III
BANKING SECTOR STABILITY AND RISKS

Strategic Development in the Banking Market

The Baltic Investment Group[1], which had been issuing loans in Estonia already before, obtained a licence from the Financial Supervision Authority on September 27 to operate as a credit institution, and thus provided an addition to the six credit institutions licensed in Estonia. Currently there are three branches of credit institutions operating in Estonia licensed in other EU Member States, and the Financial Supervision Authority has been informed by a Latvian credit institution JSC NORD/LB Latvija about their intention to open their branch here. Besides the above market participants, five foreign credit institutions have a representative office in Estonia and 90 foreign credit institutions have submitted applications to provide cross-border banking services.

Compared to the previous review period, there has occurred a change in the ownership of AS Eesti Krediidipank. The Latvian Business Bank, operating in Latvia since 1992 and owned by more than 99% by the Bank of Moscow, increased its share in AS Eesti Krediidipank to over 50%. Consequently, the share of assets of banks controlled by non-resident credit institutions and branches of foreign banks increased to over 99% of the total assets of the Estonian banking sector.

Tight competition in the Estonian banking market continued also in the second and third quarters of 2005, which revealed in aggressive loan campaigns and declining loan margins. The banks licensed in Estonia continue to conduct their activities also on other markets than Estonia. For instance, the Hansapank Group has issued over a half of the total volume of the group's loans and leasing facilities in other countries.

Changes in ownership have brought about changes in the activities of the banking groups. The role of resident banks in intermediating funds to their subsidiaries has decreased. It shows in changes in the banks' balance sheet total as well as in risk assets (see Figures 3.1 and 3.2).

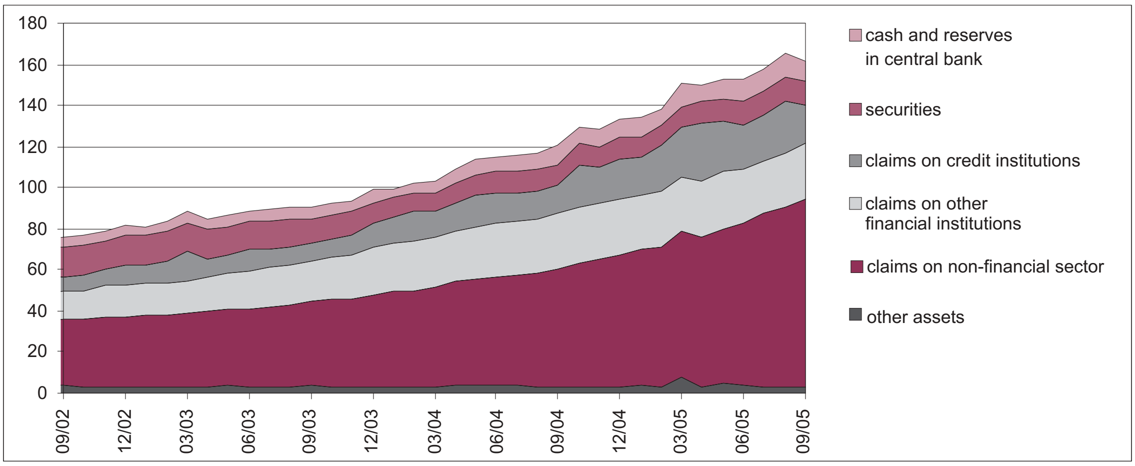

Figure 3.1. Banking sector assets (EEK bn)

[1] Data of the Baltic Investment Group were included in the statistics of the banking sector as of October 2005.

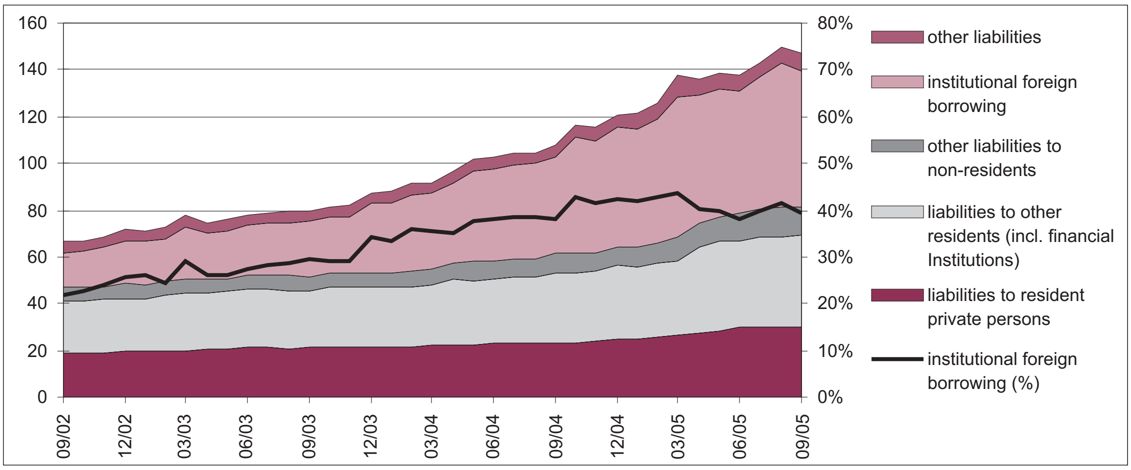

Figure 3.2. Liabilities of banks (EEK bn)

Quality of Assets

The annual growth of the **aggregate credit portfolio of banks and leasing companies operating in Estonia** picked up to over 44% by the end of September due to high loan demand from both households and companies. The volume of credit issued by banks and leasing companies grew to over 119 billion kroons on an aggregate basis by the end of the third quarter. Nearly 5% of the annual growth of finance portfolios arises from improved statistics[2].

