III BANKING SECTOR STABILITY AND RISKS

STRATEGIC DEVELOPMENT OF THE BANKING SECTOR

Seven companies licensed as credit institutions in Estonia and branches of seven credit institutions licensed in another European Union Member State were operating in Estonia at the end of September 2006. Four foreign credit institutions had representative offices in Estonia and over 120 foreign credit institutions had submitted applications to provide cross-border banking services.

The market shares of banks have not changed significantly in light of tough competition. Over 95% of the stock of loans and leases granted in Estonia is still divided among four major market participants. The same credit institutions also hold over 95% of the deposits in Estonia.

Although the year-on-year growth of the aggregate loan portfolio of banks licensed in Estonia and branches of foreign banks operating here exceeded 50% also at the end of the third quarter, the banking sector's assets increased by only a third within 12 months owing to the rearrangement of intra-group financing schemes[1] (see Figure 3.1). Thus also the share of loans issued to residents in banks' total claims has risen again. From among the claims against non-residents, those to German credit institutions comprised the greatest share at the end of September, followed by subsidiaries in Latvia and Lithuania (see Figure 3.2). However, total claims against non-bank non-resident customers remain relatively moderate, namely less than 5 billion kroons. Claims against Russian enterprises form the greatest share of this – approximately 1 billion kroons.

The rapid growth of the financing portfolios has been mostly supported by funds received from parent banks. In addition, deposit growth (which has remained over 30% despite the late summer slowdown) has contributed to the increase in banks'

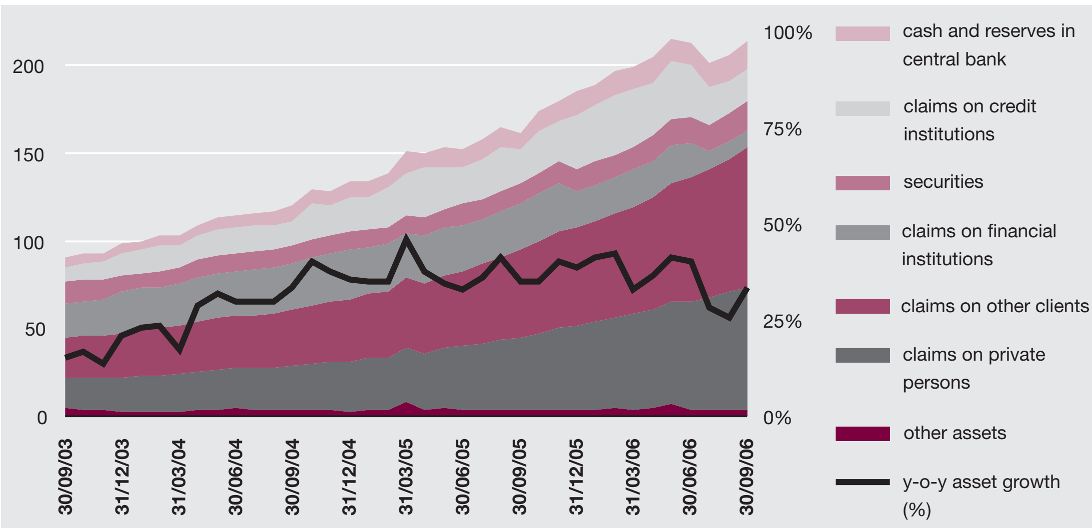

Figure 3.1. Banking sector assets (EEK bn)

[1] The intermediation of funds to subsidiary banks was reduced.

