Competition between banks in the Estonian lending market

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COMPETITION BETWEEN BANKS IN THE ESTONIAN LENDING MARKET

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SUMMARY

This paper analyses the functioning of competition between banks in the Estonian lending market. The nature of competition in the very small Estonian market is determined by an oligopoly market structure where a small number of large banks dominate. The past couple of decades have seen periods with greater and lesser competition, but competition in the lending market in Estonia could in general be considered weaker than that in most other advanced economies. This is indicated by loans being expensive over the long term while profitability in the banking sector remains consistently high. Borrowers encounter the weakness of competition most in the higher price of loans, though this has not restricted access to lending. The profitability of the banking sector is important for the supply of loans and for financial stability, but it is also important to avoid loans being so expensive that they make the economy less competitive and harm growth in it.

This occasional paper finds that ways of increasing competition in Estonia lie above all in making the supply of loans more effective. This analysis conducted jointly with Finantsinspektsioon concludes that it could and should be simpler and cheaper for borrowers to refinance their housing loans by transferring them to another bank. Borrowers should also be able to choose between different reference interest rates, and to change their decisions about the rate during the repayment period simply and cheaply. Lower transaction costs, more options for setting the price of loans, and increased information for borrowers would help the lending market function better and also encourage competition between the banks.

JEL classification: G21, D43, L11

Keywords: lending market, competition, oligopoly, market concentration, profitability, interest margin, mortgage refinancing, reference interest rate

The views expressed in this Occasional Paper are those of the authors and do not necessarily represent the official views of Eesti Pank

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INTRODUCTION

The banks in Estonia are highly profitable, while loan interest rates are generally higher than the average in the euro area and a few large banks dominate the market, and this has from time to time prompted the question of whether there is sufficient competition in the Estonian banking market. If competition is too weak in the lending market, the competitiveness of the whole economy could suffer, and that could hurt growth in the economy.

Competition moves in tandem with effectiveness, which in the context of the lending market means how effectively the economy is financed. How well competition functions consequently needs to be assessed first of all from whether loans are accessible given the risks, whether financial intermediation is efficient given the costs, and whether dynamic development of the market is ensured. It is also important to be sure that efforts to increase competition do not pose any risk to financial stability. There is a danger if lending conditions are too loose that imbalances could arise in the credit and real estate markets. Equally, the capitalisation of the banks may suffer if their profitability is smaller because loan margins are too low, and this could then limit their ability to lend.

The aim of this paper is to analyse how competition functions in the banking sector in Estonia and to map possible obstacles to it. The main focus of the analysis is on assessing competition in housing loans and investment loans to companies.

The analysis is based on earlier theoretical and empirical research on competition between banks, and it uses statistics from Eesti Pank and other central banks and international organisations. Ten interviews were also carried out with former or current heads of banks in Estonia and key people at them.

The paper has three parts. The first part covers the general shape of the banking market in Estonia and changes in the structure and concentration of the banking sector. Structural factors largely determine how attractive the market is to new entrants and what motivation and opportunities the banks have to change the dynamics of competition in it. The second part analyses how competition affects the profitability of the banks and how loan margins are set. It also considers whether there is enough competition to ensure access to loans. The third part looks at issues around mobility for borrowers and the selection of loan products. It focuses on the cost of refinancing housing loan contracts and the lack of interest banks have shown in offering clients different reference interest rates and the opportunity to change between them. The analysis ends with the main conclusions and suggests some ways that refinancing loans, changing contracts or choosing interest rates could be made more reasonable for clients while also helping to increase competition.

1. THE STRUCTURE OF THE ESTONIAN BANKING MARKET AND COMPETITION IN IT

The banking industry in most countries is an oligopoly where a few large banks control a major part of banking in the country. Theoretical and empirical research on competition in banking has concluded that oligopolies in the banking sector help maximise social welfare. It might be expected that having a larger number of banks would mean more lending for the economy and better lending conditions for clients, but there are also harmful side effects from having a lot of banks. These side effects are mainly felt through the market congestion channel and the liquidity channel[1]. Market congestion arises when the effective cost to the banks of issuing loans rises, partly because the probability of finding clients with good lending projects is reduced and partly because the administrative costs of issuing loans that need to be covered are increased, both at the level of individual banks and at the level of the system as a whole. A large number of banks also means there is greater demand for the debt and equity capital that is needed to finance the banks, which raises the cost of funding and ultimately leads to higher prices for lending. This means that competition arising from the number of market participants increases welfare only within certain limits, and the oligopoly market model with a small number of large banks can, under ideal circumstances, help to maximise the welfare of society.

For the lending market for homogeneous loan products like housing loans to operate effectively it is best to have a smaller number of universal banks competing amongst themselves, but there is always room in an oligopoly market for smaller and specialised banks that can successfully operate by providing different products. Such banks cannot rely on scale effects like the large banks can, but they can still operate profitably in loan segments where the large banks are slower or less flexible in providing new products.

As the business models of the banks are different, it is not possible to identify the perfect number of banks for a country. There are in any case countries that position themselves as international financial centres, and others where a large share of the banks see additional potential for growth in exporting banking services. Comparing the number of banks and the number of residents of a country suggests that the smaller countries in the European Union have more banks, but there are some exceptions among the larger countries (see Figure 1.1). Comparing the number of banks with each country's GDP leads to quite a similar conclusion. The strength of competition is not however measured only by the total number of banks operating, because having a high number of banks could indicate inefficiency, or it may be that there are a lot of small and specialised banks that operate successfully within their own segment.

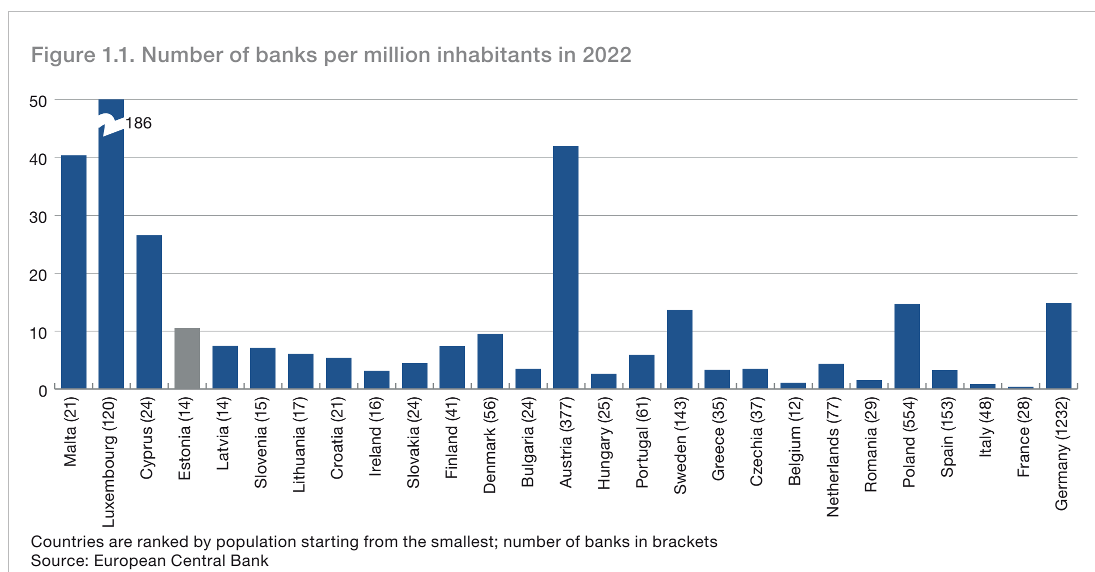


Figure 1.1. Number of banks per million inhabitants in 2022

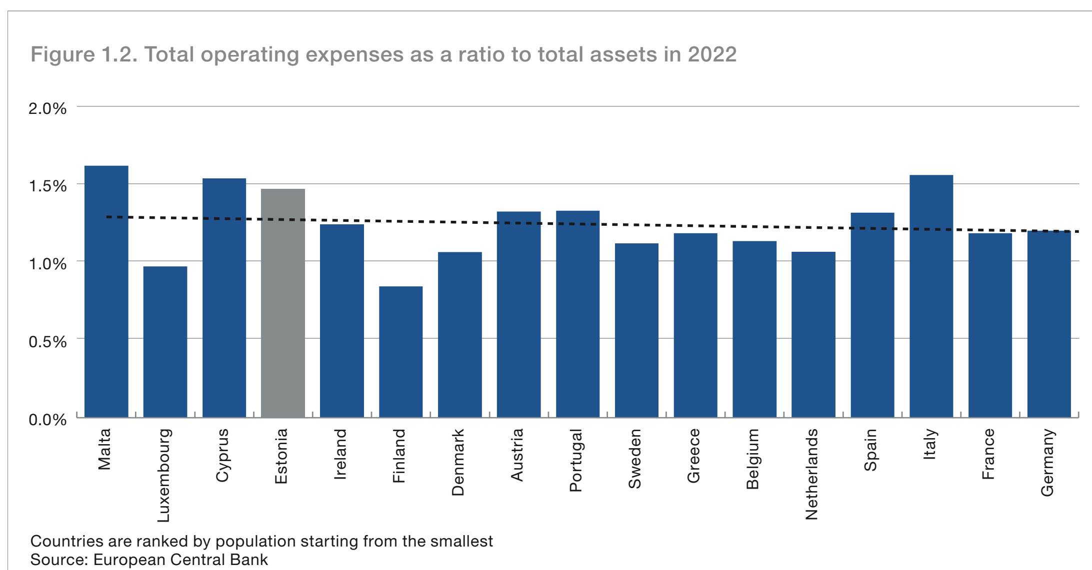
Countries are ranked by population starting from the smallest; number of banks in brackets
Source: European Central Bank

1 Dong, M.; Huangfu, S.; Sun, H.; Zhou C. (2021). *A macroeconomic theory of banking oligopoly.* European Economic Review, Vol 138, September 2021.

The small size of the Estonian market makes the oligopoly market model even more inevitable. Estonia's population of 1.3 million is not big enough to support the effective operation of a larger number of universal banks, as the potential client base on which to extend scale effects is very limited. The operating costs of a bank operating in a small market may be relatively larger and congestion can very easily arise.

Although the banks in Estonia are highly digitalised, their operating costs as a ratio to assets are higher than the average in other European Union countries, especially when the comparison is with countries where there is greater financial depth than in Estonia (see Figure 1.2). There are several reasons why the costs of the banking sector vary from country to country, ranging from the business models of the banks and whether they are banks or branches, to the degree of digitalisation in the provision of financial services. How the size of the market affects the ability the banks to increase their operating volumes also plays a role.

Figure 1.2. Total operating expenses as a ratio to total assets in 2022



Countries are ranked by population starting from the smallest
Source: European Central Bank

At the end of 2023 there were nine banks with an Estonian licence and three branches of foreign banks operating in the Estonian lending market[2],[3]. The four or five largest of those could be described as universal banks that have a relatively wide client base and focus their activities on taking deposits from the domestic market and issuing loans. Among the smaller banks are some that have grown rapidly in recent years by diversifying their portfolios of assets. The niche banks can also have a much larger role in competition in specific loan segments, especially in lending to small and medium-sized businesses and providing other credit products.

The Baltic market as a whole is small. The large Swedish banks Swedbank and SEB entered the Baltic banking market in the early 2000s and established long-term, stable client relations in the region, and they now have significant market share in all three Baltic states. This gives them an advantage in exercising market power.

The entire Baltic market of 6 million people can still be considered very small though, which makes it less attractive to large international foreign banks[4]. If a target market is very small relative to the home market,

2 There were four branches of foreign banks registered in Estonia at the end of 2023, which were AS Citadele Banka, Nordea Bank Abp, OP Corporate Bank plc and TF Bank AB (publ.), but not all of them issue loans in Estonia.

3 There were 42 banks operating in Estonia in 1992, of which only 18 survived to 1994 after the banking crisis. The Russian and Asian crisis of 1998 sparked another large wave of mergers and restructuring as the four larger banks merged into two big groups of Hansapank with Eesti Hoiupank and Eesti Ühispank with Tallinna Pank, while several small banks went out of business, either through bankruptcy in the case of Maapank, ERA Pank and EVEA Pank, or nationalisation in the case of Forekspank. By 1999 there were only six banks and one foreign bank branch left in the market.

4 There are further factors that make the Baltic market less attractive, including a location that is peripheral and carries greater geopolitical risks when seen from afar. The high level of digitalisation in Estonia could also imply greater costs and investment in technology for new market entrants.

a subsidiary or branch in that target market may demand a disproportionate amount of attention from its group. The market in the Baltic states is also fractured, as financial deepening, risk assessments and experience of crises are different in Estonia, Latvia and Lithuania, as are debt and bankruptcy law, regulation and supervision, though it is the European Central Bank that supervises large banks.

Estonia also has a lot fewer large companies to which very large loans and a wide range of banking services can be offered than other Central and Eastern European countries have (see Table 1.1). The poor potential for growth in the market may be one of the reasons why several large banks such as Unicredit in 2013, Nordea and DNB in 2017 and Handelsbanken in 2020 decided to exit all three countries after several years of operation (see Box 1). The high level of profitability in the banking sector should make the Baltic market more attractive, as should the lower level of financial deepening than in the Nordic countries, especially in Latvia and Lithuania.

