an opportunity to market Estonia more effectively, and serve as a forum to engage with foreign investors and institutions on such issues as taxation and regulation, and to respond to their needs.

– Raise awareness of Estonia through focused promotional campaigns. For example, marketing campaigns could be launched which focus on the capabilities and strengths of Estonia's financial services industry. Advertising and promotional campaigns could, in the first instance, be focused in the relevant regions.

– Existing relationships with regional stakeholders in Estonia's financial services sector could be used systematically to reach out to prospective investors and financial institutions. For example, the relationship with Nordic banks could be used to improve awareness and perceptions of Estonia.

– It would be beneficial to organise financial services conferences in Estonia which would provide an opportunity to promote the financial service industry, and increase general awareness of Estonia. Such events would also help to foster co-operation between specialists in Estonia and more sophisticated financial centres.

Medium-term options

In the medium term, efforts could focus on systematising the short-term options outlined above and expanding their outreach. So, for example, most of the short-term options may be focused on promoting cooperation with, and general awareness among, investors, while in the medium-term these efforts might be focused on highlighting very specific strengths in the niche segments that Estonia would target (if this is chosen as a proactive policy option).

5.5.2 Economic and political stability and attractiveness

The economic and political stability of a jurisdiction is important in attracting foreign capital in the first instance, and then in sustaining investor interest. Even if not tailored towards enhancing the attractiveness of the Estonian financial industry, Estonian policy-makers are likely to regard stability as a general policy objective and adopt strategies to maintain stability. In terms of economic stability, specific short- and medium-term policies therefore include generally sound overall monetary and fiscal policy, maintaining sound regulation of the financial services sector, adoption of Euro (assuming conditions are right). In terms of political stability, particularly relevant are policies aimed at improving the relationship with neighbours.

5.5.3 Tax and regulatory regimes

As already discussed, the tax and regulatory regimes are important factors which influence the competitiveness of the region. Policies geared towards enhancing the attractiveness of the tax and regulatory regimes need to be implemented in the context of the overall strategy of the government, and some options may appear more or less feasible, given EU fiscal and regulatory constraints.

Short-term options

In the short term, the priorities could include policies aimed at meeting financial services firms' needs and benchmarking competitiveness relative to alternative locations and target markets. Examples of such policies include the following.

- Undertaking a detailed comparison of the competitiveness of Estonia's tax system relative to its Nordic and CEE peers, focusing on an assessment of attractiveness from the perspective of financial services firms.

  - In interviews carried out as part of this study, specific issues have been identified that may warrant consideration, such as the appropriate VAT rate for the investment fund industry; the effective rate of capital gains tax on private persons. Also, Estonia currently lacks double-taxation treaties with some countries, particularly in the CIS region, which could hamper the growth of financial services exports.

- There are also a number of regulatory regime changes which could be considered.

  - Interview respondents expressed concern about certain elements of the regulatory regime. Specifically, it may be relevant to undertake an update of the non-UCITS fund law which is perceived by some market participants as outdated.

  - Further to the policy options regarding regional and international cooperation, it may be a policy option to set up systems and/or bodies (involving regulators and legislators, as well as industry players) to ensure better coordination between Estonia and the financial supervisory authorities in other countries, particularly in relation to the implementation of EU laws.

- In order to better understand and meet the needs of international financial services firms, one policy option is to set up meetings between the Estonia FSA and the Estonian tax authorities and local and international firms. This would permit the regulator and state bodies to assess the perceived inadequacies of the taxation and regulation regimes, and would provide a forum to discuss proposed reforms. Many of these reforms could be achieved with a limited amount of monetary cost.

Medium-term options

There are also a number of specific policies that could be implemented in the medium-term. For example, some of the tax and regulatory changes suggested above could be realistically implemented only in the medium term. Also, depending on which of the niche markets (if such a policy option is adopted) become increasingly successful, more targeted changes aimed at further improving the attractiveness of activities in given segments and functions could be particularly beneficial.

5.5.4 Development of human capital

The availability of skilled human capital is a critical factor in the development of the financial services industry. Broadly, two elements of skills are relevant: education and experience. The availability of an experienced Estonian financial services workforce is likely to take time, and will happen naturally as the industry gains maturity. Enhancing the levels of workers with relevant finance and business administration degrees is also likely to take time, although some short-term policy options could be considered.

Short-term options

In the short term, the priorities could include policies aimed at boosting the supply of skilled financial services workers. Examples of such policies include the following.

– It is possible to boost the educational levels of financial services workers by subsidising relevant academic/vocational courses and qualifications such as CFA, which are of a relatively short duration.