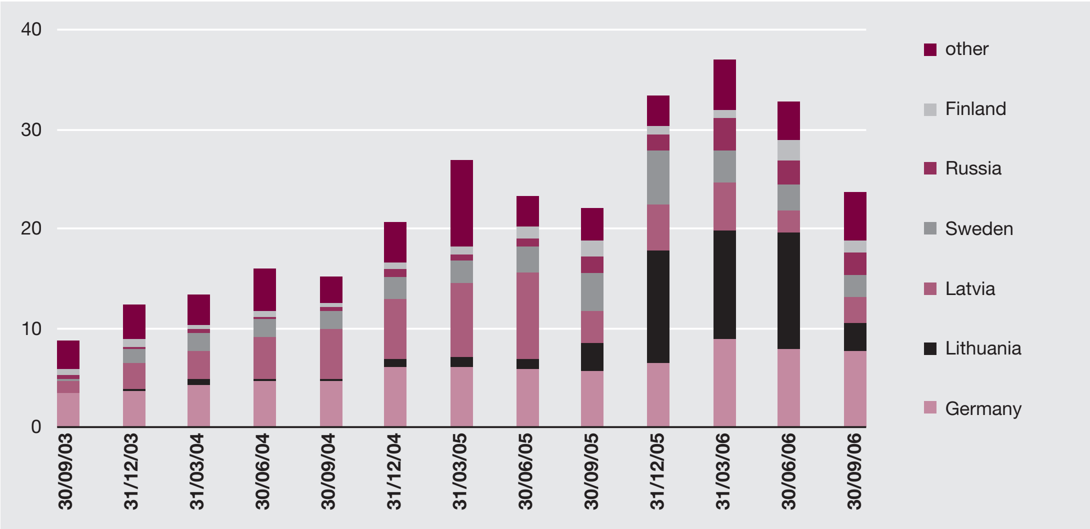

Figure 3.2. Banks' aggregate loans by client's residence (incl. MFIs; EEK bn)

financing portfolios. Thus, institutional foreign borrowing[2] comprised 39% of banks' liabilities at the end of the third quarter. The share of customer deposits has again risen to approximately 55% (see Figure 3.3).

Hence, due to rearrangements in financing schemes, direct links in between the balance sheets of non-resident subsidiaries with the local banking sector have weakened slightly. Yet, the banking sector is still heavily dependent on parent banks via management systems as well as the importance of parent bank funding.

QUALITY OF ASSETS

On the one hand, the risk level of the banking sector's loan portfolios may be regarded as diminished during recent periods, as the share of collateralised loans has risen. On the other hand, the concentration of risks is continuing. Therefore, it is increasingly important that the future loan-servicing capability of loan customers be considered more essential than the current market value of the collateral pledged and that the banks' own funds are sufficient enough to enable them to cope also with higher share of problematic loans than there currently is.

The annual growth rate of loans and leases issued in Estonia still exceeded 50% at the end of the third quarter of 2006, the total volume approaching 183 billion kroons. While the annual growth rate of corporate loans remained below 50% during the last half-year, the volume of outstanding household loans kept rising more rapidly. In early summer annual growth slowed slightly, but still remained over 60%. During the past six months the volume of household loans has increased by over 16 billion kroons.

The share of loans for the acquisition, development or renovation of real estate in banks' loan portfo-

[2] Deposits and loans, issued securities and subordinated liabilities from other banks.

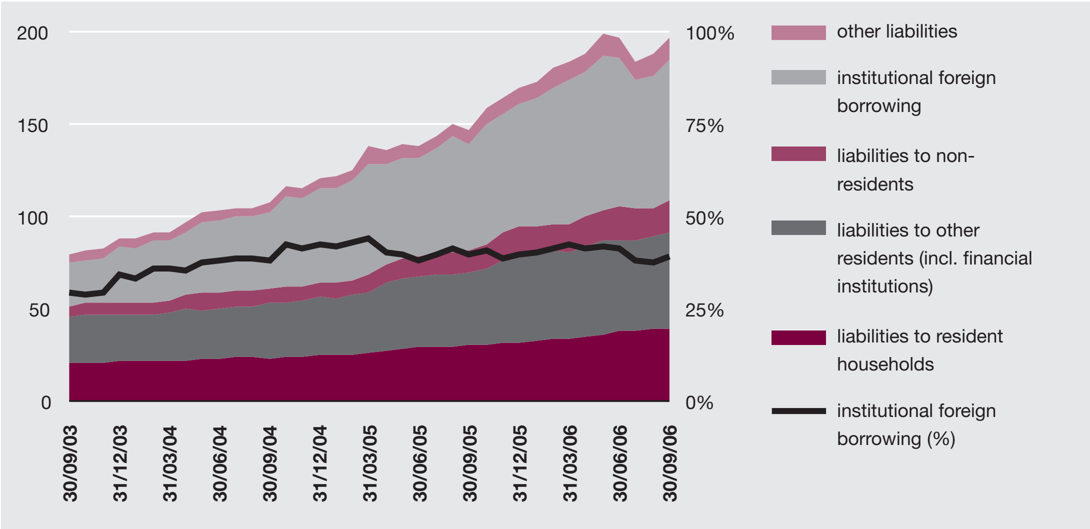

Figure 3.3. Liabilities of credit institutions (EEK bn)

lios has risen further (see Figure 3.4). The share of household loans taken to purchase or renovate real estate exceeded 32% at the end of the third quarter. The share of lease and loan financing of commercial real estate increased to 17%. The importance of using real estate as collateral for bank loans has also grown: at the end of the third quarter almost 80% of loans were collateralised by pledges of buildings or mortgages. Loans without collateral comprised less than 6% of all bank loans (see Figure 3.5). The share of (consumption) loans granted to households without collateral has increased to 2.7% within the past half-year. An estimated third of household consumer credit is collateralised by real estate.