Table 1.1. Sizes of countries and their debt in 2022

	number of people, million	GDP, billion euros	number of large companies with over 250 employees	non-financial sector debt as a ratio to GDP
Baltic states	**6.0**	**142.3**	**808**	
Estonia	1.3	36.0	150	109%
Latvia	1.9	38.9	199	60%
Lithuania	2.8	67.4	459	62%
Nordic countries	**27.7**	**1 789.9**		
Finland	5.5	268.6	671	177%
Sweden	10.5	562.5	1 457	268%
Norway	5.4	551.4		203%
Denmark	5.9	380.6	775	214%
Iceland	0.4	26.7		243%
Central and Eastern European countries	**95.1**	**1 703.8**	**9 005**	
Poland	37.7	654.6	3 107	67%
Romania	19.0	285.9	1 522	45%
Czechia	10.5	276.2	1 582	83%
Hungary	9.7	168.9	1 029	100%
Bulgaria	6.8	84.6	642	83%
Slovakia	5.4	109.6	488	97%
Croatia	3.9	66.9	388	108%
Slovenia	2.1	57.0	247	69%

Sources: Eurostat, Statista

Box 1: Several large banks decided to leave the Baltic market after the global financial crisis[5]

Western European and Nordic banks were earlier relatively active at expanding into new markets, including the Baltic markets, but the changed interest and liquidity environment after the global financial crisis prompted many of them to review their expansion plans and business models and focus on maintaining profitability by concentrating on core activities and domestic markets. There are several examples from Estonia and the other Baltic states of large foreign banks reassessing their activities and deciding to exit the Baltic markets.

Unicredit

Unicredit entered the Estonian and Baltic banking markets following the takeover in Europe of Bayerische Hypo- und Vereinsbank (HVB), which had operated in Latvia since 1996, Lithuania

5 Sources: public reports and press releases of the banks.

since 2001, and Estonia since 2004. During the takeover, HVB sold its Estonian, Latvian and Lithuanian units to Bank Austria Creditanstalt AG, which was part of the UniCredit group, in 2007. A subsidiary started to operate in Latvia under the name AS UniCredit Bank, while the branches UniCredit Bank Eesti and AS UniCredit Bank Lithuania operated in Estonia and Lithuania.

The bank focused on corporate clients in the Baltic states and started strongly in 2007 as the loan portfolio and net profit more than doubled over the year. The financial crisis meant though that it started making a loss in 2008 and write-downs meant that the loss was 46 million euros in 2010. The bank still stated in 2012 that it was committed to the Baltic markets, but all the banking activities of Unicredit in the Baltics were consolidated in Latvia in 2013 to save costs, and the Estonian branch stopped operating. Banking services stopped being provided in Latvia after that, and although Unicredit continued offering leases in the Baltic states for a while, the lease portfolio of 850 million euros was sold in December 2019 to the Latvian bank Citadele. The bank presumably left the region because the impact of the crisis was compounded by the small profits to be earned in the Baltic states, which the annual report of Unicredit Bank put at 1.4 million euros in 2011 and 1.7 million in 2012, as the contribution it was making to the total income of the Unicredit group was too small.

Nordea

The history of Nordea in Estonia stretches in some way back to the mid-1990s, but the name Nordea, which reflects its broader geographic ambition, started to be used after several Nordic banks merged in 2000. It made serious efforts to gain market share in Estonia after that through an aggressive sales campaign that offered housing loans with interest rates well below the average in the market. The other banks then started to cut their interest rates as well, and so the yearly growth in housing loans exceeded 50%. Its position as price leader in the lending market moved the Nordea branch up to third among the Estonian banks by assets, and made Nordea Finance Estonia the largest operator in the leasing market in Estonia in 2012. The heads of the bank said that their aim was to become the second-largest bank in Estonia.

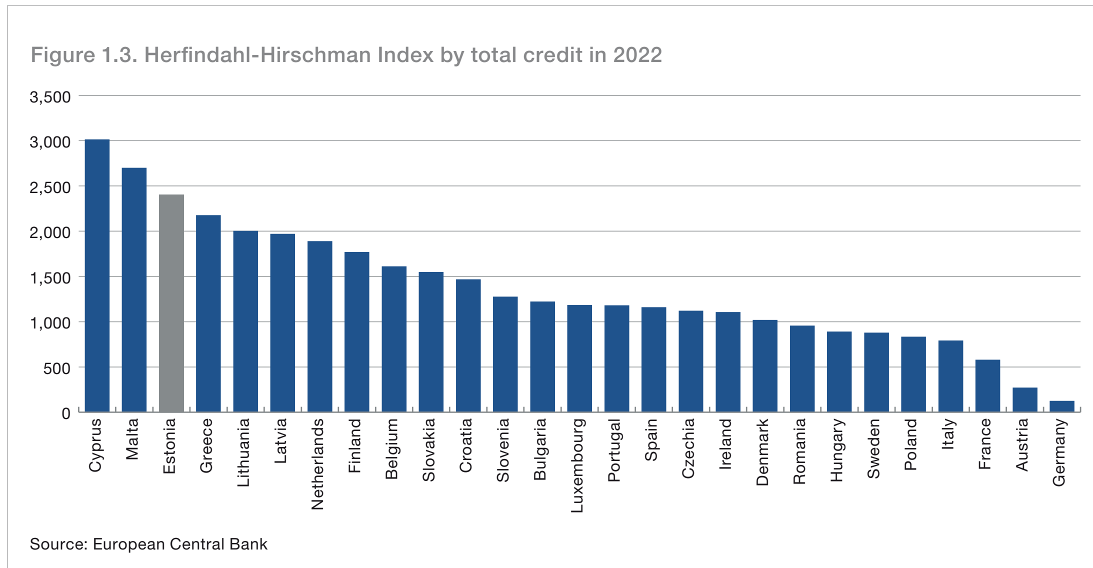
Interest rates remaining low after the financial crisis led the Nordea parent bank to change its strategy. The Nordea Group first sold its banking operations in Poland in 2014, and brought its main branches under the direct control of the parent bank. The subsidiaries and branches of Nordea and DNB in Estonia, Latvia and Lithuania were merged in 2017 into a single holding company, and operations continued under the name Luminor. The funding that had earlier come from the parent banks was gradually replaced by market-based financing, and the merger as Luminor was completed in 2019 when the headquarters of the bank were established in Estonia while branches started to operate in Latvia and Lithuania. A majority stake in the Luminor holding company was bought in 2021 by the US investment company Blackstone, which can be considered as mainly a financial investor.

Handelsbanken

Svenska Handelsbanken is one of the four largest banks in Sweden, and it opened a branch in Estonia in 2006. The bank focused on business clients, mainly on supporting the business activities in Estonia of clients from its domestic market. Handelsbanken made a modest contribution to the Estonian banking market, and in May 2019 it announced that it would terminate its business activities in Estonia, Latvia and Lithuania during 2020. The reason it gave was that despite its efforts to increase efficiency, the results of its operations in the Baltic states were not good enough as profitability was low and costs were too high.

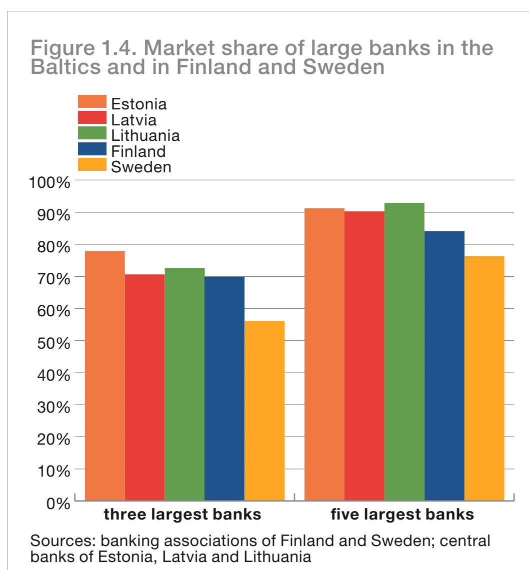
The small size of the market means that the Estonian banking sector is one of the most concentrated in the European Union. The Herfindahl-Hirschman index (HHI), one of the most commonly used measures of concentration, shows the Estonian banking sector to be one of the three most

Figure 1.3. Herfindahl-Hirschman Index by total credit in 2022



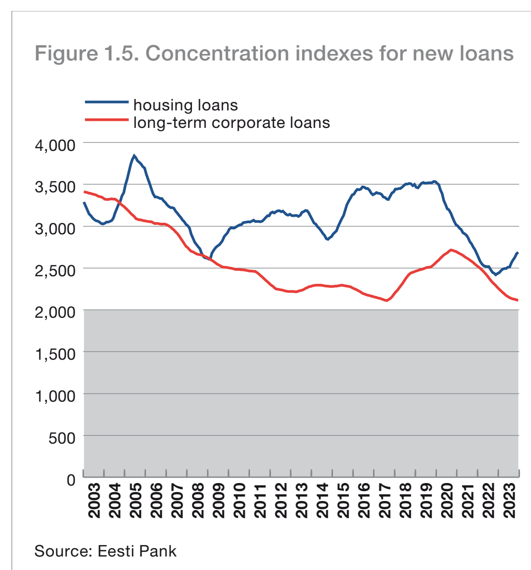
Source: European Central Bank

Figure 1.4. Market share of large banks in the Baltics and in Finland and Sweden



Sources: banking associations of Finland and Sweden; central banks of Estonia, Latvia and Lithuania

Figure 1.5. Concentration indexes for new loans



Source: Eesti Pank

concentrated national banking sectors (see Figure 1.3). It exceeds the threshold of 2000 points[6] that indicates that a sector is very highly concentrated.

The high degree of concentration in the Estonian lending market is also indicated by the large market share of some individual banks. The total share of the three largest banks in the local lending market was around 80% at the end of 2022, which is larger than that in the other Baltic states or in Finland and Sweden (see Figure 1.4). The share is quite similar in the Baltic states at around 90% if the five largest banks are aggregated.

Does a high degree of concentration always mean there is less competition? A high degree of concentration is traditionally associated with weaker competition in the SCP hypothesis[7], but recent studies of the behaviour of oligopolies have found that competition may still be strong enough even in concentrated markets if market participants are not able to use their market power to increase their profitability, and the market functions effectively given the marginal costs or the elasticity of total revenue[8]. It is not

6 The reference to the ceiling of 2000 points for the HHI comes from the guidelines in the EC Merger Regulation EU no. 139/2004, which states that the European Commission may express concerns about competition when companies merge if the HHI will exceed 2000 points after the merger.

7 The classical Structure-Conduct-Performance (SCP) paradigm assumes a stable causal relationship between market structure or concentration and pricing, profitability and the ability to exercise market power. When there are more companies they compete more on price, which reduces the market power of any one company among them.

8 See Leon, F. (2014). *Measuring competition in banking: A critical review of methods.* Serie Etudes et documents du CERDI.

clear though whether it is the market structure that dictates the behaviour of the banks, meaning the SCP hypothesis dominates, or whether the market structure results from the banks maximising their profitability in the effective market hypothesis.

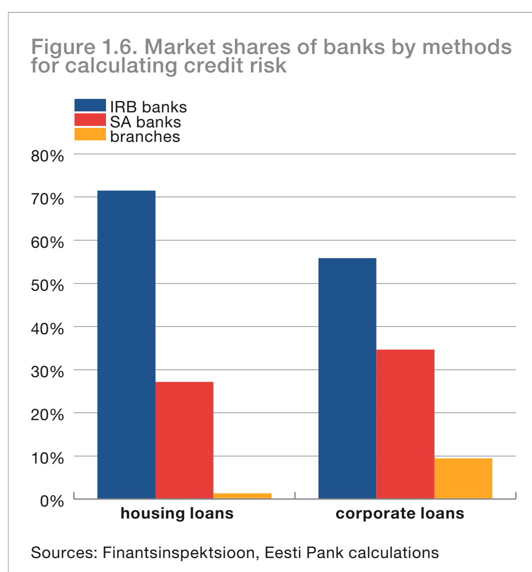
The dynamics of competition in the Estonian lending market are reflected to a certain degree in the indicators for concentration. The levels of the indicators for concentration may at some given moment seem insufficient for describing competition, but the change in those indicators is helpful for describing the dynamics of competition. The HHI for new loans in Estonia has changed quite a lot over 20 years (see Figure 1.5). The concentration in long-term lending to companies declined until the end of 2017, after which the number of banks fell and concentration increased as DNB and Nordea merged their portfolios and the branch of Danske exited the market, until the smaller banks became much more active in 2021-2022 after the pandemic and increased their loan volumes in the real estate segment above all.

The HHI for housing loans has been volatile, but concentration has generally remained higher than for corporate loans. The HHI rose particularly high at the start of the lending boom in 2005-2007, when there was aggressive competition for market share between individual large foreign banks. Concentration was also high in 2015-2019, but there has been an additional supply of loans in recent years from the small banks, as there has been in corporate loans.

The distribution of the market share of the banks in issuing new loans has become a little more even over the past two or three years for both housing loans and long-term corporate loans. This indicates that although the market structure has reached a new equilibrium where the three large banks Swedbank, SEB and LHV dominate in both loans segments, there are still opportunities for smaller banks and new entrants into the market. Their marginal costs are higher though, and whether they can successfully increase their market share depends partly on how tightly the larger banks keep their grip on the market share that they have.

