How exposed are Nordic Banks to the Baltics?

This report provides an overview of the Baltic countries' banking sectors and compares the business models of the major Nordic banks operating there. Swedbank (Issuer Rating A+, Negative) and SEB have emerged as winners in terms of size in the region, but not all of their competitors, such as Svenska Handelsbanken (Issuer Rating AA-, Stable), were seeking such scale.

Given recent conduct-related events, we put particular emphasis on Danske Bank (Issuer Rating A+, Negative) and Swedbank. In both cases, Scope revised its Outlooks to negative following the emergence of allegations of money laundering through their Baltic operations, resulting from failures in anti-money laundering ('AML') controls. The Outlook changes reflect uncertainty related to the resolution of various probes by authorities, which could also lead to the imposition of fines – essentially related to the governance of the banks' compliance functions.

Given Danske Bank's forced exit from Estonia (and decision to exit the other two countries), there is in theory a possibility that Swedbank could be faced with a similar demand. Yet this poses a conundrum for the authorities. Given the scale of the bank's operations in the Baltic countries – it is far more systemically important to the region than Danske Bank – there is the issue of how this could be applied in practice, and the effect it would have on Swedbank.

Considering the other banks' conduct issues, the only fully successful Nordic universal player in the region is SEB, which so far has not been drawn into the money laundering scandal and whose management remains confident it has the required controls in place. All other foreign operators with large ambitions have considerably scaled back their operations in recent years due to lack of commercial success. Lack of scale led Nordea (Issuer Rating AA-, Stable) and DnB (Issuer Rating AA-, Stable to pool their operations and to agree to subsequently sell the majority of their local subsidiary Luminor to Blackstone.

DnB will maintain a minority stake and Nordea will fully exit over time. While this would not insulate the banks from past failings (and without detailed knowledge of their AML controls over time it remains possible that such could emerge), there are no indications that they have been affected by money laundering through their Baltic operations on any scale comparable to Danske and Swedbank. Every bank will no doubt encounter suspicious transactions which need to be reported to the authorities responsible for investigating possible criminal activities.

Outside of the Baltics, Finnish media indicated in March 2019 that Nordea in Finland may in the past (between 2005 and 2017) have received roughly EUR 700m in suspicious Russian-originated wire transfers from the Lithuanian banks Ūkio and Snoras—two now-defunct institutions. Nordea has asserted that these transactions were already detected and reported. Finnish authorities will not be pursuing the case.

Many of the allegations surrounding Nordic banks cover historical periods. But this serves to demonstrate how past failures of governance may lead to present-day investigations, reputational damage, a hit to funding costs and possible financial penalties, especially caused by taking too much for granted in an environment where corruption has in some cases become institutionalised.

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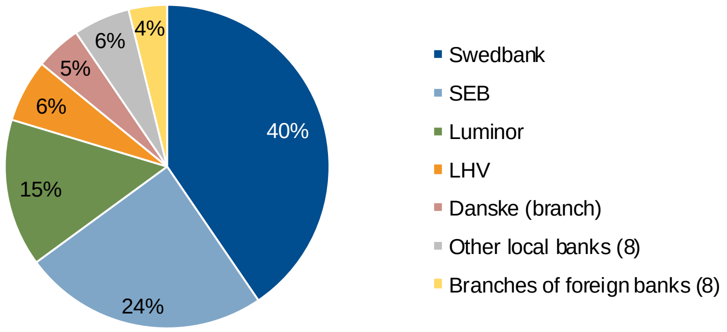
Baltic banking – a narrow market