– It may also be beneficial to fast-track the entry of financial services workers by relaxing immigration requirements.

– Hiring of a very senior recently retired executives (eg, from the UK) in the financial services sector to take up an advisory role for limited contracts could be considered.

Medium-term option

There are also a number of specific policies that could be implemented in the medium term. Notably, implementation of these policies should involve different stakeholders (government, universities, and financial services firms), which would allow to utilise the expertise of various involved parties, and also to share monetary costs associated with the implementation of these policies. Examples include the following.

– Government grants to support the development of relevant full-time university degrees (eg, MSc Finance) and vocational programmes. These could also be co-funded by financial institutions.

– Collaboration among universities and between universities and private sector to develop relevant programmes. This may also be of relevance in developing short-term courses to support and enhance the continuous professional development of financial services workers.

– It may be beneficial to create centres for (finance) excellence at universities, which could potentially be co-funded by financial services firms. Also, if, once qualified, financial services workers were to retain links with these centres of excellence, this may allow for a potential source of funding via private grants and a route for students to gain practical experience via interaction with former students leading to internships.

5.5.5 Technical capabilities (including infrastructure)

The technical capabilities and the infrastructure which supports the financial services sector are important aspects of the attractiveness of a given location. If Estonia is to develop as a regional specialist financial centre in private banking or core asset management, for example, it may also be that specialist ancillary infrastructure will be required to support the development of these specialist financial services segments and parts of the value chain.

Although the development of financial infrastructure and technical capabilities is likely to be led by the industry, specific policy initiatives may be required to support the development of this infrastructure and capabilities. For example, government and/or the financial services regulator may need to facilitate the necessary investment through direct intervention in the market (eg, in instances when investment in an important infrastructure which would be beneficial to industry is not undertaken due to the lack of coordination between market players).

5.5.6 European community and other international platforms

Estonia can improve its standing as a regional financial centre by engaging more closely with European financial industry bodies. This is relevant for Estonian industry bodies and regulators that could, for example, benefit from being able to promote Estonian interests, and gain reputational benefits from being involved in the supra-national industry platforms. The policies falling into this category can generally be undertaken with relatively low monetary cost, although it would require a non-negligible time commitment from senior executives at the relevant institutions in Estonia.

Short-term options

In the short term, the priorities would include policies aiming at participating in regional European platforms, especially for those financial services segments where Estonia may have an opportunity to develop a strong competitive position internationally. Participation in platforms which are established in the EU as a first instance may be helpful in enhancing the existing and developing new relationships. Estonian regulators and policy-makers could also participate in the European Commission's financial regulatory associations in order to better benchmark its own regulatory framework against developments in the wider industry and best practice.

Medium-term options

For the medium term, Estonia could seek to make participation in the international forums more systematic, and to host a financial platform in Estonia.

5.5.7 General business attractiveness

There are a multitude of policies which enhance the actual or perceived business attractiveness of a country. Some policies that could be adopted are outlined below, although, as such, these policies are already likely to form part of the overall government policy (not specifically related to the financial services sector).

Improvement of the transport links between main European locations and Tallinn will have an immediate impact on the business environment and on the perception of the business environment. Also, the launch of advertising and marketing campaigns which focus on promoting Estonia could enhance the perceived attractiveness of the country.

A1 Interviews and workshops

A1.1 Interviews with industry participants

The analysis in this report has been substantiated by interviews with senior executives from the Estonian financial services sector and international financial institutions. The interviews have informed the analysis and provided a check to ensure that the conclusions drawn are robust. The key objective of the interviews was to obtain qualitative insights into the latest trends financial markets in Estonia and globally (particularly in relation to the export of services), factors that determine the attractiveness of locations and Estonia's standing on those factors, and the potential developments going forward.

The interview participants are listed in Table A1.1. In some cases more than one interview was carried out with people from the same organisation. The table also reports segments where interviewees are active.

Table A1.1 Interview list

Country	Institution	Segment of activity (interviewees)
Interviews in Estonia		
Estonia	Avaron	Asset management
Estonia	KFP	IT solutions
Estonia	FSA	Regulation
Estonia	Nordea	Private banking
Estonia	SEB	Asset management, Private banking, Corporate finance
Estonia	Swedbank	Private banking
International interviews		
Belgium	Fortis	Investment banking, Asset management
Sweden	SEB	Wealth management
UK	AXA Investment Managers	Asset management
UK	BGI	Asset management

Source: Oxera.