Year-on-year, the share of loans and leasing issued to households for purchasing or renovating housing and to commercial real estate development and management companies has grown the most in the aggregate portfolio of loans and leasing issued in Estonia. The share of household loans and leasing has increased to 39% in the aggregate finance portfolio by the end of the third quarter, 30% issued for purchasing or renovating housing (see Figure 3.3). Claims against commercial real estate development and management companies, which accounted for over 14% of the aggregate portfolio, still form the largest share in corporate loans and leasing.

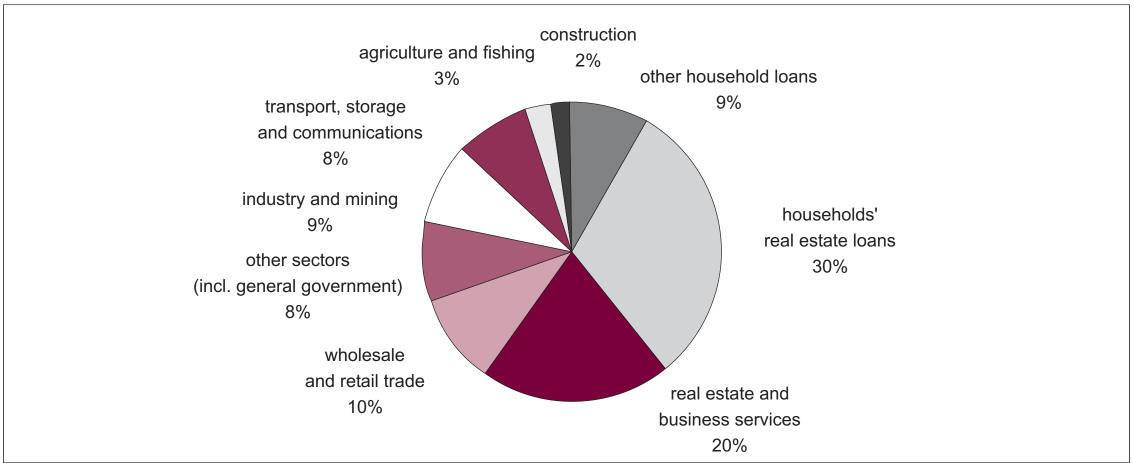

Figure 3.3. Financing by banks and leasing companies in Estonia (as at 30 September 2005)

[2] As of June 2005, leasing statistics includes in addition to the data of the members of the Estonian Leasing Association also the data of other leasing companies under the same group (Baltic Car Lease, Evison Group, Rentacar).

The share of mortgage in loan collaterals has continued growth also in the last two quarters – mortgage loans accounted for over 70% of all loans issued by banks at the end of the third quarter. Mortgage or pledge of building is used as a collateral for more than 83% of household loans; about 8% of outstanding loans (mainly study loans) are secured by guarantees (see Figure 3.4).

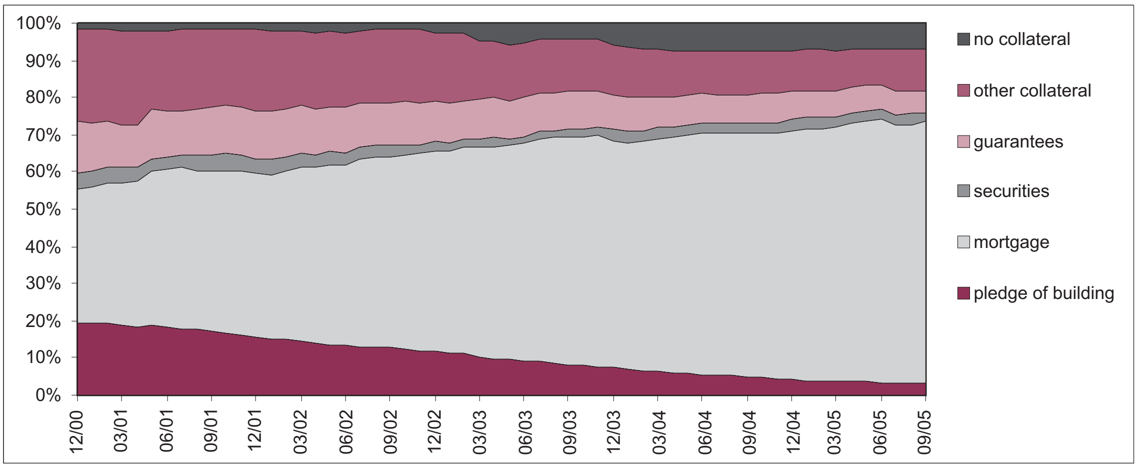

Figure 3.4. Loan collaterals by type

At the same time, the share of **loans without collateral** in the aggregate loan portfolio has decreased. At the end of September, unsecured loans constituted for less than 7% of the aggregate loan portfolio (see Figure 3.5) of which household loans accounted for the largest share (40%). At the end of the third quarter, banks classified 98.3% of all loans without collateral as "in order"; the respective indicator for household loans was 96.9%.