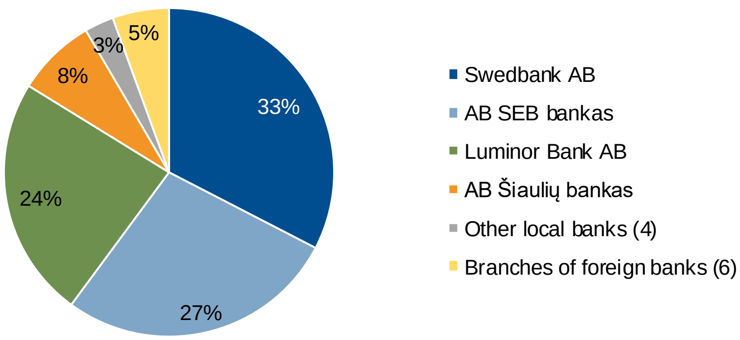
As demonstrated in Figures 1 through 3, the banking sectors of the three Baltic states are dominated by the operations of banks based in the Nordic region. Swedbank has the largest share of assets. Danske Bank's operations – though they have captured the headlines – are relatively small. In fact, Swedbank's ventures in the region have been far more successful, and it has continued to expand – in part by acquiring assets from Danske Bank.

Figure 1: Banking sector of Estonia split by total assets: 2018YE



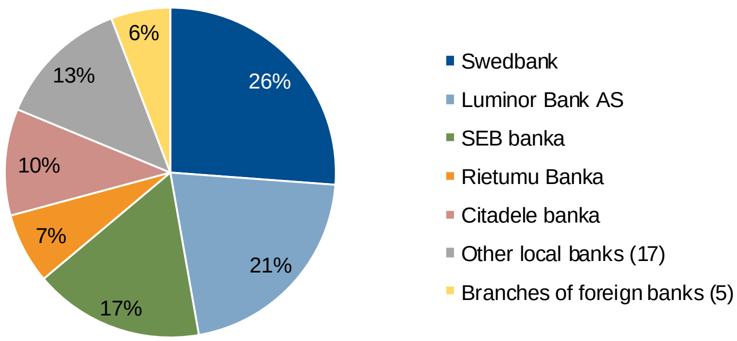
Source: Finantsinspektsioon, Scope Ratings

Figure 2: Banking sector of Lithuania split by total assets: 2018 YE



Source: Bank of Lithuania, Scope Ratings

Figure 3: Banking sector of Latvia split by total assets, 2018 YE

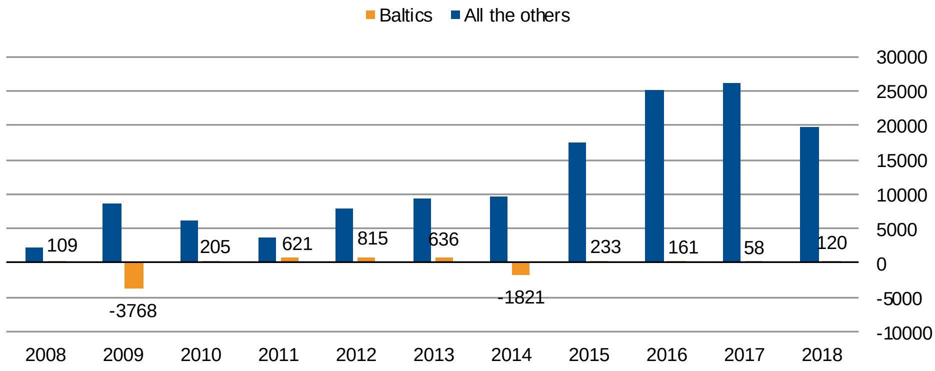


Source: Latvian Financial and Capital Market Commission, Scope Ratings

After Swedbank, Sweden's Skandinaviska Enskilda Banken (SEB) and Estonia's Luminor Bank are now the largest players in the region, each following a universal bank model with a significant retail presence and largely deposit-funded. As of year-end 2018, the three banks accounted for 79% of banking assets in Estonia, 84% in Lithuania and 64% in Latvia.