Despite increased loan-servicing costs[3], the **loan-servicing capability of loan customers has been supported by favourable economic conditions** (see Figure 3.6). The share of **loans overdue by more than 60 days** among loans issued to the non-financial sector has remained at the average annual level, i.e. 0.3% on an aggregate basis. The ratio of the stock of allowances for uncollectible claims has diminished slightly[4], but the coverage of overdue loans with provisions has still remained at a relatively high level. At the end of the third quarter, the stock of provisions for loan losses exceeded the volume of loans overdue by more than 60 days by 40%, i.e. by nearly 200 million kroons.

As for sectoral breakdown, the share of overdue consumer credit has increased along with the surge in the volume of consumer credit. At the end of September, the share of consumer credit overdue by more than 60 days reached nearly 2% on an aggregate basis[5] (see also Figure 3.7). The slight decline of the quality of consumer credit is

[3] The majority of bank loans in Estonia are issued with floating interest rates and thus, interest payments have also increased due to higher key interest rates.
[4] Among other reasons, due to changes in the accounting principles.
[5] The aggregate of “other household loans” is lower owing to the better quality of study loans.

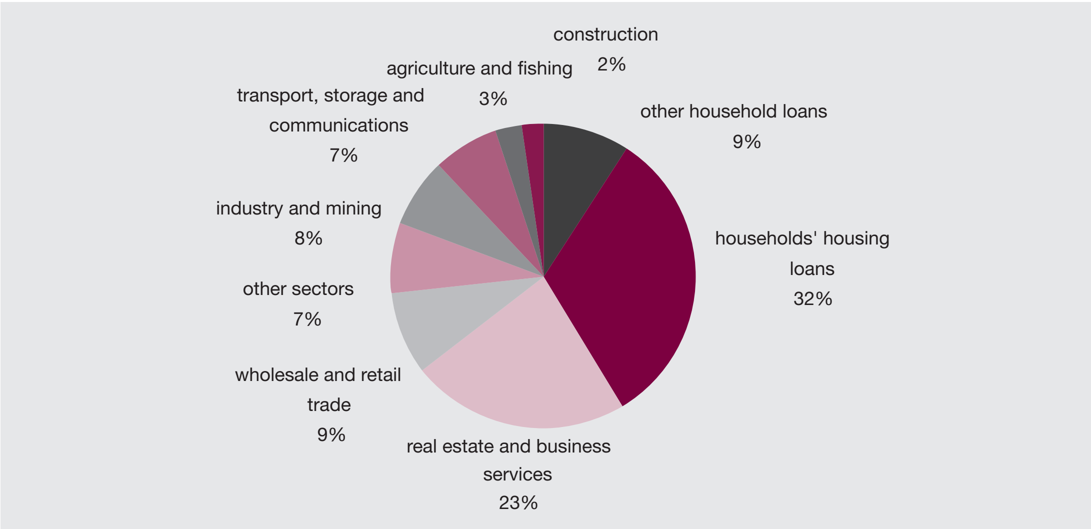

Figure 3.4. Financing by banks and leasing companies (as at 30 September 2006)