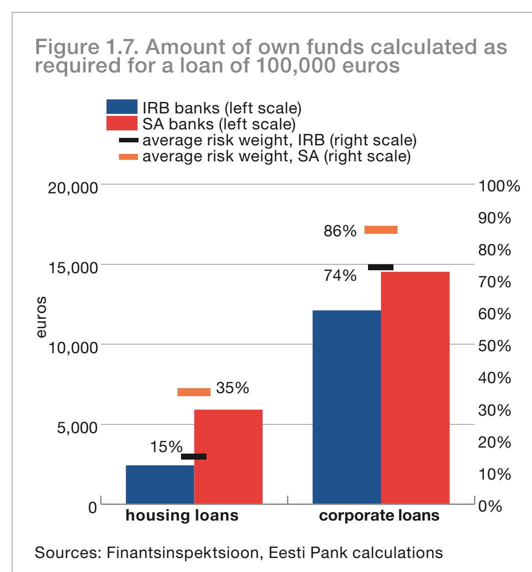
The two larger banks have a competitive advantage not only from economies of scale effects but also from the method used to calculate risk weighted assets for capital requirements. Using Internal Ratings Based (IRB) models allows Swedbank and SEB to hold much less capital to cover risks than the banks that use the Standardised Approach (SA). The differences in the risk weights for housing loans, where the IRB banks have market share of over 70%, can average as much as 20 percentage points[9]. This means that the amount of capital the IRB banks calculate to cover loans can on average be around half as much as that of the banks that use the standardised approach (see Figures 1.6 and 1.7). The difference in risk weights is smaller for corporate loans but still has a significant effect

Figure 1.6. Market shares of banks by methods for calculating credit risk



Sources: Finantsinspektsioon, Eesti Pank calculations

Figure 1.7. Amount of own funds calculated as required for a loan of 100,000 euros



Sources: Finantsinspektsioon, Eesti Pank calculations

9 The minimum requirement for the average risk weight of the housing loan portfolio the IRB banks is 15%, and the average risk weight used in calculating capital can be higher depending on the model-based assessment of the bank. The average risk weights of the housing loan portfolios of Swedbank and SEB are notably smaller than the 35% used in the standardised approach.

on the size of the capital requirements, as the amount of capital required by the IRB banks is on average 17% smaller. The competitive advantage of the IRB banks is that the lower capital requirements make it easier for them to protect their market share, and the other banks have to compete not on the price of loans but rather on other conditions, which could lead to them taking larger risks.

Using the IRB models means applying various methods and processes, and developing data collection and IT systems in order to support the assessment of credit risk, the distribution of risk exposures, and quantification of estimates. This means additional costs for an IRB bank, especially at the time that it requests authorisation to use the model. The difference in the cost of capital for the IRB banks and for the SA banks may narrow from 2025 when the introduction of the new Basel III principles for capital requirements should lower the average risk weight calculated under the standardised approach, while applying an output floor may increase the risk weighted assets for the banks that use internal models.

The market structure will largely be affected in the coming years by the trade-off between the growth strategies of the banks and the targets for the return on equity of the owners of the banks. For foreign banking groups, the picture of the group as a whole should also be considered. If the banking group is operating in the Nordic and Baltic region more broadly, it will consider strategic choices about allocating resources across products and segments by looking at their potential for growth and profit. It is possible that Baltic units are expected to deliver a higher long-term return on equity because of their greater volatility, and if competition increases this could force a compromise with the desire to maintain market share.

If the domestic banks that are listed on the stock exchange want to achieve greater growth and greater market share, they may need to adjust the high targets for profits that they have had. It is probable that other market participants will continue to be active, though some banks have chosen a strategy with a narrower focus, or are not able to compete aggressively on price in either sector because of their small size or their capital constraints.

In summary, there are several structural factors that affect competition in the lending market in Estonia, and it is important to be aware of them when assessing whether the lending market could function better and whether there are obstacles that the market itself cannot overcome. The main structural issues that need to be considered are:

1. The small size of the market that keeps the fixed and administrative costs of the banks higher than those of a bank with similar market share in one of the larger European countries. The small population and lack of large companies also mean that the market is less attractive to potential new entrants, including large foreign banks.
2. The oligopolistic market that is dominated by a few large banks defines the nature and dynamics of competition. Concentration in the lending market in Estonia is among the highest in Europe.
3. The market structure that has emerged is based on long-term client relationships at the large banks, which gives them scale effects. The two largest banks also have lower capital costs because they use IRB models, which gives them an advantage in pricing loans.

Box 2: Requirements for receiving an operating licence as a bank

A business has to have a licence to operate as a credit institution if it wants to take deposits from the public or receive other financial funds that need to be repaid, and this comes with a whole series of specific requirements. The reason for issuing operating licences to credit institutions is that it ensures only reliable and viable companies can enter the banking market. Compliance with requirements is assessed under European Union legislation and local law, and the assessment covers the general background of the business and its reasons for applying for a licence, its level of capital, its operating plan, business model and related risk profile, its structural organisation including the organisation of its IT systems and the IT services it buys in, its financial indicators,

and the suitability of the shareholders and management. The evaluation covers all the relevant aspects and whether they are proportional with the nature, scope and complexity of the activities of the business applying for the licence, and with the related risks. The requirements for the licence set quite a high bar for new local banks entering the market.

It should be noted though, that credit institutions that are already operating under an operating licence issued in some other country of the European Union can make the same transactions and operations in Estonia as in their home country by setting up a branch to do so or by providing cross-border services. To do this they need to submit information on their activities to Finantsinspektsioon through the European Central Bank, together with all the necessary documents and data.

The European Central Bank has the sole authority to issue licences to credit institutions in the euro area and to withdraw them[10]. The decision to issue an operating licence or to refuse it is taken within six months after all the necessary documentation and data have been received, and not later than 12 months after the application for the operating licence has been received.

An applicant for a licence has to submit a large amount of supporting material and evidence that is considered and assessed when the licence is issued[11]:

a. A business plan that describes the nature of the planned business activities, the organisational architecture, the internal control system, and the management structure. It should also contain forecasts and analysis of the amount of assets and share and equity capital there will be, and descriptions of the organisation of IT functions, the general strategy and planned market share, the services to be provided, financial indicators, credit policy, the general principles for risk management, and the risk management strategy.

b. Documents proving the amount of own funds. When a bank is founded as a new business the share capital paid in must be at least five million euros. Only real sums paid in may be indicated as equity capital of the bank.

c. The initial balance of the applicant and a review of its revenues and expenses, and its annual reports for the past three years if they exist.

d. Data on the information technology and other technological equipment and systems, security systems, and control mechanisms and systems that will be needed for provision of the planned financial services, and that must all comply with the regulatory requirements. The applicant must also be ready to submit regulatory reports on the bank.

e. Internal rules and procedures regulating the activities of the bank or proposals for them, and the internal rules or proposed rules for its accounting. The internal rules in various areas have to meet a large number of regulatory requirements, including those contained in European regulations, local legislation, and various guidelines issued by the EBA.

f. Details of the members of the management and supervisory boards of the applicant, the head of its internal audit or the chair of its audit committee, and its auditors. The managers have to have sufficient knowledge, skills and experience between them to match the business model and strategy of the credit institution, so that they understand the activities of the credit institution and the main risks to it. The management body has to be suitable for fulfilling its obligations and must support efficient management and taking balanced decisions.

10 European Union Council Regulation (EU) No 1024/2013.

11 Credit Institutions Act RT I, 17.03.2023, 17, § 13[1] and § 13[2].

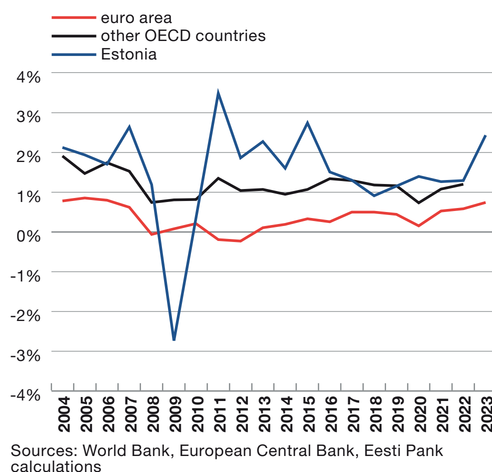
g. A list of the shareholders or members of the applicant, and details on the share or equity holdings of each shareholder or member and the voting weight given to them. Documents should also be submitted showing the material wealth for the past three years of any person who will be a shareholder or member of the applicant, if their share is larger than 2% of the equity capital or the voting weight of the applicant. Also required are the statutes of a legal person who will be a shareholder or member of the applicant and their annual reports for the past three years together with the auditor's report and a list of their shareholders, with details on their share in the equity of the business if the legal person has a share of more than 5% of the applicant's equity capital or voting rights.

2. THE PROFITABILITY OF BANKS, COMPETITION, AND THE FUNCTIONING OF THE LENDING MARKET

PROFITABILITY AND COMPETITION

Competition has little effect on the profitability of banks in the short term. It cannot be argued for example that the profitability of banks operating in Estonia was lower in 2004-2007, when there was a lot of activity in the banking market, than in 2017-2019, when several banks exited the market and competition became weaker; the opposite actually applies (see Figure 2.1). The profitability of the banks over the perspective of a few years depends mainly on macroeconomic developments, the amount of write-downs of loans, and monetary policy. Competition does have a major impact on the profitability of the banks over the long term though.

Figure 2.1. Net profit of banks to total assets

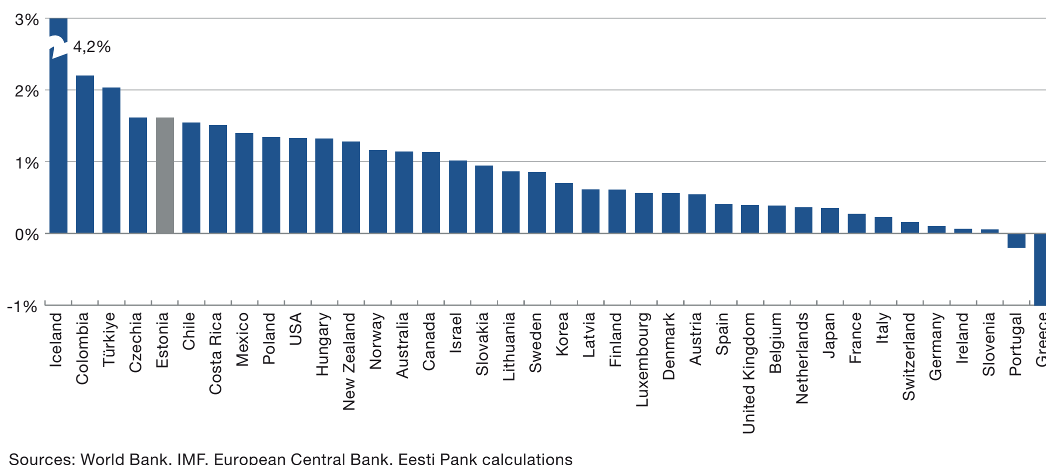


Sources: World Bank, European Central Bank, Eesti Pank calculations

The Estonian banking sector has been a leader in the euro area for return on assets when interest rates have been low and when they have been high (see Figure 2.2). Several international organisations and central banks have however been highlighting for some years now that loan interest rates in Europe do not take sufficient account of the risks and that the profitability of the banks is too low for them to be able to cope with potential loan losses, attract additional capital and supply loans during times of economic difficulties[12]. Proof of this can be seen in the years of stunted growth in lending in the euro area after the global financial crisis. It would consequently not be good for financial stability and the sustainability of the funding and development of the economy in Estonia if low interest income meant that the profitability of the banking sector was as low in Estonia as it has been in the rest of the euro area over the past decade.

The profitability of the banking sector in Estonia was at a middling level relative to other advanced parts of the world when interest rates were low, and was high when interest rates were above the average. The profitability of banks was notably higher in Estonia than in other countries in 2011-2015, when many countries and banks were handling the fallout of the financial crisis but the Estonian economy was recovering fast and the profits of the banks were supported by a lot of written-down loans starting to perform again.