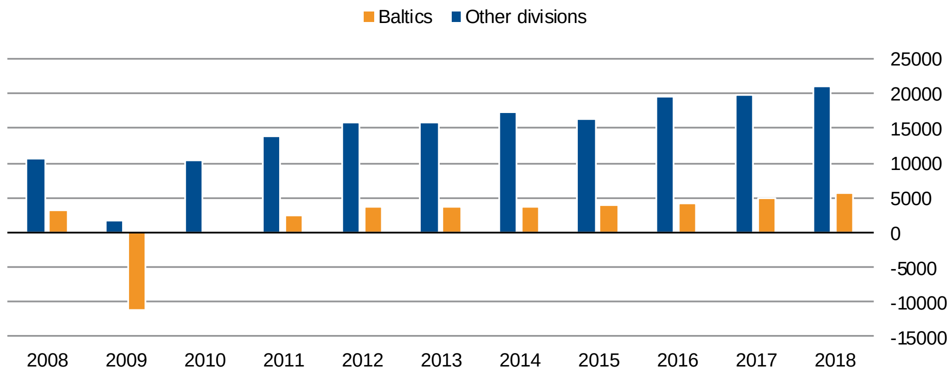
Danske Bank by contrast accounts for just 5% of banking assets in Estonia. Its current presence in Latvia and Lithuania (also via local branches) is even smaller. As demonstrated by figures 4 through 6, the Baltic region accounts for a larger share of Swedbank's operating profits than is the case for either SEB or Danske Bank. Considering other Nordic banks, Sweden's Svenska Handelsbanken and Finland's OP Corporate Bank have defined but relatively limited operations.

Figure 4: Danske's Profit before tax: Baltics vs other divisions, 2008-18 (DKKm)



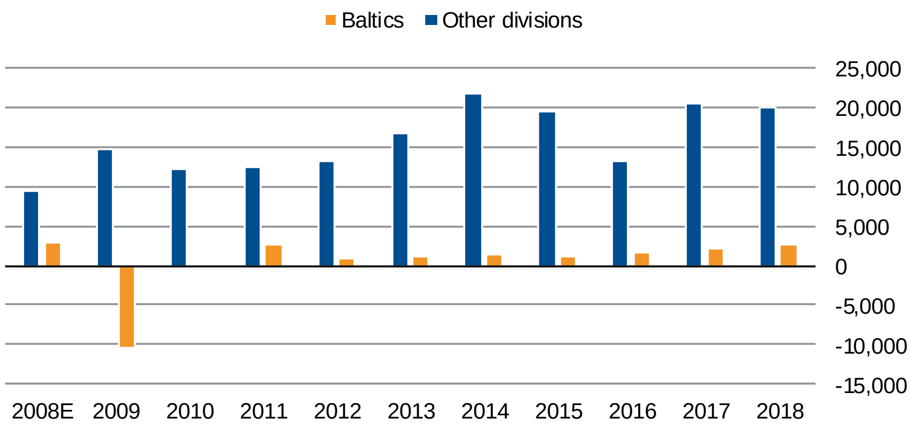
Source: Company data, Scope Ratings

Figure 5: Swedbank pre-tax profit: Baltics v other divisions, 2008-2018 (SEKm)



Source: Company data, Scope Ratings

Figure 6: SEB pre-tax profit: Baltics vs other divisions, 2008-2018 (SEKm)