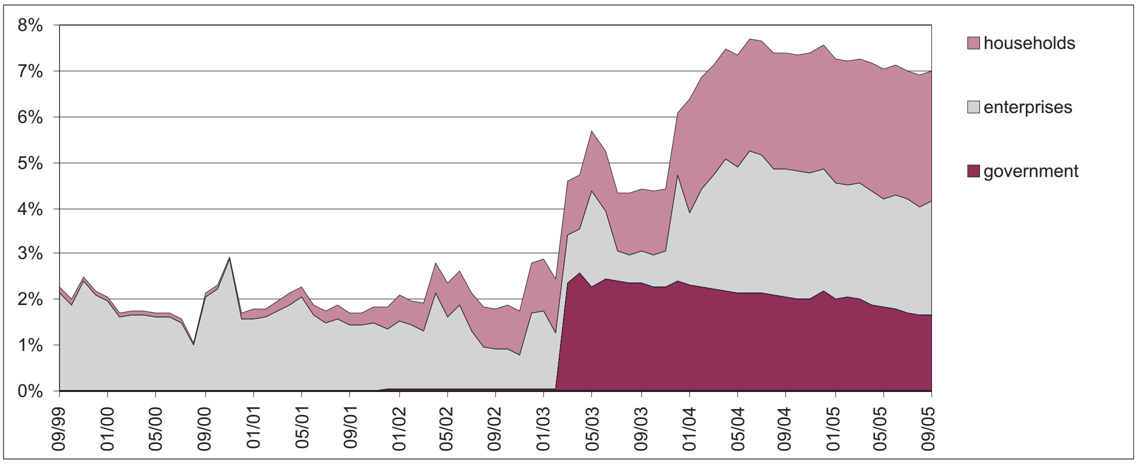

Figure 3.5. Share of loans without collateral in total domestic bank financing by sectors

Quality indicators of the banking sector's loan portfolio have generally remained good under favourable economic environment, low key interest rates and rapidly growing loan portfolios. On a solo basis, the aggregate share of **loans overdue for more than 60 days** granted to the non-financial sector has remained below the annual moving average over the last two quarters until September. In September, the share of loans overdue for more than 60 days increased to over 0.51% because of larger overdue loans among the loans granted to export-oriented companies. Loans issued to the industrial sector formed approximately 45% of the aggregate loans overdue for more than 60 days at the end of September. The share of such loans in other sectors has been rather stable on an aggregate basis, but the share of loan repayments overdue for a shorter period has started to grow again (see Figures 3.6 and 3.7).

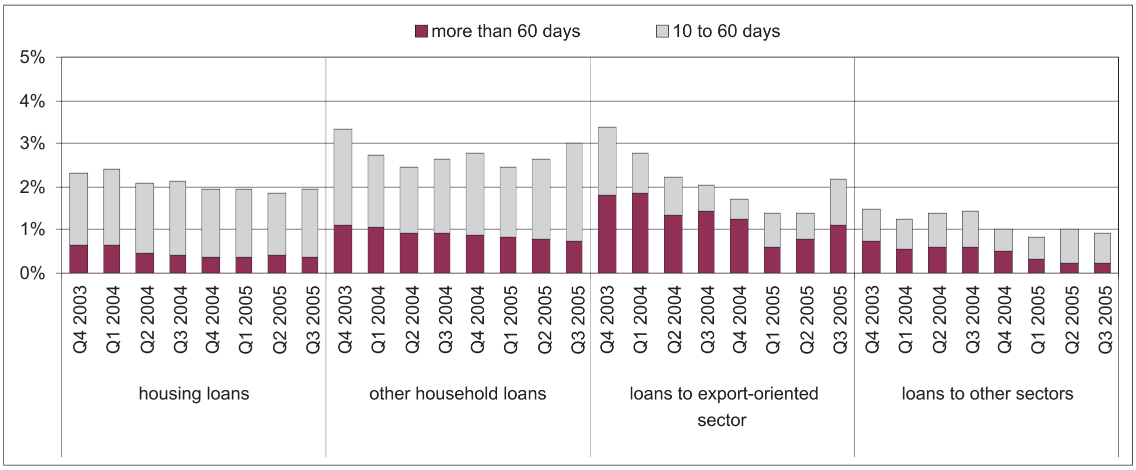

Figure 3.6. Overdue loans by economic sectors

* 3 months average

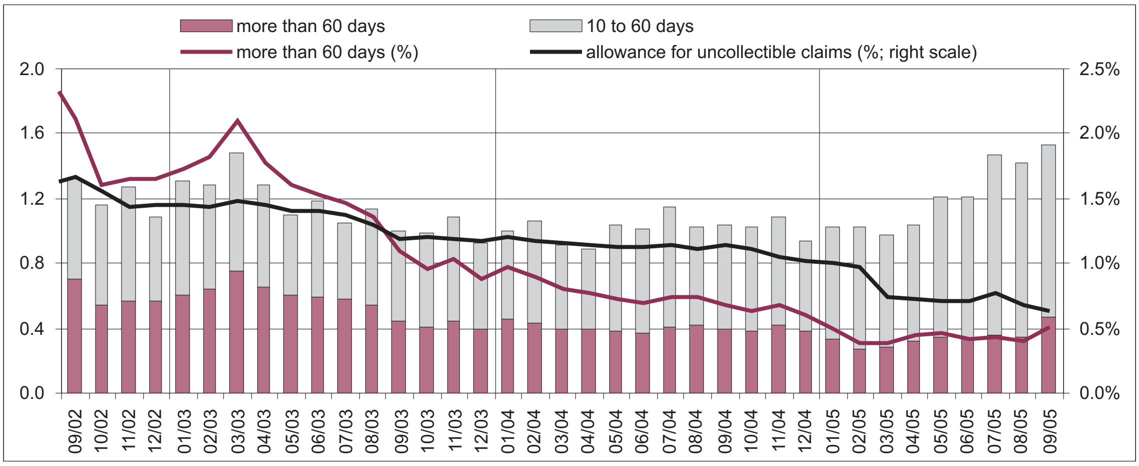

Figure 3.7. Volume of overdue loans (EEK bn; left scale) and share of overdue loans and allowance for uncollectible claims in banks' loan portfolio

The ratio of allowance for uncollectible claims, i.e. the ratio of banks' provisions for loan losses, to the total loan portfolio has decreased from 1.15% at the end of the third quarter of 2004 to 0.64% by the end of the third quarter of 2005. The decline in the provisioning ratio arises not only from better asset quality but also from changes in the provisioning principles[3]. At the end of September, the share of loan write-downs exceeded loans overdue for more than 60 days by 1.3 times on aggregate.