Figure 2.2. Net profit of banks to total assets, average for 2005-2022



Sources: World Bank, IMF, European Central Bank, Eesti Pank calculations

12 European Central Bank (2018). *Financial Stability Review,* November 2018.

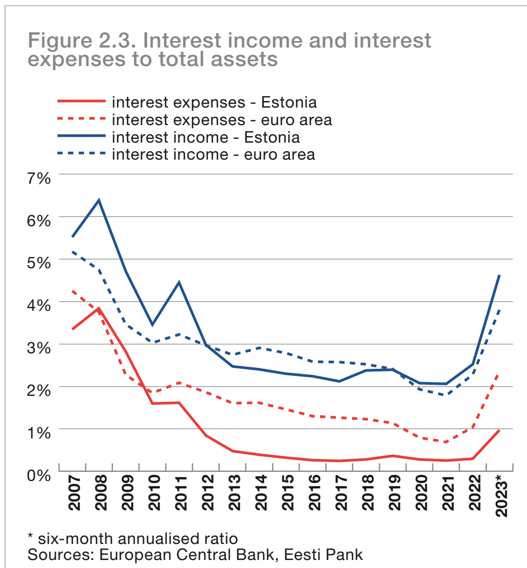


Figure 2.3. Interest income and interest expenses to total assets

* six-month annualised ratio
Sources: European Central Bank, Eesti Pank

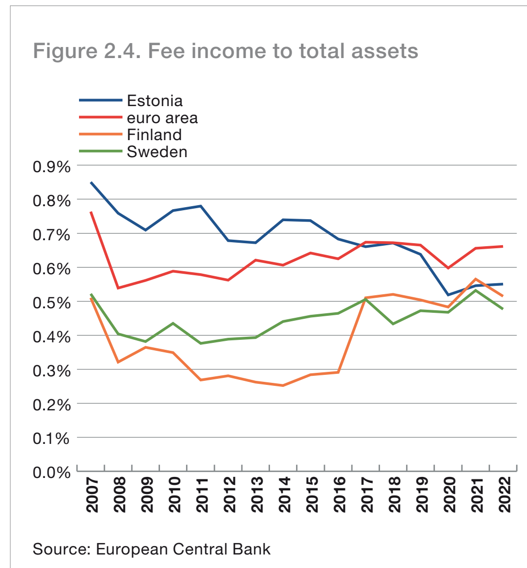


Figure 2.4. Fee income to total assets

Source: European Central Bank

The profitability of the banks operating in Estonia has also received a lot of support from the very low cost of funding they have faced, because deposits, and especially demand deposits, have been a very large part of their liabilities. Interest expenses as a ratio to assets for the Estonian banks have been around 0.7 percentage point lower than the euro area average since 2007 (see Figure 2.3). The interest income of the banks has been 0.2 percentage point higher at the same time, which has additionally boosted high net interest income. The low cost of funding does not come entirely from the structure of liabilities, as differences in interest rates also play a role. Interest rates on term deposits and demand deposits in Estonia were notably lower in 2011-2017 than they were in the rest of the euro area. Before and after that period they were relatively equal in Estonia and the rest of the euro area[13]. Competition for deposits has generally been weak in Estonia[14].

The fee income and other non-interest income of the banks in Estonia as a share of total assets is around the average of other countries and is trending downwards. It could be that competition is working better in this area. Payment and securities intermediation services, which are heavily dependent on fees, are more exposed to international and non-bank competition, which has probably driven the income earned from fees down (see Figure 2.4).

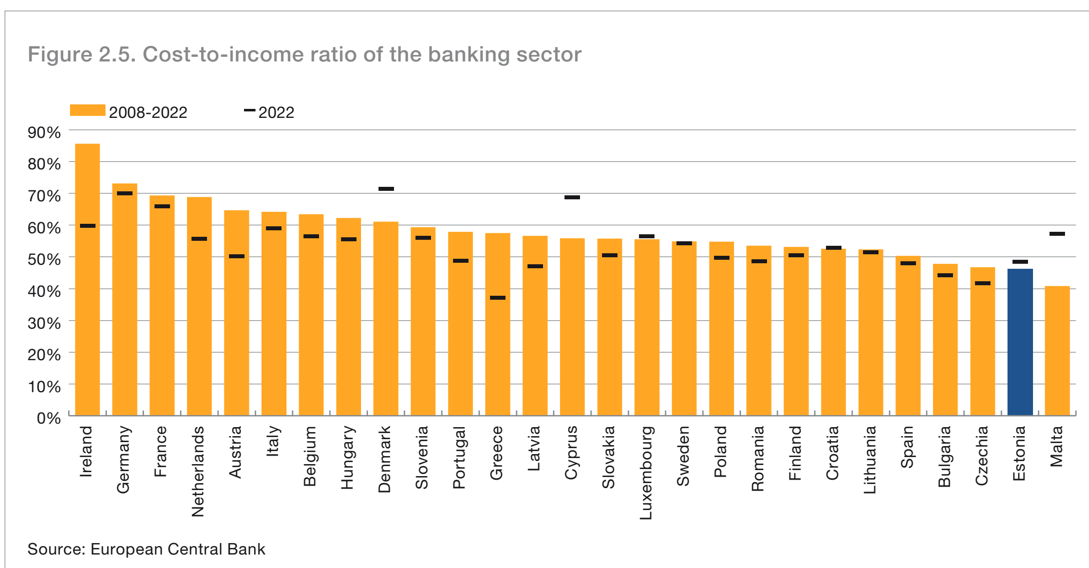


Figure 2.5. Cost-to-income ratio of the banking sector

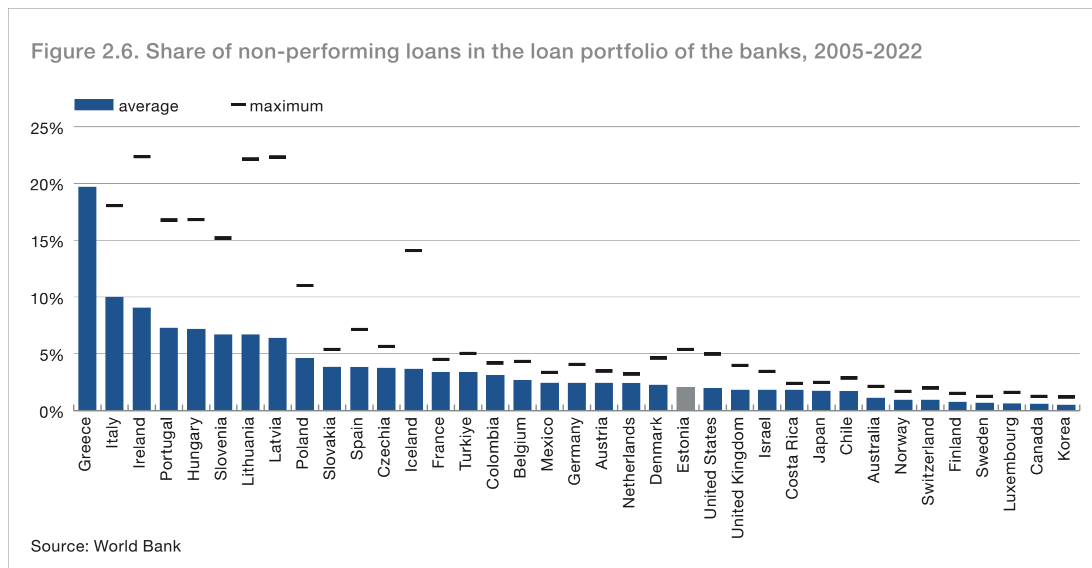
Source: European Central Bank

13 There was something of an exception from 2020 to the middle of 2022, when negative interest rates were used more widely for corporate deposits in other parts of the euro area than they were in Estonia.

14 It is possible that this was also caused by a shortage of alternative liquid investment opportunities in Estonia that meant the banks were able to access cheap resources for lending.

The cost efficiency of the Estonian banks is above the average for the European Union. The cost-to-income ratio has been one of the lowest in the European Union over the longer term (see Figure 2.5), but although the banks in Estonia have worked very successfully to optimise their operating costs, including by developing digital solutions, the low ratio tells more the story that they have managed to cover their operating costs, which are high because the market is small (see Figure 1.2), especially by keeping the level of net interest income high.

Figure 2.6. Share of non-performing loans in the loan portfolio of the banks, 2005-2022

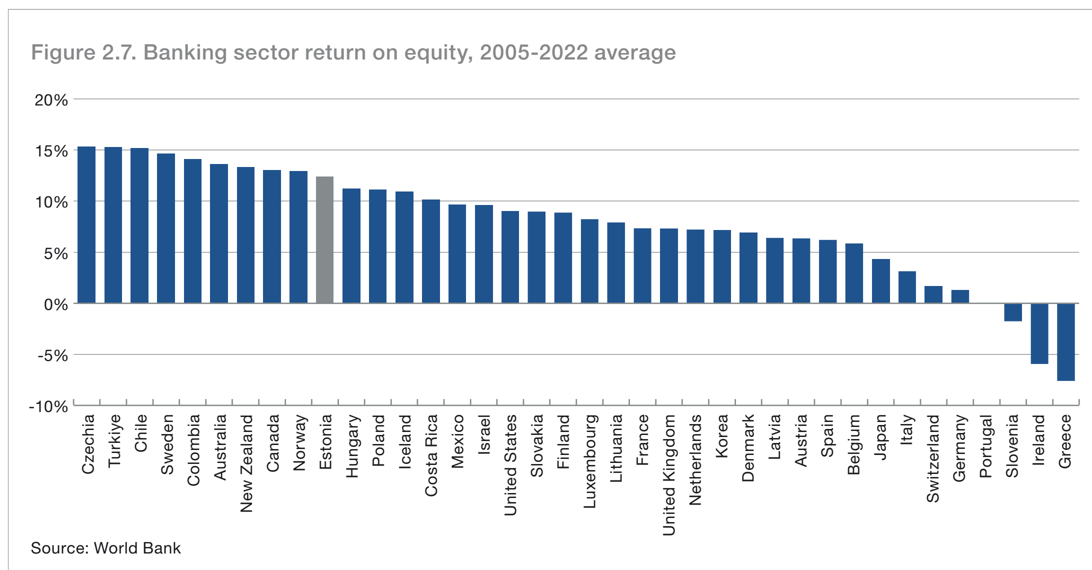


Source: World Bank

Profitability has also been helped by the share of problem loans remaining small. The loan losses in Estonia at the time of the global financial crisis were relatively large, but the average level of problem loans over the past 17 years has been low relative to that in other countries in the OECD (see Figure 2.6). This indicates that the relatively high price of loans in Estonia cannot be attributed to differences in credit risk, though loan losses can be larger over the short term.

The profitability targets of the banks operating in Estonia are set high, as the larger banks target a return on equity of 15-20%. The average ratio of net profit to equity in the OECD has been around 8% in recent years and over the whole interest rate cycle (see Figure 2.7). The figure for the banks operating in Estonia over that time has been around 12.5%, though it should be noted in that that the earlier income tax system meant that Swedbank and SEB kept large equity buffers at their Estonian subsidiaries[15].

Figure 2.7. Banking sector return on equity, 2005-2022 average



Source: World Bank

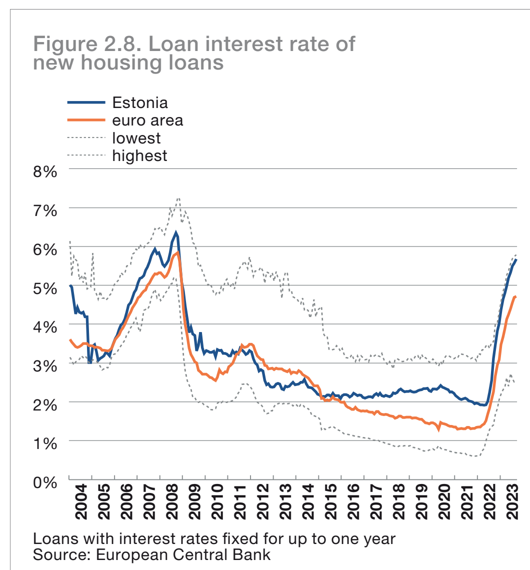
15 The profitability of the banks is also stronger than that of companies in the non-financial sector, as the average return on equity of non-financial companies in Estonia has been around 12% over the past couple of decades.

The high profitability targets show that the banks want to earn higher premiums in the Estonian market because the market is small, and that goal has previously been achievable. Equally though, if the banks in Estonia hold on to their profitability and stick to their targets for it, it is hard to see how the price for customers could be as low as it is in many other countries

LOAN INTEREST RATES AND MARGINS AND COMPETITION

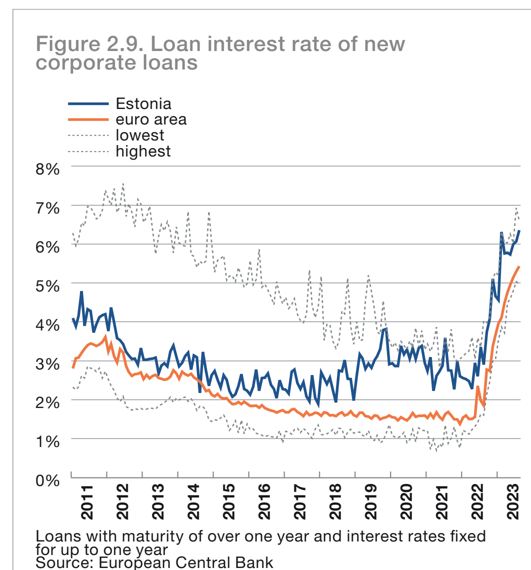
Interest rates on new loans in Estonia have mainly been higher than the average in the rest of the euro area over the past decade. The difference from the euro area average has been relatively wide in recent years and the interest rates on new loans in most countries of the euro area have been lower than those in Estonia (see Figures 2.8 and 2.9).

Figure 2.8. Loan interest rate of new housing loans



Loans with interest rates fixed for up to one year
Source: European Central Bank

Figure 2.9. Loan interest rate of new corporate loans



Loans with maturity of over one year and interest rates fixed for up to one year
Source: European Central Bank

It is however hard to compare interest rates between countries over a short period, as loan contracts with floating interest rates[16] use different reference rates that can be widely different when interest rates are changing. The 12-month Euribor was 1.7 percentage points higher in autumn 2022 than the 1-month Euribor for example, while the historical average difference between them has been only 0.4 percentage point. Banks in several countries price their loans using their own prime rates, which are generally less volatile than Euribor. This means that a better comparison is found by looking at interest rates over the whole interest rate cycle. Over 10 years on average, loan interest rates have been higher than those in Estonia in Croatia, Ireland, Cyprus, Greece and Malta (see Figure 2.10). Interest rates have been consistently similar to those of Estonia in Lithuania, and in recent years also in Latvia, Slovenia and Slovakia.

