48 Hours in the Tallinn City-State

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Leave a cold London and step off the plane in Tallinn into warmth, blue sky and sunshine; cheerful English speaking taxi driver; ten minute taxi journey into the city centre; easy payment in euros ….Good omens for a speech to the Finance Estonia First International Forum!

When the invitation had pinged into my inbox, after a quick check of the map to confirm it really was the place with the medieval red roofs just across the channel from Helsinki, I accepted immediately. It seemed too good an opportunity to find out how a small society had coped with a 15% drop in GDP in 2009, a rapid bounce-back to the fastest growth rate in the euro-area and the lowest public debt ratio - of just 10%. How are they doing it? Are there any lessons for other EU states struggling with long and deep recessions? What is it that made `Europe' and its currency so attractive to the country – in such sharp contrast to the doomsayers of London? A lot to pack in to 48 hours – and can only be a superficial glimpse at best.

The tragedies of past occupations by all their neighbours has left many scars, both cultural and physical, but it is now seen as a strength because of the understanding of the languages and business cultures of them all. Remarkably, Tallinn is a major sea route for trade from China into Russia. However, the giant eastern neighbour may be a massive business opportunity but is still tinged with menace – underlined by stories in the beer cellar of winter military training in the forests bordering Russia!

Into a hectic round of meetings (and even the doorkeepers speak English so no need for any nervousness about getting to the meeting in the first place!) The sheer energy of the meetings immediately impressed: these are people who know they have to strive for their own personal success, but equally for the future of their country. Finance Estonia had already stated their priority sectors for developing their niche in the European financial market place:

- Corporate Treasury & Shared Service Centres;
- Financial Technology;
- Fund Services;
- International Private Banking

Reading round these topics beforehand is simple but cannot give the flavour of the enthusiasm of the participants and presenters at the Forum. Nonetheless, after hearing about the desire for an Estonian capital market, it still came as a shock to be told 99% of Estonian companies would fall within the EU definition of a Small/Medium sized Enterprise (SME).

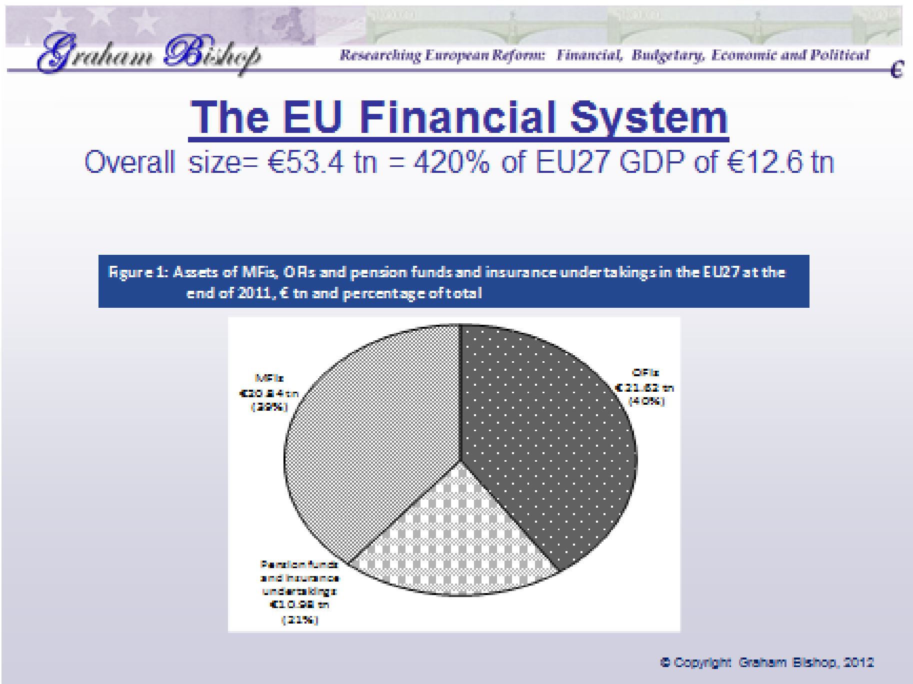
So the idea of an active market in Tallinn in Estonian equities looks a little fanciful as the key problem for SMEs is always that investors cannot easily sell their shares because potential buyers cannot become sufficiently familiar with the company unless they are willing to do substantial `due diligence'. But that is exactly the hallmark of the private equity industry so it was fascinating to hear about the steps already taken to encourage that industry – including a legal framework for a fund of funds. Moreover the iconic example of Skype's development through venture capital is still ringing in everyone's ears! Perhaps another Estonian innovation – highly secure biometric recognition of bank clients via an app on their mobile phone (BIOMETRY) - has the capability of shifting a large part of smaller consumer payments away from banks to telecoms companies.