[3] From 2005 onwards according to international financial reporting standards (IFRS/IAS) provisions for loan losses should be made only when there is objective evidence of loan impairment.

Aggregate indicators of banking groups have changed likewise. Rapid growth in loan portfolios (annual growth 49%) has expanded the aggregate portfolio of loans and leasing financing to almost 178 billion kroons. The ratio of allowance for uncollectible claims to the loan portfolio decreased on an aggregate basis from 1.3% at the end of the third quarter of 2004 to 0.8%.

As regards changes in **risk levels of loan portfolios**, earlier trends have continued over the past two quarters: the share of mortgage loans has grown, and the ratio of allowances for uncollectible claims to the total loan portfolio has decreased.

Thus, it is important that banks retained prudent conservative approach to assessing the future loan-servicing ability of borrowers despite competitive pressures. Moreover, for the sustainable operation of banks they should retain such approach also to assessing the potential future changes in the collaterals' market value (incl. real estate prices), as the real market value of the collateral should exceed the sum owed by the customer when customer's inability to service the loan might call for disposing the collateral.

Capital Adequacy

Fast loan growth reflects in a pickup in the annual growth of banks' **risk assets** to 30% by the end of the third quarter. The growth in banks' risk assets on a solo basis could have even been faster if financing of activities of other companies of the group through banks licensed in Estonia had not been diminished. The share of credit risk weighted balance sheet items increased to more than 90% in total risk assets on an aggregate basis (85% in September 2004). Credit risk weighted off-balance-sheet items accounted for 8.3% of the risk assets on an aggregate basis. Trading portfolios and risks related to foreign exchange positions formed only 2.2% of banks' risk assets at the end of September (7.3% at the end of the third quarter of 2004; see Figure 3.8).

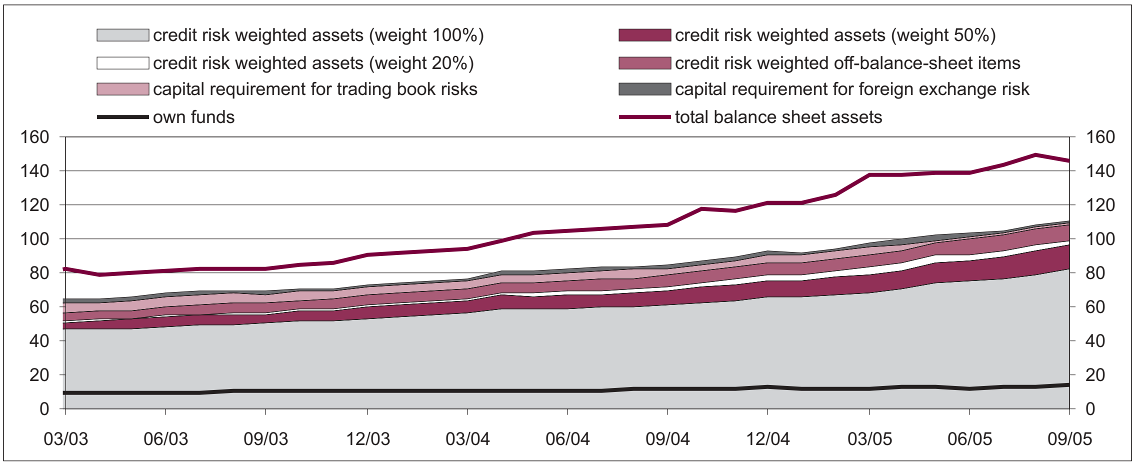

Figure 3.8. Structure of banking groups' risk weighted assets and own funds (EEK bn)

The 16% annual growth in banks' **own funds** mainly arose from retaining of profit under own funds[4] as well as from additional subordinated liabilities. The volume of the net own funds was also affected by an increase in the amounts deducted from banks' gross own funds, as these are included in the own funds of banks' subsidiaries. On an aggregate basis, banks' net own funds reached 13.7 billion kroons by the end of the third quarter. Banks' aggregate capital adequacy ratio remained at a lower level than in 2004, reaching 12.4% at the end of September (the lowest capital adequacy ratio of a bank on a solo basis at the end of the third

[4] The Financial Supervision Authority sent a letter to all banks in March 2005 asking them to retain freed capital in their own funds so as to guarantee sufficient capitalisation and sustainable operation also under conditions less favourable than today. Major banks did not pay dividends in 2005 and retained profit under own funds by including it in capital adequacy calculation.

quarter was 11.0%).
As regards banks' open **foreign exchange positions**, a major change occurred in September 2005 in the open EUR position. A large foreign exchange transaction between Hansapank and its parent bank resulted in a decrease in the open long EUR/EEK position from 40.5 billion to 16 billion kroons (see Figure 3.9) as Estonian banking sector aggregate.

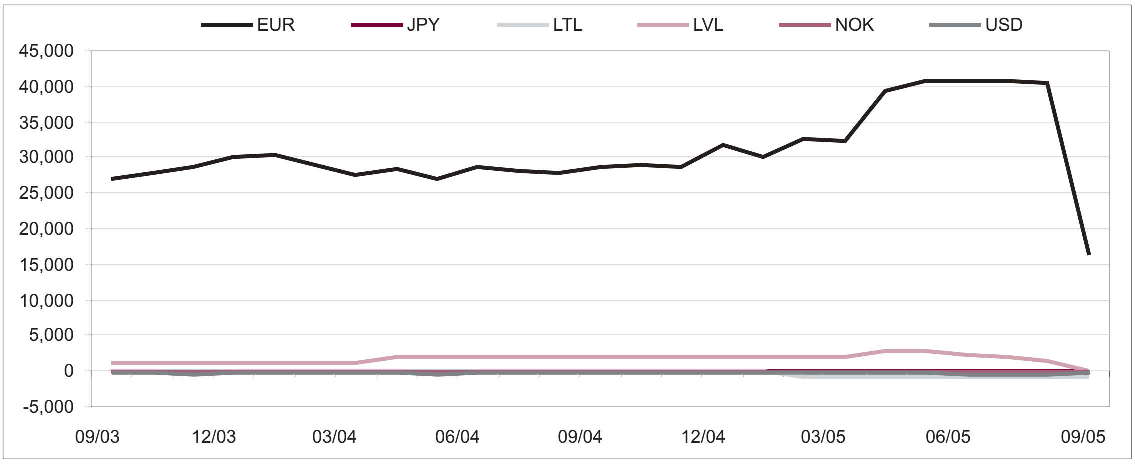

Figure 3.9. Open foreign exchange positions by currency (EEK m)