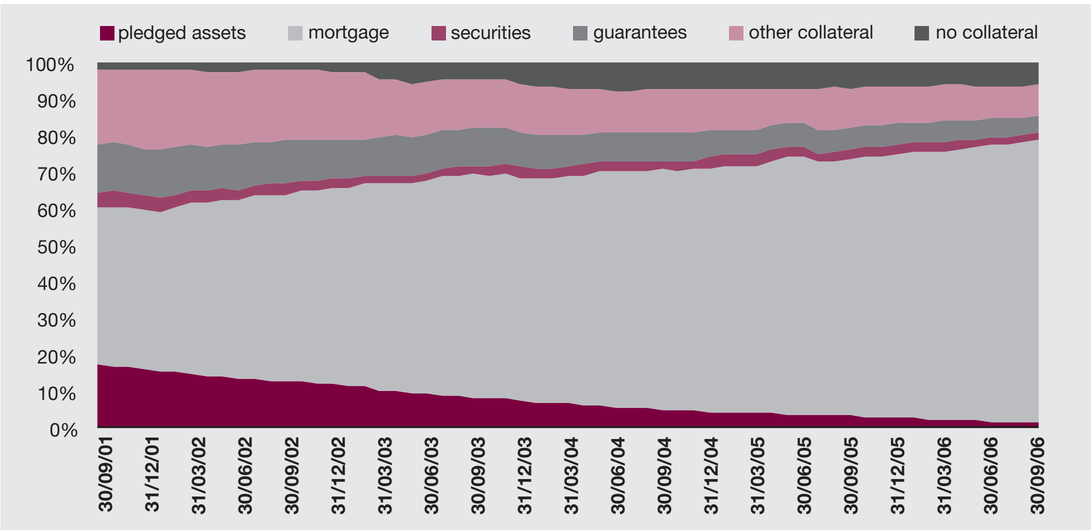

Figure 3.5. Loan collaterals by type

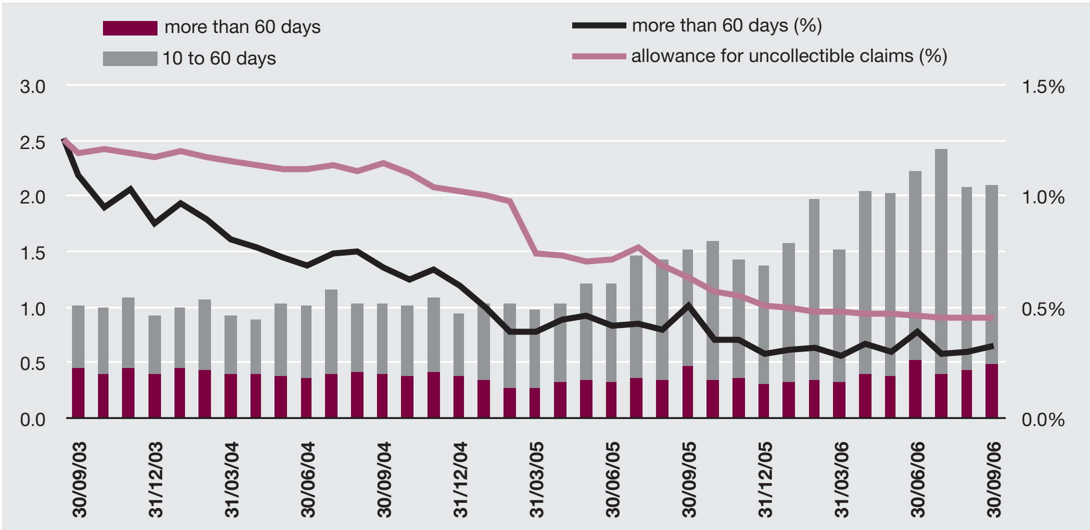

Figure 3.6. Volume of overdue loans (EEK bn; left scale) and share of overdue loans and allowance for uncollectible claims in banks' loan portfolio (right scale)

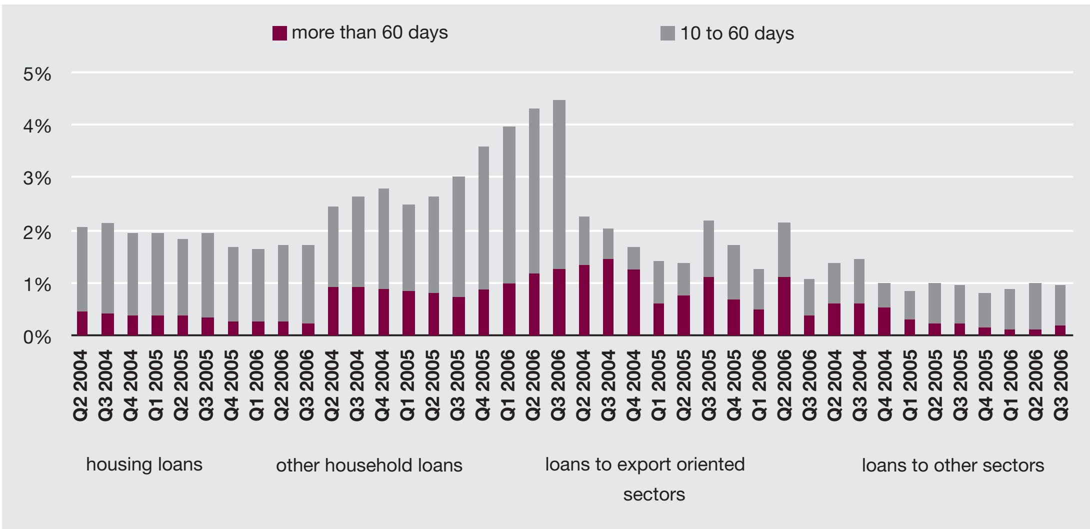

Figure 3.7. Overdue loans by economic sectors (3 months average)