One reason why loan interest rates have been higher on average in the Baltic states is that competition is weak. A great number of factors affect the price of loans, such as the cost of funds for the banks, capital requirements, demand for loans, the credit risk of borrowers, and the size of companies (see also Box 3). Research by the Latvian central bank in 2021[17] found though that all these reasons explain only a small part of why the interest rates on corporate loans in the Baltic states have been above the average in the euro area. Market concentration and changes to it have had slightly more of an effect, but even when that is accounted for, a large part of the difference remains unexplained by the model, and the authors suggest that this could be a consequence of the weakness of competition. Research by Eesti Pank in 2022[18] found that market concentration has a major impact on the interest margins for housing loans.

16 Contracts with floating interest rates are generally defined as those where the interest rate is fixed for up to one year.

17 Beņkonvskis, K.; Tkačevs, O.; Vilerts, K. (2021). *Interest rate spreads in the Baltics and the rest of the euro area: Understanding the factors behind the differences.* Bank of Latvia, Discussion paper 2/2021.

18 Kukk, M.; Levenko, N. (2022). *Interest rate spreads in Estonia: Different stories for different types of loan.* Eesti Pank, Working Papers, 7/2022.

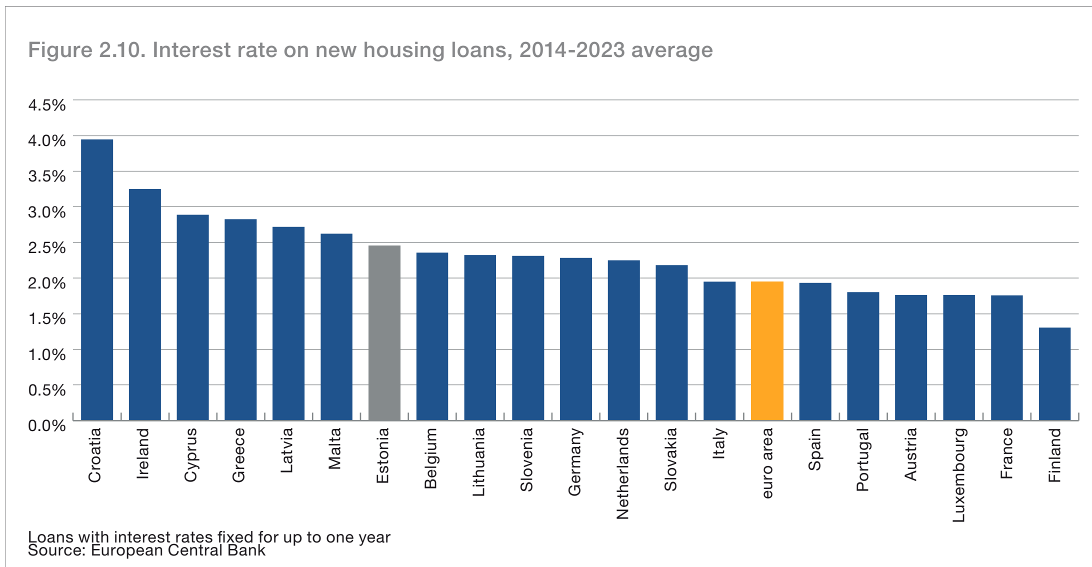


Figure 2.10. Interest rate on new housing loans, 2014-2023 average

Loans with interest rates fixed for up to one year
Source: European Central Bank

Changes in interest margins and the concentration index and survey data show that Nordea and DNB merging their Baltic activities and the Danske branch exiting the market reduced competition between the banks by a substantial amount. Competition pressures eased particularly for corporate loans, especially in the segments of loans for micro-enterprises and quite large companies. Research by the Lithuanian central bank in 2022[19] found that a large part of the increase in margins on housing loans and corporate loans in 2015-2019, which was the time when Danske Pank exited the market and Nordea and DNB merged their activities, can be explained by increased market concentration, the composition effect when clients had to move from the banks exiting the market to different banks that had more expensive loans, and wider loan margins at the banks that remained in the market as competition declined[20]. Estonian data also show the same factors dominating, and reveal that banks in Estonia consider that competition eased substantially in 2018-2019 (see Figure 2.11).

Increased competition pressure has pushed the interest margins on housing loans and corporate loans down in the past couple of years. The vacuum left by the banks that exited the market allowed smaller banks to grow fast. The growth of local banks has again increased competition and average interest rates have come down together with that (see Figure 2.12). Interest margins have also

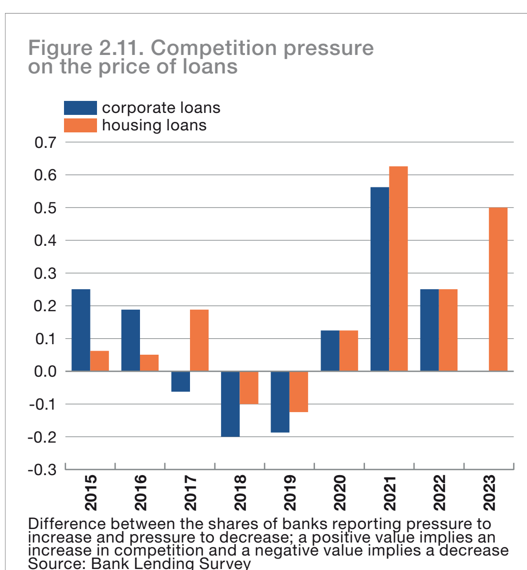


Figure 2.11. Competition pressure on the price of loans

Difference between the shares of banks reporting pressure to increase and pressure to decrease; a positive value implies an increase in competition and a negative value implies a decrease
Source: Bank Lending Survey

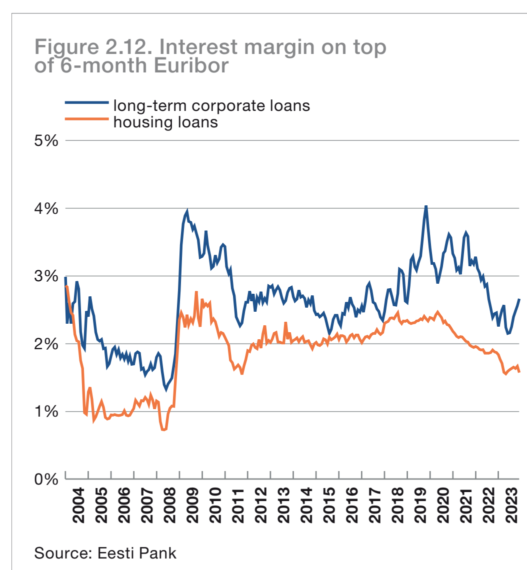


Figure 2.12. Interest margin on top of 6-month Euribor

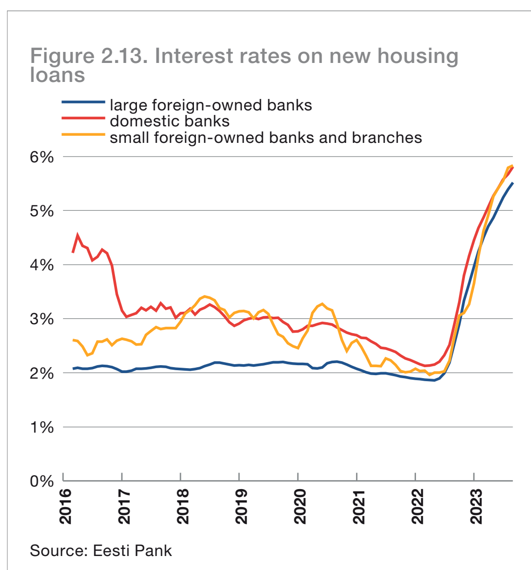
Source: Eesti Pank

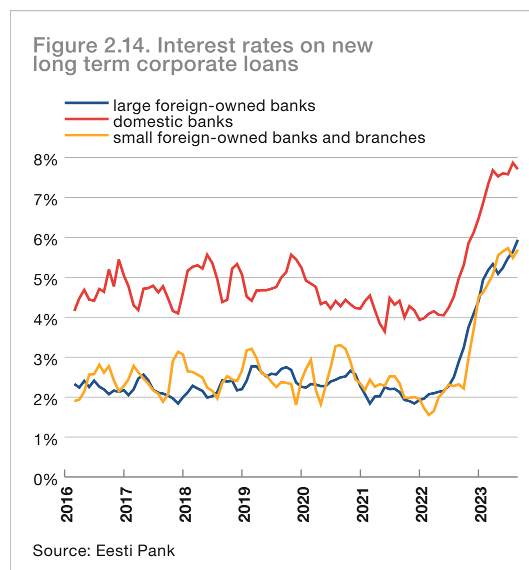
19 Karmelavičius, J.; Mikaliūnaitė-Jouvanceau, I.; Buteikis, A. (2022). *What drove the rise in bank lending rates in Lithuania during the low-rate era?* Bank of Lithuania, Occasional Paper Series, 43/2022.

20 The dynamics of interest rates on loans in Lithuania and Estonia have been almost identical in the past decade, and the market structure and changes in the banking market have also been very similar.

been pushed down in the past year and a half by the rise in Euribor, which has allowed the banks to reduce margins without losing profitability. The rise in Euribor has also led people and businesses to pay more attention to loan interest rates, and has motivated them to look at what the different banks are offering for new loans and for old ones. The drop in demand for loans has probably also put pressure on the banks to compete more with each other for clients.

The big foreign-owned banks are able to lend at lower interest rates. The interest rates on long-term corporate loans and on housing loans issued by smaller banks have been higher (see Figures 2.13 and 2.14). There are several reasons why the interest rates are lower at the large banks. The first is that their large client base plays a key role in allowing them to benefit from economies of scale. The demand deposits used for settlements let them access very cheap funds, while the smaller banks finance themselves through term deposits, which are much more expensive. The foreign-owned banks can also access funding from their parent banks, which makes their loan capital cheaper. The two larger banks also use internal models for assessing risk, and the low risk weights used mean that their capital costs are lower (see Section 1 Figure 1.9).





Some of these reasons also help explain why the average interest margin increased substantially when several foreign banks exited the market five years ago. The smaller banks succeeded in increasing their market share though despite higher costs of funding and prices of loans, because competition was weak and the large banks had limited interest in filling the vacuum left in market by the banks that exited it. The growth of the smaller banks was probably also helped by a preference among clients for domestic banks, while factors other than the price of loans, such as the speed of the loan decision, were more important when demand for loans was strong.

The price of loans at a medium-sized bank that has grown rapidly in recent years is increasingly able to compete with that offered by the large, foreign-owned banks. It is unclear how much the banks really want to compete like that though, as they have so far tended to prioritise their high targets for profitability. The smaller banks are now only able to grow by taking larger risks than before, because the vacuum left by the banks that exited the market has now been filled, and it is probable that demand for loans moving forward will be lower and interest rates will be higher than over the past decade.

ACCESS TO FUNDING AND COMPETITION

Although the number of banks is small and the price of loans is high, access to loans in Estonia has been relatively good. The estimate by Estonian companies of the availability of financing over the past decade has mainly been a little better than the European Union average (see Figure 2.15). This has clearly been helped by the fast economic growth in Estonia and by the good financial standing

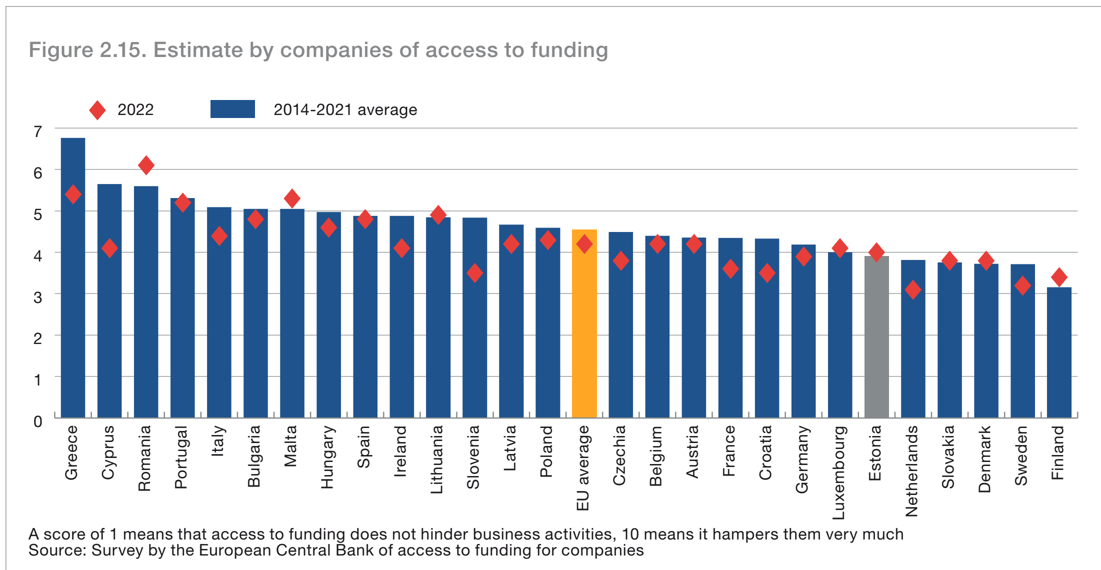


Figure 2.15. Estimate by companies of access to funding

A score of 1 means that access to funding does not hinder business activities, 10 means it hampers them very much
Source: Survey by the European Central Bank of access to funding for companies

of the companies themselves. It also shows though that there has been enough competition between the banks to ensure that companies get relatively good access to loans. Surveys of private individuals have shown though that the share of people in Estonia with credit constraints and the share of loan applications that are satisfied are close to the average for the rest the European Union[21].