The rapid growth (higher than 41% annual growth) of **risk assets of banking groups** reflects also the fast growth of finance portfolios on other markets where subsidiaries of banks licensed in Estonia operate. Thus, the aggregate risk assets of banking groups are expected to exceed 180 billion kroons by the end of the third quarter of 2005. Credit risk weighted balance sheet items accounted for about 90% of the aggregate risk assets of banking groups at the end of the third quarter. The share of credit risk weighted off-balance-sheet items rose to 7.5% by the end of the third quarter, reaching close to the year-ago level. The share of risk arising from trading portfolios and foreign exchange positions diminished to below 3%.

The **own funds of banking groups** grew 34% to 20 billion kroons at the end of September. Banks' aggregate capital adequacy ratio on a consolidated basis was lower at the end of September (11.4%) than a year ago (12.0%; see Figure 3.10). Similarly to the solo indicator, the lowest capital adequacy ratio of a banking group was 11.0% at the end of the third quarter.

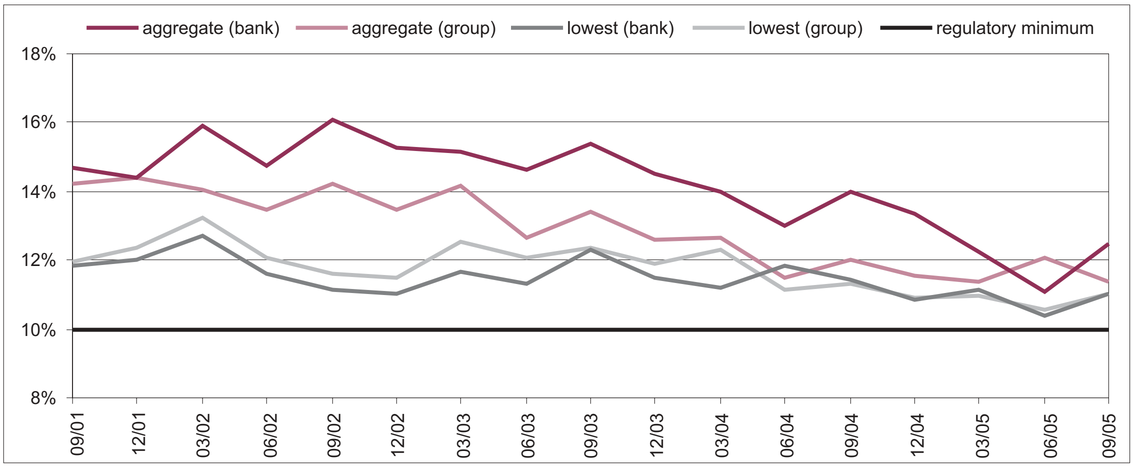

Figure 3.10. Capital adequacy

Upon the evaluation of banks' capital buffers the favourable economic environment and customers' rather good loan-servicing ability should be taken into account. The provisioning of banks' claims has decreased. Changes in the economic environment, however, may entail a growth in loan losses. Should banks increase the share of assets/operations with higher risk level in order to maintain profitability, it is important that the increase in risk level be appropriately reflected also in banks' capital buffers.

Liquidity

Funding of Banks

The accelerated growth of deposits and a temporary slowdown in financing growth supported the decline of the **financing-deposit ratio** in March and April, following a record high in February (see Figure 3.11). The growth of financing picked up in May and June and thus the indicator started to rise as well, reaching 1.48 in September. The need for **institutional foreign borrowing** has slightly decreased and its share in the liabilities fell to below 40%. This was caused by a rapid increase in deposits as well as the fact that non-resident subsidiaries of larger banking groups are now more often funded by parent banks based in the Nordic countries. Since changes in the ownership of Hansapank that attracted the majority of market-based funds, funding has now been mainly based on parent bank funding. Thus, slightly over half of non-resident institutional funding of the banking sector at the end of the third quarter was obtained from the parent banks based in the Nordic countries, whereas about six months earlier market-based funding accounted for nearly 60%.

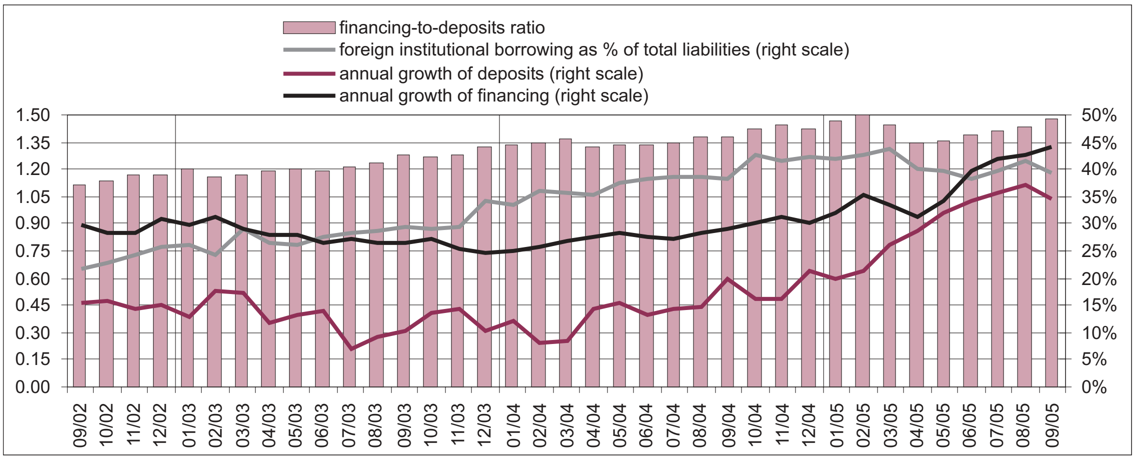

Figure 3.11. Financing-deposits ratio and share of foreign institutional borrowing in total liabilities