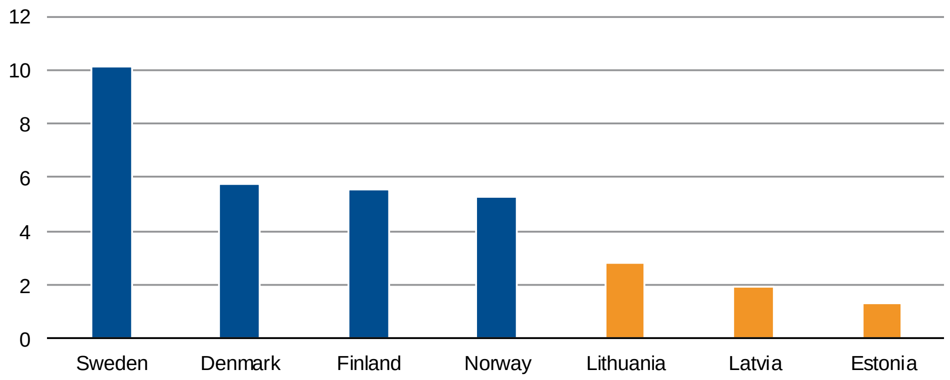


Source: Company data, Scope Ratings

Baltics offer limited upside to most, but significant operational risk

There were always likely to be winners and losers, despite initial optimism from most Nordic players about high growth potential when entering the Baltic markets during the 1990s and early 2000s. The combined population of Estonia, Latvia and Lithuania is only 6.2 million (see Figure 7), not much higher than that of Denmark or Norway, and the size of the combined Baltic banking sectors' assets of EUR 75bn are dwarfed by the size of combined banking sector assets in the Nordic countries, standing at EUR 2.6trn (both as of YE18)[1].

Figure 7: Populations of the Nordic and Baltic countries: 2018YE (in millions)



Source: Eurostat

Banking in the Baltic states is primarily domestically focused, while the larger Nordic banks have sizeable international operations. But this only partly explains the difference in scale. These considerations serve to limit the number of players that can reasonably achieve scale and make sustainable and meaningful profits – even with the inherent subsidies that flow from being part of a much larger group, such as access to technological development and management know-how.

Thus, Nordea and DnB, among those who expanded in the region when it began to open up to Nordic banks, are in the process of exiting banking business in the Baltic region, with DnB set to maintain a minority stake in Luminor Bank. Luminor was created in 2016 by pooling its assets with those of Nordea. The majority of the bank is set to be acquired by Blackstone Group of the US in 2H19. DnB and Nordea will each retain a c.20% stake. Nordea has agreed to sell its remaining stake to Blackstone in the future.

ALBV: the canary in the coal mine

Swedbank and Danske Bank are far from being alone in the Baltic region in having been caught out in recent months due to some very well-organised schemes for laundering large amounts of money out of Russia and some CIS states. This has also proved to be problematic for several local banks over time, although events surrounding these have garnered less attention, given the relatively small size of the banks concerned, and international investors’ minimal exposure to them.

[1] Sources: European Banking Federation, Statistics Sweden, Statistics Finland, Estonian FSA, Latvian Financial and Capital Markets Commission, Bank of Lithuania.

Figure 8: Geography and occupied history until the 1990s link them to Russia

Source: Scope Ratings

The case of Latvia's ABLV Bank in 2018 shows the possible danger posed even to a local bank without a US presence. ABLV was forced into voluntary liquidation by US authorities in 2018 by cutting it off from US dollar funding and market access due to alleged money-laundering and sanctions breaches. Danske Bank does not have a US banking presence, although it does have funding programmes and a correspondent banking network. Swedbank has a US branch and a small broker-dealer.

Scope does not consider the ABLV case to be the directly comparable to that of Danske Bank or Swedbank, where at least for now the focus is on money-laundering rather than sanctions breaches. It is also important to note that both Swedbank and Danske Bank have pledged full co-operation with regulators – which is no guarantee of leniency, but better than offering none. As of 21 February 2019, the Swedish FSA and the three supervisory authorities in the Baltic states have commenced a joint investigation into events at Swedbank, expected to finish in October 2019.

With regard to business risk, Danske Bank has been asked by Estonia's FSA to exit its banking operations in the country. Many questions remain unanswered concerning Swedbank – which is being jointly investigated by supervisors in Sweden and the three Baltic countries – and it has not yet been made clear how the FSA would deal with Swedbank were wrongdoing thought to have been committed on a similar scale. Danske Bank's presence is relatively small, so its exit will have limited impact on the overall market. By contrast, given its dominance as a deposit-taker and a lender, it seems unlikely that Swedbank could so easily be asked to exit. That may yet prove to be a benefit of scale, which has not been achieved by every Nordic entrant to the region.

Swedbank – the region's largest player

Swedbank – originally through its acquisition of Hansapank during the 1990s – has for a considerable period been the most exposed of all foreign banks to the Baltic countries. In 2018 the division accounted for 21% of the Group's pre-tax profit.