The ability of the banks to supply credit and the availability of financing are also illustrated by growth in loans in Estonia being notably faster than the average in the euro area over the past 10 years[22] (see Figures 2.16 and 2.17). It is primarily important that loans be available throughout the whole economic cycle, meaning that banks must be able and willing to lend even during a recession and the recovery from it.

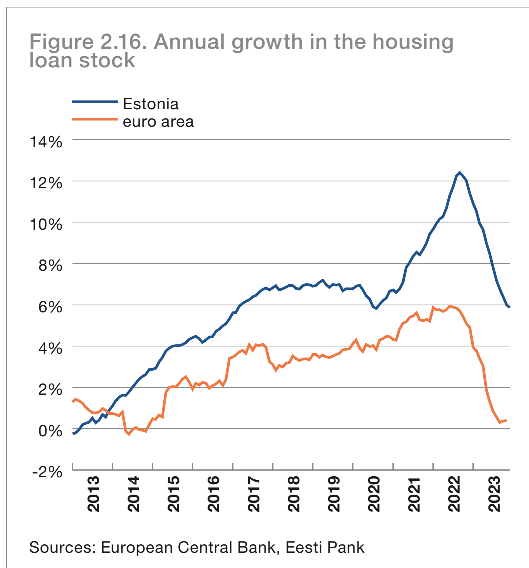


Figure 2.16. Annual growth in the housing loan stock

Sources: European Central Bank, Eesti Pank

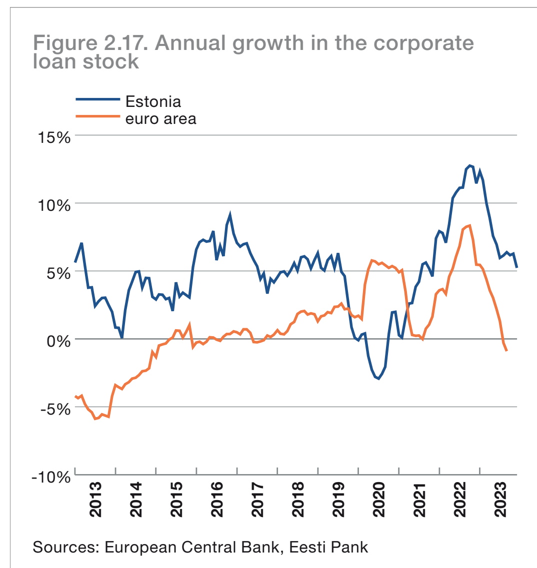


Figure 2.17. Annual growth in the corporate loan stock

Sources: European Central Bank, Eesti Pank

In summary, competition is probably weaker in the Estonian banking market than it is in most other advanced economies, which is partly indicated by the high profitability and high price of loans. Access to loans has been good though, and access to funding is more important for the long-term stable development of the economy than loans having the lowest possible price. How sustainable the level of interest margins is should also be considered when looking at loan interest rates, meaning how much interest margins affect the profit of banks and their ability to cope with loan losses, and the sustainability of their

21 Korasteljov, S.; Laarmaa, A.; Meriküll, J.; Rõõm, T. (2023). *The assets and liabilities of Estonian households: results of the 2021 survey.* Eesti Pank. Occasional Paper 1/2023.

22 Growth in lending has of course also been affected by strong demand for loans.

capacity to provide loans. The higher interest rate in Estonia helps the banks continue providing loans even during economically difficult times. The supply of loans would however probably still be sustainable with lower levels of profit, and a lower lending price would support the competitiveness of the non-financial sector

Future developments in loan prices and competition will depend largely on whether the banks Estonia agree to adjust their high targets for profitability. Once there is a critical mass of market participants looking to grow fast in the future, there will probably be increased competition pressure on the price of loans.

Box 3: The pricing of loans should be linked to risk and based on cost

The guidelines of the European Banking Authority that started to apply from 30 June 2021[23] expect banks to base the price of loans on risks. The guidelines list the main risk-based elements that banks should consider and reflect when setting the price of loans, though the precise strategy for setting prices remains the commercial responsibility of each individual bank.

The framework for price setting should reflect the risk appetite of the bank and its business strategy, including its targets for profitability and its risks. Price setting can consequently vary across types of loan and for different borrowers. Price setting for loans to consumers is based more on portfolios and products for example, while prices of loans to large companies are based more on the type of transaction and loan. A difference can also be drawn by looking at the typical risk level of loans, such as the probability of payments being past due, the credit rating of the borrower, the income of the client, the purpose of the loan, the type of contract, or climate risk considerations.

When pricing and profitability are assessed, including cross-subsidisation of loans or business units or sectors, risk-weighted performance indicators[24] need to be considered so that they match the size, nature and complexity of the loan and the risk profile of the borrower. Banks also need to set out principles for the fair distribution of costs, so that business areas, and as much as possible individual loans, reflect correctly the estimated return that corresponds to the risks taken. This means that transaction risk, pricing and expected profitability need to be linked together, including across different business sectors and products. All major transactions made with a price lower than their cost need to be justified and documented. This means that pricing needs to be risk-based and cost-based in every case.

Pricing needs to take account of the six main components of cost, which are the cost of capital the cost of funding, the cost of operations and administration, the cost of credit risk, the costs connected to other loans, and market conditions.

1. **Capital costs** cover both regulatory capital and operating capital. The bank sets the cost of operating capital internally and it covers the internal capital that the bank needs to administer any possible risks, but the cost of regulatory capital is set by the capital requirements for the banks, which are regulated by the capital requirements regulation and directive of the European Union (CRR/CRD). There are various methods for distributing the cost of capital, such as geographically, across business sectors or across products. A conservative approach may assess the whole cost of capital, but it is also possible to start from particular products, by for example pricing housing loans using the cost of capital for housing loans, which is lower than the total cost.
2. **The cost of funding** needs to match the main characteristics of the loan such as the expected maturity of it, also considering the terms of the contract and other

23 Guidelines on loan origination and monitoring (EBA/GL/2020/06), issued as Finantsinspektsioon advisory guidelines.

24 These indicators include for example return on risk-adjusted capital (RORAC), risk-adjusted return on capital (RAROC), and return on risk-weighted assets (RORWA).

risks stemming from client behaviour such as the risk of early repayment. The cost of funding depends on the market conditions for deposits and on the capacity of the individual bank to access funding, which includes its capacity to get funding from parent companies, or the rating of the bank.

3. **The operating and administrative cost** component of the price of the loan depends on how the bank divides its costs internally. It may divide them across products, channels or client segments for example.
4. **The costs of credit risk** need to reflect adequately the risk level of the borrower. When estimating the costs of credit risk the bank needs to consider its earlier experience of losses arising from credit risk. These estimates of expected loss can be made at the level of the portfolio, the segment or the client. The costs of credit risk may also be affected by the existence and amount of collateral, or by a state guarantee scheme.
5. **Other loan related costs** may for example be potential tax implications.
6. **Market conditions** mean that the pricing of the loan must consider the prevailing conditions for the segment and products in the market. If necessary the banks should take measures to ensure compliance with their own targets and risk appetite.

3. THE FLEXIBILITY AND EFFICIENCY OF SIGNING AND CHANGING LOAN CONTRACTS

An important factor that promotes competition between the banks is the mobility of clients and their ability to choose between different offers. If the borrower is able to refinance an existing loan at the lowest possible cost from their own bank or from a different bank, or to choose the offer for a new loan that best matches their needs and risk appetite, this helps to increase competition in the lending market and allows banks looking to grow to do so faster. It is particularly important in an oligopoly market, like the Estonian banking market, that the costs of refinancing should not stop the market from operating effectively. Competition is also made more dynamic if there is wider variety in the supply of loan products. This section analyses obstacles relating to these two factors in the current Estonian law on debt and the lending practice of the banks, with a focus on housing loans.

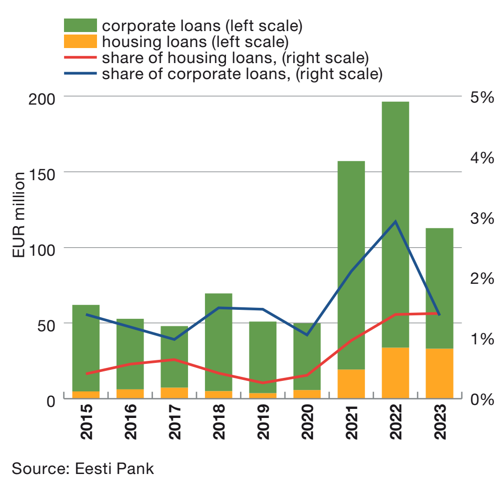
3.1. REFINANCING LOAN CONTRACTS AT ANOTHER BANK

The level of mobility in clients of retail banking is generally considered to be very low[25], and they are mainly loyal to their home bank, both for individual products and for broader packages of products. One reason that mobility is low is the switching costs from moving bank, which can be immaterial costs as well as financial expenditures. Immaterial costs can be the time and additional effort it needs for the client to search for the best offer or make additional transactions, or the loyalty of the client may be retained by a bank because of benefits from their client status. **High switching costs make consumers less interested in changing to a different bank, even if it has better offers**.

A report by the OECD on competition in banking[26] noted that if a client considers it too expensive to change from one service provider to another and prefers to remain where they are, the bank has more market power and protection against competition. In the extreme case, competition then focuses exclusively on new clients who get initial offers with very favourable terms that over time, as the client becomes more tightly tied to the bank, cease to be quite so favourable. If a client is in any case not price sensitive and prefers to maintain a long-term client relationship with their bank, the banks do not necessarily have any motivation to invest in introducing new technologies or adapting their processes to cut costs.

Very few loan contracts in Estonia have been moved from one bank to another. The highest level of transfers in recent years was reached in 2022, when 1.4% of all the housing loans issued during the year and 2.9% of the corporate loans were used to refinance earlier loans from another bank (see Figure 3.1)[27]. A total of 361 housing loans and 158 long-term corporate loans were transferred. Transfers of housing loans continued in 2023 at the same level as in the previous year, but the movement of corporate loans declined.

Figure 3.1. Value and share of loans refinanced from another bank



Source: Eesti Pank

Surveys of retail clients changing bank show that housing loans are the product that is moved between suppliers least often in other European Union countries as well. A Eurobarometer survey in 2016 found that 2% of clients moved their housing loan to a different bank, while 8% of current accounts were transferred. The countries where clients change

25 OECD (2009). *Competition in Financial Markets.*

26 OECD (2011). *Bank competition and financial stability.*

27 The data do not cover movements of loans en masse from one bank to another, like the transactions connected to the loans issued by the branch of Danske.

bank most often were Denmark and Sweden, while some countries in Central and Eastern Europe saw the smallest share of movement[28].

The costs of transferring a loan contract

Transferring a loan essentially means using another lender to refinance a loan contract. This means that a new loan is taken to pay off the old loan and the initial loan conditions are replaced with new loan conditions. Loan contracts are usually refinanced in order to get better conditions such as a lower interest rate or a more suitable payment schedule. Refinancing can also be done to avoid payment difficulties and to pay off liabilities at the right time.

Refinancing loans comes with various fees, some for ending the old contract early, and others for signing the new contract. Other compulsory transactions can also raise costs for clients. The costs that arise from refinancing loans in Estonia come from early repayment of the loan, valuation of the collateral, signing of the refinancing contract, the notary transaction to change the mortgage, and the change to the entry in the land register.

(1) Early repayment of the loan

Article 25 of the mortgage credit directive covers the early fulfilment of obligations that arise under a consumer credit agreement secured by a mortgage in the European Union[29]. The directive gives consumers the right to end their contractual liabilities before the agreed maturity. This right is not unconditional, because the lender may demand compensation for the costs that come directly from the early repayment of the loan. The directive does not directly give creditors the right to receive the compensation, but each member state can establish this right and set conditions for it in its own legislation. If the domestic legislation of a country permits early repayment, the compensation should meet the minimum required in the mortgage directive.

Under § 411 of the Law of Obligations Act, banks in Estonia cannot refuse to accept early repayment of a credit contract, and so the bank has the right to receive fair and objectively justifiable compensation for the costs that arise directly from the early repayment of a loan[30]. To give adequate protection to the rights of the borrower and prevent banks from demanding disproportionately high fees for early repayment of a loan, the Law of Obligations Act states that the borrower does not owe the bank any interest or other costs for the period that the loan is not used for. This takes account of the bank's ability to re-lend the loan that has been repaid, given that the early repayment has saved costs for the bank. The amount of compensation is different for loan contracts with fixed or floating interest rates.