As the share of funds of parent banks, which are mainly short-term, has increased over the last six months, the **share of short-term liabilities in total liabilities** grew to over 80%. In September, the respective indicator fell again to below 80% due to the inclusion of subordinated liabilities and large long-term loans from the parent bank (see Figure 3.12). The structure of liabilities by instruments has been rather volatile over the last six months, mostly because of the above mentioned changes in the financing scheme.

In line with the EURIBOR, which is increasing in anticipation of the expected rise in the key interest rates in the euro area, the **average price of funding** has also increased in case of nearly all instruments (see Figure 3.13). A rise in the share of funding by the parent bank may also affect the funds price. It may decrease due to different maturities of instruments, as the parent bank's funds are in most cases received with a shorter maturity and at a lower price than e.g. bonds. However, given the large share of customer deposits, a shift in the funding structure will evidently not influence the average price of funding of the banking sector significantly.

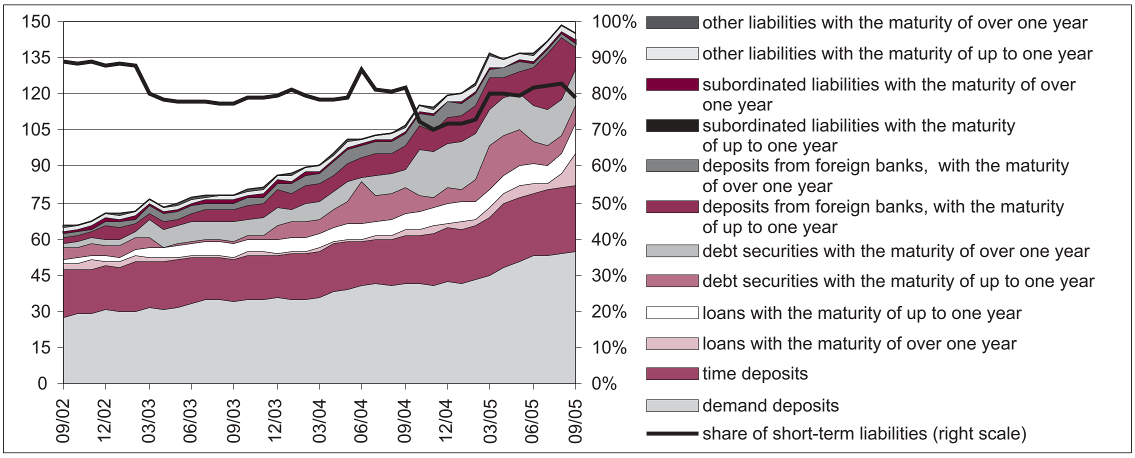

Figure 3.12. Structure of banks' liabilities (EEK bn)

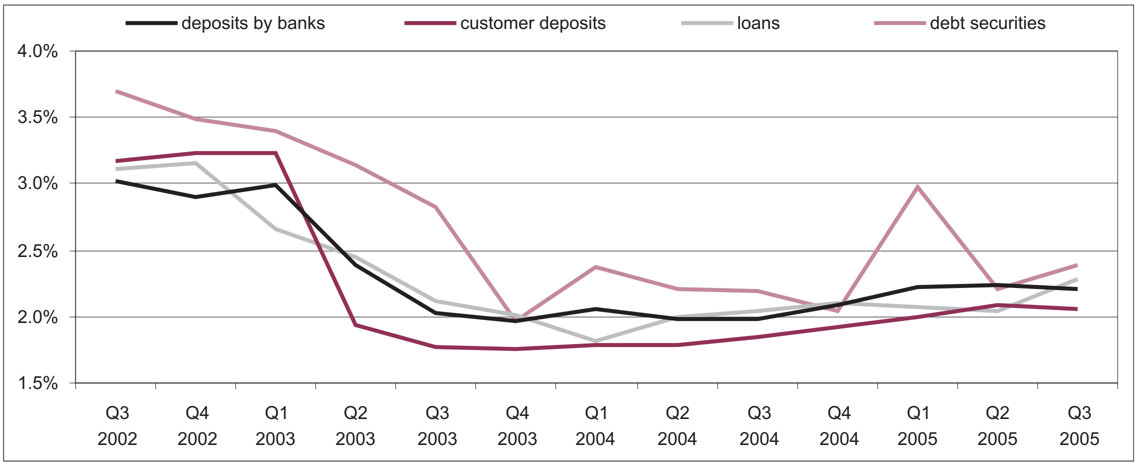

Figure 3.13. Weighted average interest rate on funds attracted by instruments

Liquid Assets

A decline in the interest income from interest-earning assets and less active inclusion of market-based funding have brought about a decrease in the share of **liquid assets**, which are generally low-yield instruments, by 6 percentage points to 19% of the total assets compared to the period six months ago. This indicator remains 2 percentage points below the average of the last three years (see Figure 3.14). Meanwhile, the liquidity of nearly all major banks has decreased which may be related to changes in liquidity management, whereas for smaller banks a rise in the share of liquid assets can be detected. The decrease of liquid assets in major banks might deepen even further, which might entail higher demands on banks' liquidity management and make banks more dependent on their parent banks and the market situation.