A1.2 Workshops

Oxera carried out two workshops in Estonia as part of this project, with the objective of engaging with the stakeholders in the Estonian financial services industry, including senior business executives and policy-makers, by discussing strategic business opportunities and future growth of the sector.

The first workshop was held soon after the start of the project in order to gather the views of senior decision-makers regarding business opportunities and areas for development, as well as an insight into challenges facing participants in the Estonian financial industry. The second workshop was held following the finalisation of the draft report in order to discuss observations from Oxera's analysis and offer an opportunity to executives in the Estonian financial services industry, as well as government representatives and other stakeholders, to express their opinions and comment on the emerging conclusions.

Workshop 1
The agenda for the first workshop held in Estonia on May 18th 2009 was as follows.

– Session 1: Presentation from Oxera on the objectives of the project following by an initial questions and answers session on project scope and objectives.
– Session 2: Presentation from Oxera on the implications of the financial crisis on the financial services industry in Europe.
– Session 3: Discussion sessions—servicing local demand; and the export of financial services.
– Session 4: Presentation of findings by participants.

The participants at the workshop are listed in Table A1.2.

Table A1.2 Participants at May 18th workshop

Participants	Institution
Kaidi Ruusalepp	Nasdaq OMX
Rain Tamm	Gild Bankers
Mihkel Torim	Swedbank
Katrin Talihärm	Estonian Banking Association
Art Lukas	Swedbank
Mihkel Oja	LHV
Janek Uiboupin	Eesti Krediidipank
Veiko Tali	Ministry of Finance
Kristjan Lepik	Tark Investor
Mihkel Oim	Limestone Funds
Kaido Kaljulaid	Kit Finance
Enn Metsar	Swedbank
Peter Treialt	Nordea
Kardi Haldre	Avaron
Jaan Priisalu	Swedbank
Lauri Karp	KFP
Margo Karp	KFP
Aet Rätsepp	Swedbank
Anneli Simm	Deloitte
Kristjan Kolbre	Nordea
Taavi Lauri	Swedbank
Viljar Arakas	Eften Capital
Jelena Fedotova	Swedbank
Rait Matiisen	Estonian Traffic Insurance Fund

Source: Estonian Development Fund.

Workshop 2
The agenda for the second workshop held in Estonia on August 3rd 2009 was as follows.

– Session 1: Oxera presentation of the findings in the report.
– Session 2: Question and answer session on general findings and analysis conducted by Oxera.

– Session 3: Policy implications: discussions in groups, following a short introduction from Oxera.
– Session 4: Policy recommendations: conclusions from the discussion in the sub-groups and plenary session.

The participants at the workshop are listed in Table A1.3.