- **Compensation in a period** when the interest rate is fixed may not exceed 1% of the amount of the repaid loan if there is more than one year between the date of the early repayment of the loan and the end of the contract, and 0.5% if there is less than one year. The bank may also demand additional compensation from the borrower for a housing loan if it suffers larger losses because of the early repayment of the loan. Practice has shown that the banks base the fee for repayment on the current market interest rate; if that rate is lower than the fixed base rate in the contract then the repayment fee is equal to the interest spread.
- **The bank has the right** to demand compensation for early repayment in a period of floating interest rates that is equal to the interest it will not receive from the borrower in the next three months. The interest rate that is used is the one that would be used for calculating the interest under the loan contract if payments were made in the next three months. Practice here has shown that borrowers do not need to pay the fee for early repayment if they give the bank sufficient advance warning, say three months, of their desire to repay early.

28 European Commission (2019). *Study on switching of financial services and products.* November 2019.

29 Directive 2014/17/EU of the European Parliament and of the Council of 4 February 2014 on credit agreements for consumers relating to residential immovable property and amending Directives 2008/48/EC and 2013/36/EU and Regulation (EU) No 1093/2010 Text with EEA relevance. OJ L 60, 28.2.2014.

30 Varul, P., Kull, I., Kõve, V., Käerdi, M., Sein, K. Võlaõigusseadus I Üldosa (§§1-207) kommenteeritud väljaanne. [Discussion of the Law of Obligations Act in Estonian]. Tallinn, Juura, 2016. § 84 p 4.3.

Banks in Finland have the right to claim compensation from the borrower for early repayment of a housing loan if the loan is for more than 20,000 euros and the interest rate is fixed or the fixing period for the reference interest rate is at least three years[31]. The compensation the bank can claim is the loss resulting from the reduction in the interest rate. The exact method used to calculate the maximum compensation that can be demanded for early repayment of a mortgage loan is set out in Finnish legislation[32].

Banks in Sweden may only demand compensation if the loan is repaid early while the interest rate is fixed. The right to demand compensation at any other time must be defined in the loan contract. The amount of compensation must be in line with good practice of lenders[33]. The maximum amount of compensation is defined as the interest rate spread between the interest rate on the loan and the current interest rate on mortgage bonds at the moment of repayment plus 1%.

(2) Valuation of collateral

There is a requirement for the banks that they must assess the value of the property used as collateral when they issue a loan. The Creditors and Credit Intermediaries Act says that the property must be valued by the creditor or credit intermediary or by a third-party[34], and the valuation must be carried out as required by law and by the regulation of the Ministry of Finance[35]. The requirement to value the property also applies when a housing loan is refinanced, as the refinancing is a new contract for the other bank, and it must follow all the requirements for signing new contracts.

The cost of the valuation service depends primarily on which region of Estonia the property is located in and on the type of property and whether it is an apartment, house, a piece of land, a commercial property, or something else. It is usually the buyer who orders and pays for the valuation, and for refinancing a housing loan this means the person who wants to refinance their contract.

(3) Signing of the refinancing contract

Refinancing means a new loan is issued that covers the liabilities under the previous contract. This is done by the parties signing a new loan contract with new lending conditions to refinance the old loan. The bank has the right to demand a contract fee for signing a loan contract. The size of the fee is generally 1% of the amount of the loan, but the banks generally also set a minimum floor for the contract fee[36].

(4) The notary transaction to change the mortgage

The Law of Property Act requires that a real right contract that establishes a mortgage needs to be notarised[37]. This is required because the mortgage reduces the rights of the owner of the property. It is the job of the notary to establish clearly the desire of the parties to the contract to engage in it, and to make sure that the transaction is executed legally correctly. The notary also explains the meaning and legal consequences of the transaction to the parties. This is to make sure that the parties understand before they sign the contract what the transaction could imply for them[38].

31 Kuluttajansuojalaki 20.1.1978/38, Finlex, Section 7 § 20.

32 Asuntoluoton ennenaikaisesta takaisinmaksusta perittävän enimmäiskorvauksen laskentaan käytettävät menetelmät. Määräykset ja ohjeet 4/2011.

33 Konsumentkreditlag (2010:1846) § 36.

34 Creditors and Credit Intermediaries Act, RT I, 17.03.2023, 13. § 53 (2).

35 Requirements for valuing the property used as collateral for consumer credit contracts related to residential property. Regulation of the Ministry of Finance. RT I, 17.06.2016, 8.

36 The pricelists of the banks show that the minimum fee for signing a contract in autumn 2023 was 100-200 euros.

37 Law of Property Act, RT I, 17.03.2023, 57, § 326.

38 Notarisation Act, RT I, 06.07.2023, 104, § 18 (1).

Refinancing of a housing loan contract needs the confirmation or attestation of a notary, depending on the conditions of refinancing. Confirmation of the notary is sufficient for the transfer of a mortgage, but if the requirements for the mortgage change when the lender changes, a notarised contract needs to be signed.

The requirement for notarisation ought to be a moderate measure that protects the legal rights of the parties. The property owner does not get any additional protection from the warning function of notarisation of a transaction if a mortgage that has already been agreed is moved from one lender to another. The entry in the land register cannot however be changed if the transaction has not been notarised and entered in the land register.

A notary fee is charged for the notarised transaction, and the size it depends on the value of the transaction[39].

There is no requirement in **Finland** for notarisation of transactions to establish or end a mortgage. Establishing a mortgage in **Sweden** needs to be notarised, but there is no such requirement when a housing loan is refinanced.

(5) The change to the entry in the land register

The existence of ownership of property rights is defined by the status recorded in the Land Register. The Land Register collects, stores and discloses information on the creation, transfer and encumbrance of immovable property with real rights, and on changes to these[40]. This makes the Land Register important for housing loans, as it records information on the owners of properties and on the mortgages on those properties. When a mortgage is refinanced by another bank, no real right is transferred until the entry has been made in the Land Register. The public visibility of each legal change is also guaranteed because the changes are noted in the Land Register and can be seen there.

A state fee has to be paid for making an entry in the state register. The state fee for entering a transaction in the Land Register depends on the value of the transaction[41].

There is in some cases a state fee in **Finland** for entries in the land register changing the mortgage lender, while there are only fees in **Sweden** if the property ownership changes, not if the data are changed because of refinancing.

The monetary impact of these five types of fee on the borrower with a housing loan can be illustrated with an example where a borrower wants to refinance from a different bank a mortgage loan of 100,000 euros with a floating interest rate for a typical apartment in Tallinn. The loan to be refinanced has a remaining maturity of 20 years, the earlier interest rate on the loan was 6%, and the mortgage has been set at 150,000 euros. In this example the costs of refinancing the loan could exceed 3000 euros, or 3% of the value of the loan (see Table 3.1). The largest costs are the service fees for the banks, with the fee for ending a contract early making up about half of the total.

Table 3.1. Example of the costs of refinancing a housing loan of 100,000 euros

	amount in euros	share of the fees	share of the amount of the loan
fee for early termination of the contract, 3 months of interest payments	1 497	50%	1.5%
approximate fee for valuation of the collateral, depending on the price list	250	8%	0.3%
fee for signing the refinancing contract, 1% of the amount of the loan	1 000	33%	1.0%
notary fees	201	7%	0.2%
state fee for transactions in the Land Register	55	2%	0.1%
total	**3 003**	**100%**	**3.0%**

Source: Eesti Pank calculations

39 Notary Fees Act, RT I, 06.07.2023, 58, § 6.

40 Land Register Act, RT I, 06.07.2023, 42, § 1 (1).

41 State Fees Act, RT I, 30.12.2023, 6, § 359 (1) and §362 (1).

Finland and Sweden are not the only countries in the European Union where the maximum fees for changing bank are more tightly limited than those in Estonia. Italian legislation is considered the most consumer friendly, as it does not allow any fees for a client moving a housing loan from one bank to another beyond the 35-euro notary fee for registration[42].

In summary, the fees for refinancing a loan in Estonia can amount to quite a large part of the value of a housing loan. Not only is there the financial cost, but the client also has to spend a lot of time on difficult transactions. The largest part of the costs are the fees demanded by the bank, especially the fee that the bank is permitted to demand for early termination of the loan under the Law of Obligations Act. In practice the banks do not need to demand a fee, at least not at the maximum permitted level. Banks can also make discounts on the fee for signing a contract or could carry out valuation of the collateral at their own expense.

3.2. THE LIMITED CHOICE OF REFERENCE INTEREST RATES AND LACK OF FLEXIBILITY IN CHANGING CONTRACTS

As base interest rates rose in 2023, the loan servicing costs of borrowers in Estonia went up sharply. This is because a large share of loans have floating interest rates, and loans linked to the six-month Euribor dominate among them. Passing interest rate risk on to their loan clients means the banks increase their credit risk, and in the longer perspective that could make it harder to finance the economy, and so it is worth considering whether the lending practice that has been followed so far with its focus on floating interest rates, mainly on a single reference rate, is still the best given the current level of development in the banking sector. Competition in the loan market would also be improved if clients had a wider choice when setting the interest rate for their loan and if the reference rate used for loan contracts could be changed simply and at a lower cost.

Loans with floating interest rates[43] have been standard in the Estonian market for more than a couple of decades. Floating rates started to be applied to housing loans and long-term corporate loans from the early 2000s, when the large Nordic banks entered the Estonian market, bringing with them the standard practices from their home markets. The banks at that time used the Euribor benchmark rate and also other base interest rates that they defined themselves, but over time there was an almost total transition to the Euribor, probably because it is a rate that can be observed from day to day, making it easier to explain changes in interest rates to clients.

Reference interest rates and the criteria for them

Reference interest rates, which are also known as benchmark rates, are regularly updated interest rates that are publicly accessible. They are used as references in various financial contracts, including those for mortgage loans.

Reference rates need to meet certain criteria[44]. Reference rates are calculated following clear rules and under strict supervision to ensure that the reference rates can be trusted and to prevent them being manipulated or erroneously marked. Key criteria are the robustness of the reference rate, which is how accessible it is when there is turmoil in the market, and how regularly it is published, which is important for the ongoing calculation of market value for assets and contracts. The representativeness of the reference rate and whether it is based on a large enough sample of banks is also important. The Euribor meets all of these conditions in the euro area.

The Euribor (the Euro Interbank Offered Rate) is calculated daily from the lending between a panel of 19 of the largest banks in Europe. The Euribor is fixed for five different interest periods, which are one week, and one, three, six and 12 months. The requirements for calculating Euribor are set by a regulation of the European Union[45] in order to maintain trust in it, and the calculation of it is administered by the European Money Markets Institute and its accuracy is checked by a special supervision committee.

42 European Commission (2019). *Study on switching of financial services and products.* November 2019.

43 The European Central Bank defines loans with variable interest rates as those with a floating interest rate or rates fixed for up to one year.

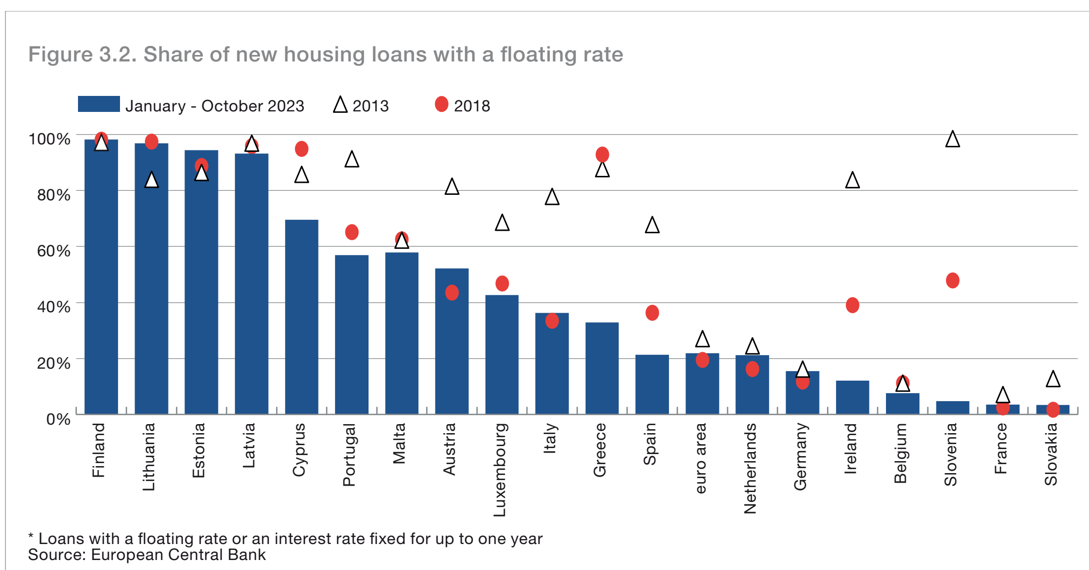
44 IOSCO (2013). *Principles for Financial Benchmarks.* July 2013.

45 Regulation (EU) No 2016/1011 of the European Parliament and of the Council.

Fixed interest rates are generally higher than floating rates. This is because using Euribor as a reference rate moves the interest risk off the balance sheet of the bank and onto the client. When the interest rate is fixed, the bank bears the interest risk, and so is able to charge the client a risk premium for doing so. This means that a fixed interest rate cannot be equal to the future short-term floating interest rate over the interest cycle, and that makes it more expensive for the client than a floating interest rate at the moment of borrowing. It is also harder to change a loan contract with a fixed interest rate because the bank may not allow payment holidays with fixed interest rates, or may require the interest loss to the bank to be compensated if the loan is repaid early.