Its largest market is Estonia, where it is the leader across the board. It also has a strong presence in Latvia and Lithuania, particularly among private individuals.

Swedbank operates 33 branches in Estonia, 33 in Latvia and 59 in Lithuania, with 3,569 full-time employees at YE18. It is essentially a retail bank with approximately 3.3 million private customers and 300,000 corporate customers, mostly local companies or subsidiaries of Nordic customers. Almost all its funding is deposits from customers. Swedbank maintains that systems, policies and governance across the region are fully integrated with the rest of the Group.

The business, which makes heavy use of telephone, internet and mobile banking channels, is considered very profitable, with a return on allocated equity of 20.6% in 2018, assisted by a cost/income ratio of 35% and reserve writebacks (leading to a cost of risk of minus 13bp). The Baltic states represent 10% of Group loans, with the highest proportion (47%) in Estonia. Of Swedbank's loans in the region 47% are residential mortgages.

Swedbank has asserted that it has only a small proportion of non-resident customers in its Baltic banking business and that the largest share of these are private individuals within the EU. Its stated policy in the Baltics is to serve customers with clear local business ties. Swedbank is responsible for about a quarter of Estonia's outgoing cross-border payments.

Swedbank has in recent months been the subject of allegations originally aired by Swedish Television that approximately EUR 135bn of non-resident funds flowed through its Estonian branch between 2010 and 2016. The International Private Banking department at Swedbank's Estonian subsidiary, with a focus on non-residents, was set up in 2006 when it was still known as Hansapank. Allegedly after 2009, some former clients of Danske Bank began opening accounts at Swedbank after Danske Bank began closing them. Press reports suggest that money may also have been laundered through Swedbank's operations in Latvia and Lithuania.

As was the case with Danske Bank, both its Chairman and CEO have been forced to leave the bank as a result, and the bank is in the process of rebuilding its Board. On 18 June 2019, it was announced that the CEO and CFO of Swedbank's Estonian unit have left their positions on its Management Board and been suspended. A member of the Management Council in Estonia has also left the bank.

Swedbank is undergoing investigations by US regulators and a joint investigation by Swedish and Baltic regulators. Many questions remain unanswered concerning the alleged flows at this point. Although Swedbank had a somewhat minimal and rapidly-compiled investigation into aspects of its business conducted by a third-party, this did not satisfy investors so the bank is pursuing more detailed internal investigations.

Danske Bank – withdrawing from the region, scale is already modest

Danske Bank's venture into the Baltic countries was relatively unsuccessful compared to some rivals. The bank announced the exit of personal banking operations in the Baltic states in 2014, noting that it did not have enough scale to generate an acceptable return. By 2015 all personal banking customers in the Baltics had been transferred to Danske's non-core banking portfolio. During 2016 Danske Bank's retail operations in Latvia and Lithuania were sold to Swedbank.

The money-laundering allegations relate to the problematic 'non-resident' portfolio, now closed, that existed in the Estonia branch from 2007 until early 2016. Many of the non-residents (i.e. non-local and non-EU residents) were from Russia or other CIS countries. The origins of the problems are historic. At the beginning of 2007, Danske Bank bought the whole of Finland's Sampo Bank along with its Baltic units and a small bank in St Petersburg. The bank already had substantial dealings with non-residents. As detailed in the third-party report published by Danske Bank in September 2018, control failings were able to develop locally.

The Estonia branch was not migrated on to Danske's main IT platform due to cost, a decision taken during the financial crisis in 2008. Many documents were in Russian or Estonian. Group insight into the branch was limited. AML procedures existed, but they were not sufficient nor being applied properly. The non-resident portfolio was managed by a separate group of employees, many of whom are now subject to criminal investigation. It has been widely reported in the local press that several of these were originally from Sampo Bank.