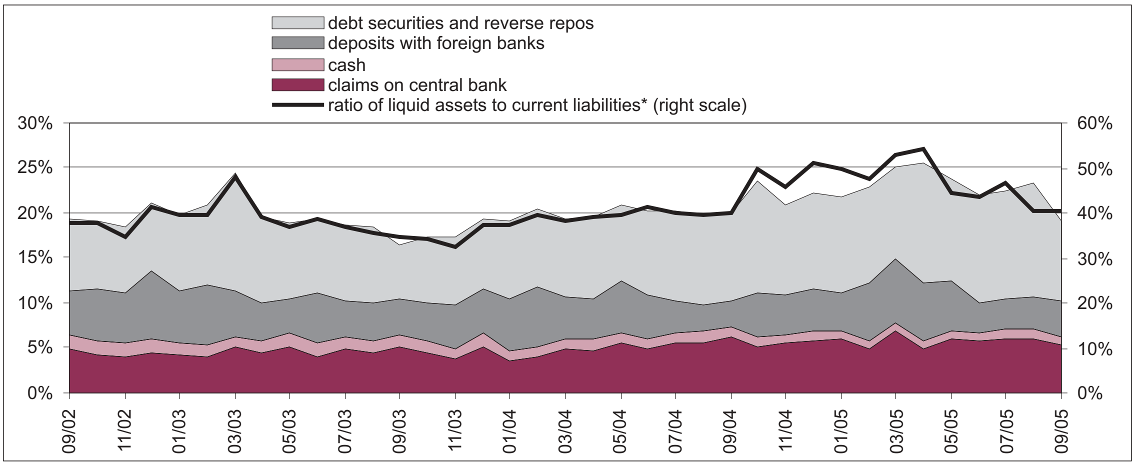

Figure 3.14. Share of liquid assets in total assets and current liabilities

* current liabilities – remaining maturity of up to one month

Efficiency and Profitability

Efficiency and Profitability of Banks on a Solo Basis

Asset utilisation[5] of the banking sector, i.e. the ability to earn income, is going through a steady decrease due to rapidly growing interest-earning assets and the declining net interest margin (see Table 3.1). **Profit margin**[6], i.e. the ability to earn profit from income, has increased due to improved cost efficiency, changes in the accounting of provisions and goodwill arising from the adoption of IFRS/IAS, as well as due to a slight rise in other operating income. Thus, **return on equity** of the banking sector rose by 2.7 percentage points to 22.3% in the third quarter, year-on-year. The level of return on equity of major banks has also levelled off.

Table 3.1. Banks' profitability on a solo basis

	2001	2002	2003	Q3 2004	2004	Q1 2005	Q2 2005	Q3 2005
Asset utilisation	11.4%	9.3%	7.9%	7.6%	7.4%	7.2%	7.2%	7.1%
Return on assets	2.66%	1.55%	1.70%	2.17%	2.14%	2.06%	2.08%	2.12%
Profit margin	23.4%	16.8%	21.7%	28.6%	28.8%	28.6%	28.8%	30.0%
Return on equity	20.7%	14.7%	14.1%	19.6%	20.0%	20.3%	21.4%	22.3%
Cost-to-income ratio	0.53	0.62	0.53	0.45	0.46	0.46	0.46	0.45

The share of **net interest income** in total income fell from 30% to 27%, year-on-year, owing to the fall in interest income and the rise in interest expenses. The decline in the interest income as a share of **interest-earning assets** slowed down in the last two quarters, which partly owes to the larger share of the loan portfolio that increased at the expense of a decrease in the share of liquid assets. Therefore, the fall in **net interest margin** and **spread** has also slowed down (see Figure 3.15). The rise in the interest expense as a share of **interest-bearing liabilities** that started in the last quarter of 2004 has remained slow but stable. The increased share of deposits did not decrease the average price of funding, as for larger banks deposits offer an alternative for the parent bank's funding at a comparable price.

[5] Asset utilisation is calculated by dividing total income by total assets. Return on assets is calculated by dividing net profit by total assets.
[6] Profit margin is calculated by dividing net profit by total income.

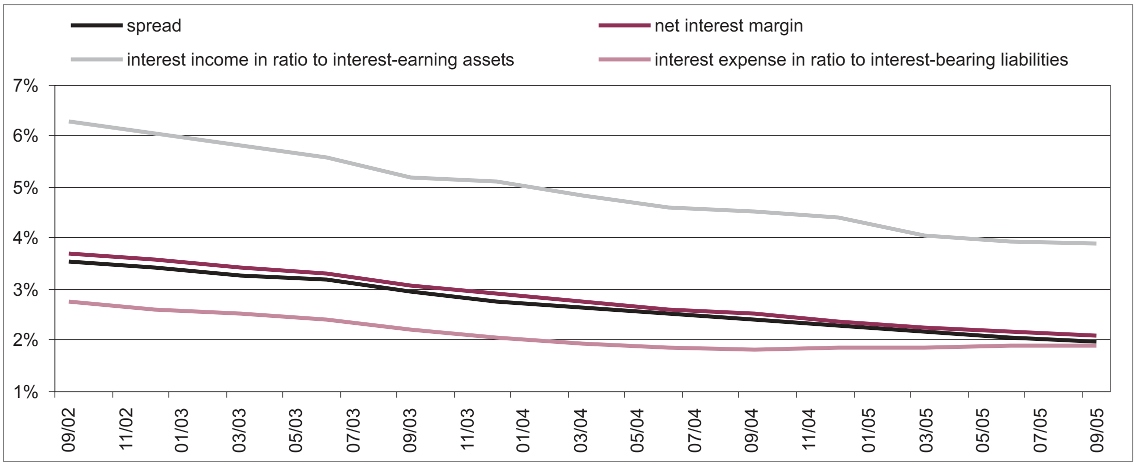

Figure 3.15. Net interest margin and spread on a solo basis

Net income on financial investments in subsidiaries accounted for about one tenth of the total four-quarter income of the banking sector, which shows no remarkable year-on-year change (see Figure 3.16). **Net fee and commission income** has remained around 14% of the total income from the beginning of 2004. In line with a decrease in asset utilisation, the ability to earn fee and commission income has also declined. This reflects banks' limited opportunities to raise fee and commission income under tight competitive pressures, even though their pricing is less transparent compared to e.g. interests.