These factors underline the wisdom of Finance Estonia's decision to focus on utilising the nation's `wired' status to encourage development of support services to the euro-denominated financial industry just as that industry is about to undergo profound change.

Economic earthquakes – current and future: Implications for Estonia

A financial/economic earthquake has been shaking the EU since 2007 and may now be in its later stages - but is certainly not over as a false move by the EU could plunge us all back into turmoil. However, even as the after-shocks die away the warning tremors of another financial earthquake are already being felt. A huge array of regulatory change is underway for all sectors of the financial system. For Estonia, the compulsory re-thinking of the service centres that will supply the new financial system opens up a series of opportunities to compete for internet-based business opportunities where the existing suppliers are still in a direct line of legacy decisions from the era of the quill pen.

Figure 1 illustrates the potential impact for a state that is only 1% of the EU-27's GDP. If a significant part of the banking system (MFIs – monetary financial institutions) has to shift into the `other financial Institution' (OFI) sector, the possibility of capturing even a small part of the servicing arrangements would be highly significant.



Leading European Parliamentarians are currently arguing that when a bank is taken into temporary public ownership moral hazard should simultaneously be addressed by wiping out previous shareholders and bailing in unsecured debt-holders to the largest feasible extent, with uninsured deposits being preferred in the hierarchy. This preferment seems to be increasingly accepted by Europe's politicians but, inevitably, there will create profound structural changes in the nature of Europe's financial system.

The interaction of all these regulatory changes may produce surprising/unintended consequences that need to be thought through. Have the EU institutions really done this? What should the Euro area financial system look like at the end of the next European Parliament/Commission term in 2018? Decisions about banks' asset quality and supervision as a branch banking system spanning the euro area – by far the simplest model to supervise - will drive profound changes to the EU banking structure – the second earthquake. But this will not be happening in isolation. The Single Resolution Authority (SRM) should also be starting in 2015 just as major banks are required to have their `living wills' fully operational.

The 1980's fad for bringing all finance under one roof may be exposed to critical examination once this living wills exercise has been completed. Will the information about the capital involved in each activity (and its rate of return) be restricted to the Board of Directors? How will shareholders respond to information about the profitability of different sectors? Given the lead times for reactions, 2020 may come round quite easily as the earthquake tremors build up.

- **Bank maturity structure:** The natural upshot of `depositor preference' is that banks may well find that their funding becomes shorter term as bond buyers become more reluctant to provide long term funds. So banks should match that by reducing longer term lending. The recent Commission Green Paper on Long Term Investing (LTI) clearly identifies the need to reduce reliance on banks in this longer maturity sector by selling securities to investment institutions. Curiously, it identifies insurance companies and pension funds but seems to ignore the largest single sector – UCITS. This process would shift the `capital uncertainty' burden directly to citizens – who will only accept it if they are confident they will be treated fairly by the publicly-regulated financial system.
- **Public debt sustainability:** Public debts are hovering close to sustainability levels in many states (but certainly not Estonia). In the modern technological world, should banks be intermediaries between the citizens and short-term government debt at all? The undoubted need for an adequate supply of high quality and ultra-liquid short term assets can be met by this author's proposal for a Temporary Eurobill Fund link that provides `European' debt rather than national government debt as a bank asset. It can also provide a safe asset for citizens who wish to have absolute capital certainty.
- **The banking revolution:** The implication of the LTI paper is that banks should move out of the long-term finance space, thus moving another large chunk of their balance sheet to the fund management area. The Liikanen Group examined the split of banking activities between ordinary deposit-takers and investment banking activities such as securities dealing for clients and on own-account i.e. the classic universal banking model. But there has not yet been any

consideration of the role of financial `supermarkets' that offer universal banking services as well as asset management and insurance.

Should these functions be completely separate from `deposit taking' banks? UCITS are one of the EU's major success stories. The ability of citizens to make simple cross-border payments via SEPA (including by direct debits early next year) will complete the revolutionary process of enabling the consumer to make full use of the euro. Mobile phone payments may simplify this process even further. **Add in the possibility of dealing with assets held in UCITs or the Euro Treasury Bill Fund and the second financial earthquake would be well underway.**

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