Since the money-laundering allegations came to light, the bank's strategy has evolved rapidly, partly by choice but also out of necessity. It announced in April 2018 that the branches in the Baltic states would focus only on supporting subsidiaries of Nordic customers and global corporates with a significant Nordic footprint. The exit from serving local businesses and private banking customers has been executed as a wind-down. Existing loans were left to mature in accordance with contracts, but relationships were to be wound down, with services being withdrawn over a period.

As of 19 February 2019, Estonia's FSA ordered Danske Bank to cease all banking operations in Estonia within a period of eight months. Danske Bank agreed to comply. As of 2 June 2019, it announced the sale of its EUR 470m Estonian private loans portfolio to local bank LHV, expected to close later in the current year.

Separately but simultaneously, Danske Bank announced that it would cease its remaining activities in Latvia, Lithuania and Russia. There is no exact timeline for the closures outside of Estonia – it is ongoing considering the management of existing customer relationships.

Although the risk of significant regulatory fines remains, these activities are relatively small in the context of the Group. The closures will have no effect on profit guidance for 2019, and very little on the bank's overall business model. Danske Bank's banking market shares in the Baltic countries are small compared to those of Swedbank, SEB, and Luminor Bank. Thus, its partly forced withdrawal from the region is, in itself, less of a credit negative than it would be for its much larger competitors.

Danske Bank intends to maintain a large presence in Lithuania but will not be offering banking services once the existing portfolio has been run off. Its activities in the country will continue in the form of its local IT unit and a global service centre, both of which contribute to the Group as a whole. The IT unit was set up at the end of 2014 as part of Danske Bank's Group IT division and employs around 800 IT professionals. The Global Service Centre handles banking support operations (markets, transaction banking, daily banking, consulting for large and corporate customers, etc.). It also handles professional services and some business support functions and front-end product development. It has nearly 1,500 employees.

SEB – the region's second largest universal bank

As the second Swedish 'winner' after Swedbank in the Baltic states, SEB's history in the region goes back to 1998 when it entered into co-operation agreements with leading local banks in search of capital and strategic partnership following the effects of the Russian financial crisis. Full acquisitions were completed in 2000.

SEB's strategy was to exploit a relatively undeveloped banking market, to distribute its products, strengthen local management competency, offer broader services to existing customers, and to develop a product base locally, expanding services both for corporates and private customers.

SEB has adopted a universal banking model in the Baltic states, as is the case in Sweden – and in contrast to other countries where SEB focuses on corporate banking.

The business model is based on domestic clients and subsidiaries of Nordic companies. Banking and advisory services are provided to roughly 950,000 private customers and 101,000 SME and corporate customers. SEB operates through 75 branch offices, online or using mobile apps. It is also able to offer remote video advice. SEB also has strength in local asset management and life insurance. Baltic real estate holding companies also form part of the division, although SEB has worked to liquidate these, and the last properties were sold in 2018.

The division accounted for 10% of 2018 Group operating profit (2017: 10%). At YE18 it accounted for 12% of the Group's outstanding risk-exposure amount, 9% of loans and 11% of deposits. There were 2,347 full-time employees in the Baltic banking division as of end-2018, with a further 925 staff located in these countries, but employed in other businesses, which include Life and Investment Management and Large Corporates and Financial Institutions in Lithuania.

SEB's CEO has noted that the bank is comfortable with its AML controls, from 2008 to-date. The bank does not believe there are reasons to directly compare its activities in this regard from 2008 to the present time. With respect to AML controls, SEB states that it does annual reviews for large exposures and does know-your customer checks on all clients. Methods used include mandatory training of employees and using algorithms to catch anomalies in trading and payment patterns. In 2018, the bank appointed a senior officer for AML, as a member of the Group Executive Committee.