The type of interest rates used in loan contracts across the euro area varies quite widely between countries. Floating interest rates have always predominated in mortgage contracts in the Baltic states and Finland, while housing loans tend to be issued with fixed interest rates in Belgium, the Netherlands, France and Germany (see Figure 3.2). In Spain, Ireland, Greece and Slovenia, rates that are fixed for some time have over time come to be preferred over floating interest rates. Borrowers have probably been encouraged in this preference by interest rates remaining low for several years, or by the expectation that rates may rise.

Figure 3.2. Share of new housing loans with a floating rate

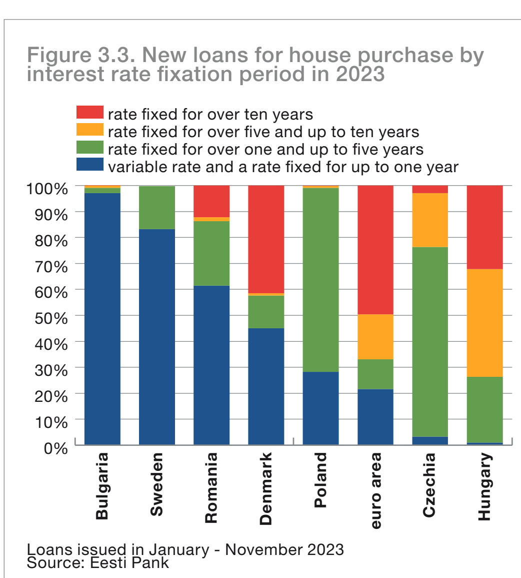


* Loans with a floating rate or an interest rate fixed for up to one year
Source: European Central Bank

It is still very common in the euro area as a whole for interest rates on loans to be fixed for a long time. Two thirds of the new mortgages issued in 2023 had interest rates that were fixed for at least five years (see Figure 3.3).

There are various factors that may affect the choice of interest rate type. Research has shown that households tend to prefer floating interest rates at times when the gap between long-term and short-term interest rates is wide, growth in economy is strong, or unemployment is low[46]. It has also been found that earlier experience of inflation can direct the choice of type of interest rate, as floating interest rates tend to be preferred in volatile inflation environments, while fixed rates are preferred when there is macroeconomic stability[47]. It is also possible that

Figure 3.3. New loans for house purchase by interest rate fixation period in 2023



Loans issued in January - November 2023
Source: Eesti Pank

46 Ehrmann, M. & Ziegelmeyer, M. (2014). *Mortgage choice in the euro area: Macroeconomic determinants and the effect of monetary policy on debt burden.* ECB Working Paper Series No 1631, January 2014.

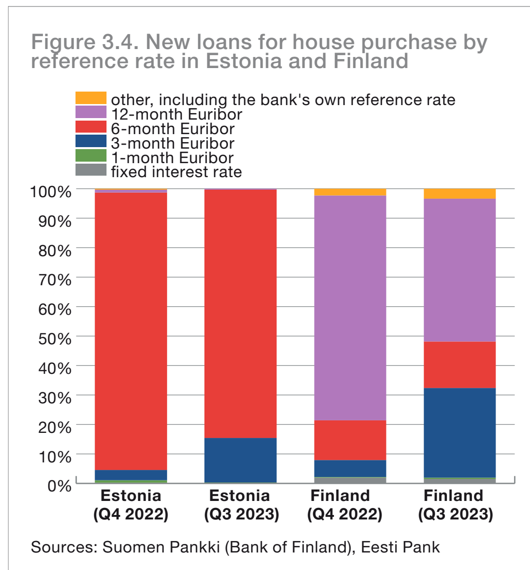
47 Cenzon, J., Szabo, B. (2023). *Mortgage Choice and Inflation Experiences in the Euro Area.* Universitat Pompeo Fabra.

other factors that are difficult to measure may affect the choice, such as preferences driven by the taxation system, or cultural influences.

Most of the housing loan contracts in Estonia use the six-month Euribor as the reference rate. This has been standard practice in the market for a very long time, and although some banks started in 2023 to offer loans with the interest rate linked to a shorter-term Euribor, the standard interest rate offered by most of the banks at the end of 2023 was still the six-month Euribor. The reference rates used in Finland are much more varied than those in Estonia, and changes in money market interest rates there have led to larger changes in the structure of the reference rates used in loan contracts (see Figure 3.4).

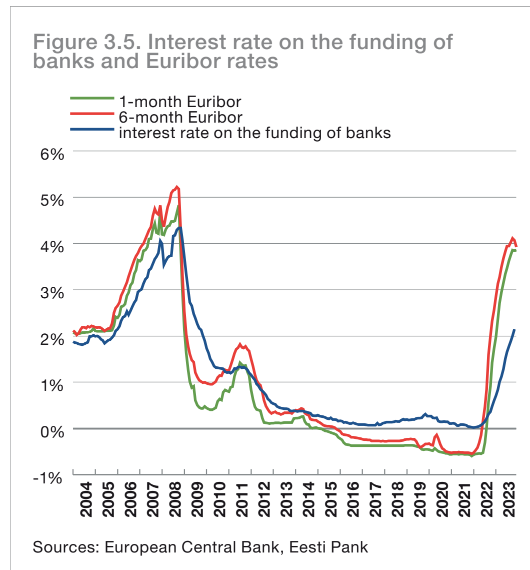
In general the cost of funds for Estonian banks has followed the movements in the euro money market interest rates quite closely but with some lag. The sharp rise in interest rates over the past year has however led these rates to diverge widely (see Figure 3.5).

Figure 3.4. New loans for house purchase by reference rate in Estonia and Finland



Sources: Suomen Pankki (Bank of Finland), Eesti Pank

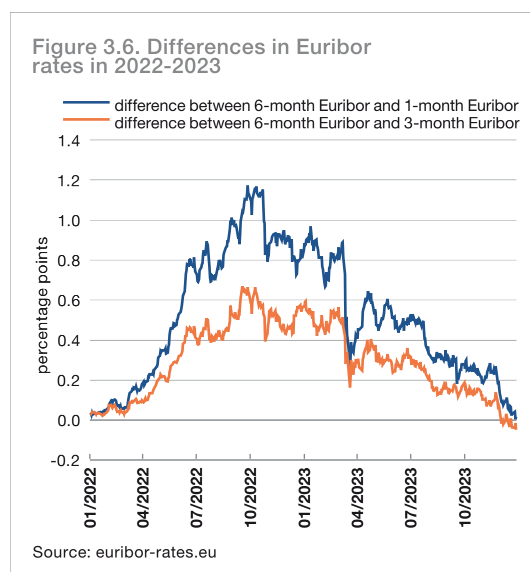
Figure 3.5. Interest rate on the funding of banks and Euribor rates



Sources: European Central Bank, Eesti Pank

The six-month Euribor has reacted more strongly to the rise in base interest rates than the shorter-term one-month and three-month Euribor reference rates have. Depending on when the contract was signed, the loan interest rate based on the six-month Euribor could temporarily have been almost 1.2 percentage points higher in autumn 2022 than if the one-month Euribor have been used, and 0.6 percentage point higher than with the three-month Euribor, though the difference narrowed in subsequent months and disappeared by the end of 2023 (see Figure 3.6). The difference is small over the long-term between the reference rates of up to a year, as the six-month Euribor has been 0.3 percentage point higher than the one-month rate over the past 20 years, and 0.1 percentage point higher than the three-month rate. Even so it should be possible for borrowers to reduce their loan servicing costs if an appropriate reference rate for the interest environment was used, including fixing the reference rate for three or five years, and if that reference rate could be changed flexibly when the environment changes.

Figure 3.6. Differences in Euribor rates in 2022-2023



Source: euribor-rates.eu

The banks charge a fee for changes to contracts and can make it uneconomic for a client to change their loan interest rate. It is quite expensive for a client to change their loan conditions in

Estonia, as the fee for doing so is 0.5-1% of the outstanding loan, depending on the bank. Changing the interest type on a loan from a Finnish bank costs around 200-300 euros, and the client is able to make the changes to the current contract on their own using the internet bank. Experience from other countries also shows that it can be made more efficient and cheaper for a client to change their reference interest rate or the margin than it currently is in Estonia.

In summary the predominant use of the six-month reference interest rate in loan contracts reflects the standard practice in the Estonian market in offering loan products. It could also indicate that there is insufficient competition, which is hampering the development of loan products.

The banks want to link the interest rate on loan products with a long maturity to the euro money market interest rates rather than to their own cost of funding, as this is a way to minimise interest risk. Changes in the financing structure of the banks, which has mainly been based on client deposits and demand deposits, can be hard to predict over the long term, and so using Euribor to set the price of loans has been understandable as an opportunity cost. Changes in the need of the banks for funding, such as greater use of bonds including covered bonds, and developments in the market could however encourage the banks to develop their interest risk management, and it could lead to more reasonable prices on loan products for clients.

SUMMARY AND CONCLUSIONS

Like it is in many other countries, competition in the Estonian market is determined by an oligopoly market structure where a small number of large banks dominate. The potential client base for universal banks in Estonia is very small, which makes the market less attractive for large foreign banks and could tempt the larger banks operating in the market to abuse their market power by, for example, pricing loans more expensively than their cost level would demand. This means that structural factors do not encourage competition in the banking market in Estonia.

Even so, the oligopoly market can function efficiently, at least for periods, as competition pressures could arise from time to time that could seriously upset the balance in the market. There have been several cases in the past couple of decades in the very concentrated banking sector in Estonia where the business opportunities that arise for one individual bank have unexpectedly and rapidly either tightened or reduced competition until the immediate market reaction fades and a new equilibrium is achieved.

Larger changes in the dynamics of competition in the banking sector in Estonia have been caused by the larger banks, but the role of smaller banks and potential new entrants in the lending market in increasing competition should certainly not be underestimated. New entrants looking at applying for an operating licence need to consider though that the costs of entry are relatively high and that the smaller banks already operating in the market are not able to use the advantages of economies of scale that the large banks have. By starting off with niche products with wider margins though, they can gradually increase their market share and later provide competition to the larger banks.

The profitability of the Estonian banking sector and the price of loans have generally been higher over the longer term than those in many other advanced economies, which indicates that competition in Estonia is weaker. The revenue structure of the banks in Estonia is strongly biased towards interest income. The share of income coming from fees for payment and securities intermediation, which are more exposed to international and non-bank competition pressures, has meanwhile fallen over the past five years. The steep increase in interest income with interest rates high has been supported by the practice of the Estonian banks of setting loan interest rates to match the dynamics of Euribor and linking them less to the actual long-term cost of funds of the banks, as is more common in several other European countries. It is also important in the price of loans that the margins on the loans be sustainable and profitability sufficient that the banks can cope with loan losses, raise additional capital, and continue to lend even during difficult times. This means that the ideal price of a loan from the point of view of financing the economy is one that balances support for the competitiveness of the economy with a sustainable margin over the whole loan cycle. Access to lending in Estonia has been relatively good compared to that in other countries despite the high price of loans. Estonian companies are however worse off than several of their competitors in terms of their loan costs.

The banks consider both costs and risk when pricing loans. Larger banks have an advantage in pricing because their cost of funding is smaller since their client base is larger. The two largest banks, which use internal ratings when calculating their capital requirements, have a lower cost of capital because they are able to use lower risk weights. The smaller banks though get a relatively large part of their funding from more expensive term deposits. They also need additional capital if they are to achieve rapid growth. The current low level of demand for loans and the rise in the cost of funding has made it harder for smaller banks to compete. They can succeed in increasing their market share by offering clients more favourable conditions and taking on larger risks, if it is assumed that the larger banks still consider it more important to meet their high targets for return on equity than to maintain their market share.

It can in summary be concluded that the level of competition in the loan market in Estonia has been weaker for a long time than that in the majority of other European countries, but it is at around its historical average level in the context of the Estonian market. There are reasons in the structure of the banking market that explain why competition is weak, so ways to increase it can be found primarily in making the supply of loans more effective.

Retail clients generally move very rarely between banks, and nor do they look in their home bank for ways of making their loan contract more favourable. This is often because of the cost of making changes to a contract and the complexity of doing so. Lower transaction costs, more options for setting the price of loans, and increased information for borrowers would help the lending market function better and also encourage competition between the banks.

Competition in the lending market could first of all be increased through measures that make it simpler and cheaper for borrowers to refinance their loans from other banks. The fees from the banks for repaying housing loans early and signing new contracts or refinancing old ones, and the costs for legally required procedures can make borrowers less interested in refinancing their loan with one from another bank with a lower margin. Experience from several other European countries shows that it can be made easier to refinance housing loans and the costs for the borrower can be substantially smaller.

A second solution is that borrowers could be offered more choice of reference interest rates apart from the currently standard six-month Euribor. The offers from the banks could include reference rates with a shorter interest period, such as the one-month or three-month Euribor. The recent sharp rise in interest rates after they have remained low for years was also a good lesson for consumers that borrowers should always be able to choose a fixed interest rate over a longer period such as five or more years. The borrower should be able to choose the reference interest rate for their housing loan when applying for the loan and should be able simply and cheaply to change their interest type during the loan period. The current high transaction fees of the banks make it quite expensive and consequently not tempting for borrowers to make changes to their contracts.

The third improvement that would simplify matters for borrowers would be if they could easily access and compare between banks information about the loan interest rates on offer, transaction fees and other conditions. The consequence of this would be increased awareness among clients, which would allow them to assess the loans offered by the banks and would encourage competition.