Table A1.3 Participants at August 3rd workshop

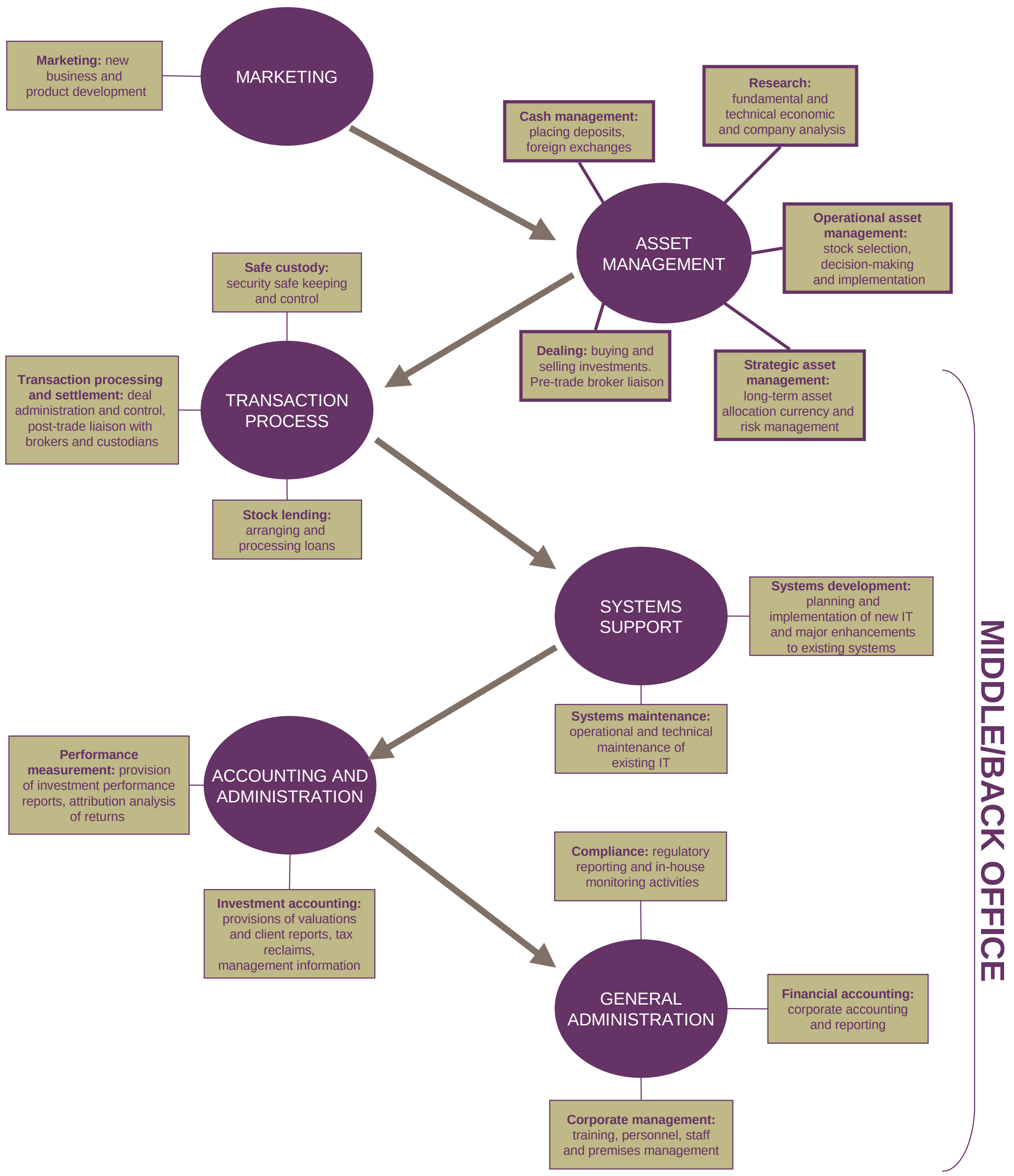
Participants	Institution
Kristjan Lepik	Tarkinvestor
Reimo Hammerberg	Sorainen
Kaidi Ruusalepp	Nasdaq OMX
Kaido Kaljulaid	KIT Finance Europe
Kadri Haldre	Avaron
Viljar Arakas	Eften
Andres Viisemann	LHV
Ege Metsandi	Trigon
Kristel Kivinurm	Avaron
Kristel Meos	Swedbank
Mihkel Torim	Swedbank
Tiina Norberg	Swedbank
Andres Vesilind	Nordea
Janek Uiboupin	Eesti Krediidipank
Hele Hammer	Amserv
Joonas Pärenson	Estonian Student's Body Union
Kristjan Niinemaa	Estonian Traffic Insurance Fund
Silja Narusk	Ministry of Finance
Kristjan-Erik Suurväli	Financial Supervision Authority
Gert Stahl	Enterprise Estonia
Lauri Tammiste	Ministry of Economic Affairs and Communications
Aet Rätsepp	Swedbank
Lauri Karp	KFP
Margo Karp	KFP
Tauno Olju	Ernst & Young
Mart Repnau	Tallinna LV
Villu Zirnask	Columnist
Raul Allikivi	Ministry of Economic Affairs and Communications
Regina Raukas	Ministry of Economic Affairs and Communications
Ott Pärna	Estonian Development Fund
Kitty Kubo	Estonian Development Fund
Neeme Raidvere	Estonian Development Fund
Imre Murk	Estonian Development Fund
Heidi Kakko	Estonian Development Fund
Siim Sikkut	Estonian Development Fund
Jelena Fedotova	Swedbank

Source: Estonian Development Fund.

A2 Illustrative value chain of asset management activities

Figure A2.1 shows a stylised value chain in asset management, for illustrative purposes.

Figure A2.1 Example of a generic asset management value chain



Source: Oxera.

Park Central
40/41 Park End Street
Oxford OX1 1JD
United Kingdom

Tel: +44 (0) 1865 253 000
Fax: +44 (0) 1865 251 172

Stephanie Square Centre
Avenue Louise 65, Box 11
1050 Brussels
Belgium

Tel: +32 (0) 2 535 7878
Fax: +32 (0) 2 535 7770

Thavies Inn House
7th Floor
3/4 Holborn Circus
London EC1N 2HA
United Kingdom

Tel: +44 (0) 20 7822 2650
Fax: +44 (0) 20 7822 2651

www.oxera.com