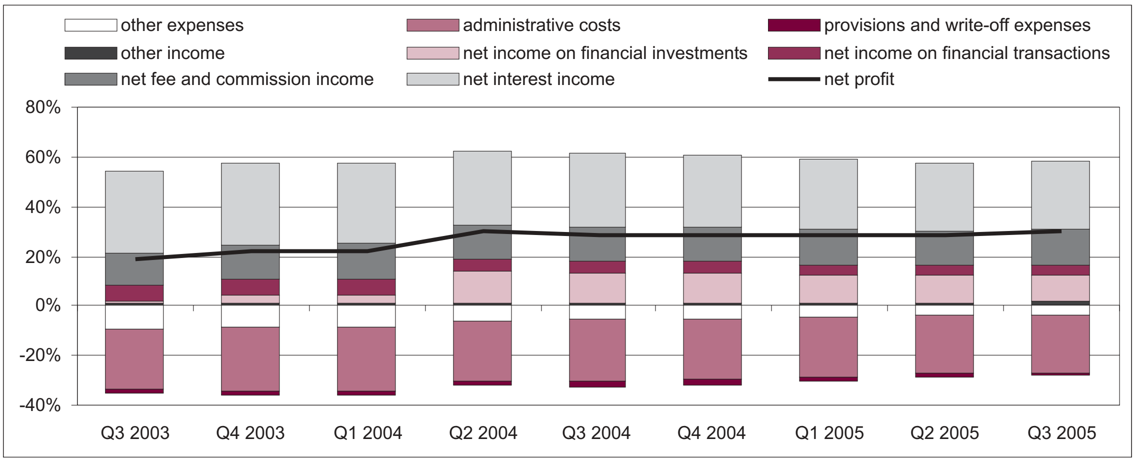

Figure 3.16. Income, expenses and net profit on a solo basis (% of total income)*

* All figures are four-quarter moving cumulative

A decrease in the **write-offs of claims and off-balance-sheet liabilities** contributed largely to the increase in profitability. This stemmed not only from better loan quality under favourable economic conditions, but also from changes in the accounting of provisions arising from the adoption of IFRS/IAS. Profitability was moreover boosted by a decrease of other costs. Cost-to-income ratio fell by 0.3 percentage points to 45.0% over four quarters. This was caused by the implementation of the above standards, which brought about a decrease in depreciation costs of goodwill, and control of administrative costs. Cost efficiency varies greatly across banks: in the third quarter, the median cost-to-income ratio was 58% (branches excluded), which indicates opportunities for an additional raise in the cost efficiency of the banking sector.

Further development of banks' profitability is affected by various contradictory factors. On the one hand, the economic outlook is expected to remain good, facilitating loan demand and loan quality as well as banks' income growth. A further decline in loan margins is unlikely, as their level is already low compared to the euro area loan margins. On the other hand, the rise in the euro area key interest rates would raise the EURIBOR and this, in turn, should restrain loan demand and banks' income growth. Moreover, the increase in key interest rates enables banks to postpone the rise in deposit interest and save on funding cost. The interests of loans with floating interest rate, which are dominant in banks' loan portfolio, would automatically rise. Further improvement of cost efficiency could increase banking sector profitability as well.

Efficiency and Profitability of Banks and Banking Groups on a Consolidated Basis[7]

Even though the income base has been strongly expanding, the consolidated **asset utilisation** of banks and banking groups has continued to decrease, similar to the solo indicators of the banking sector (see Table 3.2). Although **net interest rate margin** and **spread** declined further, the fall in **net interest income** was inhibited by increasing loans-to-assets ratio over the last two quarters. Unlike the solo indicator of the banking sector, banks and banking groups have been able to considerably enlarge the consolidated share of **net fee and commission income** in total income as well as in net interest income. This indicates the growth potential of the usage of banking services in Latvia and Lithuania. Thanks to the satisfactory quality of assets and changes in the accounting of provisions and goodwill arising from the adoption of IFRS/IAS, **profit margin** has also increased notably. Thus, consolidated **return on equity** of banks and banking groups has increased by 2.3 percentage points to 23.9%, year-on-year.

Table 3.2. Banks' and banking groups' profitability on a consolidated basis

	2001	2002	2003	Q3 2004	2004	Q1 2005	Q2 2005	Q3 2005
Asset utilisation	10.3%	9.1%	8.7%	8.7%	8.2%	8.0%	7.8%	7.7%
Return on assets	2.11%	2.12%	2.07%	2.15%	2.22%	2.15%	2.16%	2.18%
Profit margin	22.2%	24.6%	25.4%	26.7%	29.3%	29.5%	30.3%	31.3%
Return on equity	20.0%	20.3%	20.0%	21.6%	22.8%	22.8%	23.2%	23.9%
Cost-to-income ratio	0.61	0.61	0.52	0.50	0.50	0.49	0.48	0.47

[7] Consolidated analysis of banks and banking groups includes credit institutions, which form a consolidation group, and their subsidiaries on a consolidated basis, one separate credit institution on a solo basis, and branches of foreign credit institutions operating in Estonia, except for return on equity, when branches of foreign credit institutions operating in Estonia are excluded.