Svenska Handelsbanken – a small presence focused on services for home market customers

Handelsbanken's attitude to expanding in the region contrasted with that of its Swedish competitors, and its presence in the Baltic states has always been modest. It has one branch in each of Tallinn, Riga and Vilnius, opened in 2006, 2008 and 2009 respectively. Most operations are based in Tallinn. Except for a few local state-owned companies, the branches only serve customers from its home markets – the Nordic countries, the UK and the Netherlands. Services offered are primarily for corporate banking customers; in Estonia some accounts are also offered to individuals. Handelsbanken does not deal with 'non-resident' customers in the Baltic countries. Assets in the region amount to approximately SEK 2bn, less than 0.1% of the Group's total assets. The total number of employees is around 30.

Senior management has noted that while other banks were seeking growth opportunities from the 1990s onwards, Handelsbanken decided that it would not actively expand in the Baltic states because it viewed the underlying risks in these markets as difficult to analyse. Handelsbanken did buy a stake in Parex Bank of Latvia in 2006 (the bank subsequently collapsed and was taken over by the state) but preferred to stick to its tried-and-tested business model, which involved winning business in mature markets based on superior personal customer service. This approach was fully in line with Handelsbanken's conservative approach to doing business. Handelsbanken's strategy towards international expansion has been to focus on mature 'home' markets with the aim of competing as a challenger to local banks based on a high level of customer service. This business model mirrors that applied in Sweden.

Nordea and DnB – lack of scale led to the creation of Luminor Bank

Nordea's history in the region dates to the 1990s, when one of its predecessor banks, Finland's Merita Bank, opened a branch in Estonia in 1995. It entered Latvia in 1999 and Lithuania in 2004.

DnB's history in the region began in 2006, when it entered into a joint venture with NORD/LB, which had entered the Baltic markets in 2000. This was known as DnB NORD. DnB first acquired 51%, upped to 100% in 2010. With considerable optimism, DnB noted that these markets had higher growth potential than seen in Western Europe. The strategy was to service pan-Nordic clients. DnB NORD also covered the Polish, Danish and Finnish markets, taking over DnB's Swedish operations.

However, lack of scale proved critical. In August 2016 Nordea and DnB agreed to combine their operations in Estonia, Latvia and Lithuania to form the universal Luminor Bank, conducting both corporate and personal banking. This transaction closed on 1 October 2017, creating the third largest financial services provider in the Baltic region. Nordea's presence was strongest in Estonia and Latvia; DnB was stronger in Lithuania and Latvia. They noted that the combination would lead to better scale, more balanced geographical presence and a broader product offering. DnB had strength in SMEs, for example; Nordea with large corporates.

The two banks are largely or entirely withdrawing from the region. In September 2018, Nordea and DnB agreed to sell 60% of Luminor Bank to a consortium led by private equity funds managed by US asset manager Blackstone Group, a transaction expected to close in 2H19. The two banks each hold about 20% of Luminor and retain board representation. Nordea will also sell the remaining 20% to Blackstone over the near to medium term. In arranging to finally exit the Baltic states, Nordea has cited the wish to pull back and focus on its main Nordic markets.

Luminor Bank has a c.16% market share in deposits and 22% in lending. It has about one million customers and around 3,000 employees. Its main customer focus is on SMEs, entrepreneurs and large savers.

Both banks' customer portfolios were reviewed prior to the creation of Luminor. Baltic residents account for 95.8% of deposits and other EU/EEA residents a further 2.2% (2% are non-EU residents).

Op Corporate Bank – Modest presence focused on home market corporate customers

Finland's OP Corporate Bank (formerly Pohjola Bank) has modest operations in the Baltic countries. According to YE18 accounts, about 9.7% of the bank's exposures within its Banking segment are in the Baltic countries – a total of EUR 3.3bn. The bank is focused on its Finnish large and medium-sized corporate customers or their subsidiaries in the Baltic countries. It maintains a bank branch in each of the Baltic states, and certain subsidiaries. As well as offering financing solutions (trade finance, leasing services, vendor financing), it also provides payment and cash management services and currency trading facilities. Following the sale of its Baltic non-life insurance subsidiary in 2018, the bank said it is examining various strategic options for its Baltic Banking business. The operations generated net income of just EUR 10m in 2018 (versus pre-tax Banking profit of EUR 354m).

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