also reflected in banks' assessments of uncollateralised household loans. At the end of September, banks classified 96% of all household loans without collateral as "in order" (almost 1 pp less than six months ago). Regarding the total loan portfolio, however, banks' assessments have become slightly more positive during the past half-year.

CAPITAL ADEQUACY

As of 1 March 2006, the central bank decided to increase the risk weight for housing loans issued to Estonian residents in calculating the risk weighted assets from 50% to 100%. As expected, this has brought along a rise in the capitalisation of banks. The higher capitalisation, however, is not a reflection of a slowdown in the growth of loan portfolios, but rather of the rearrangement of intra-group financing schemes and the inclusion of additional own funds.

Although financing has kept growing rapidly, since the end of the first quarter **banks' risk weighted items have increased** by only 15 billion kroons (about 10%) up to 166 billion kroons. During the past six months, **own funds** taken into account in the calculation of banks' capital adequacy have increased by 25%, i.e. by 4.6 billion kroons up to 23.4 billion kroons (see Figure 3.8).

However, the **structure of risk weighted items** has not changed significantly during recent quarters – nearly 98% of the risk weighted items still stem from credit risk weighted on- and off-balance-sheet items. Meanwhile, the **structure of banks' own funds** has changed – the share of Tier 2 own funds has increased (see Figure 3.9). In September last year, subordinated liabilities (which fall under Tier 2 own funds) comprised approximately 10% of Tier 1 own funds, whereas in September 2006 this indicator exceeded 40%. The possibilities for a further increase in the share of subordinated liabilites are limited due to the legal provision pursuant to which the sum of subordinated liabilities and preferred shares included in Tier 2 own funds may not exceed 50% of Tier 1 own funds. Furthermore, major banks have already included an essential part of the current period's profits in own funds. Therefore, banks' possibilities to increase own funds by auditing the current period's profit and thereafter including it in own funds are limited.

On an aggregate basis, the capitalisation of banks and their ability to absorb loan losses

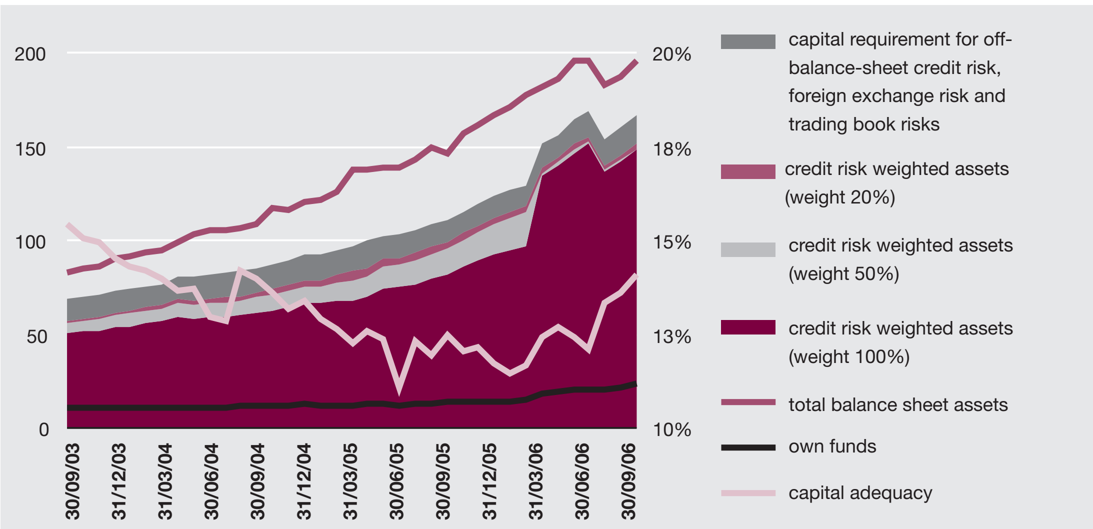

Figure 3.8. Structure of banks' aggregate risk weighted items and own funds (EEK bn)

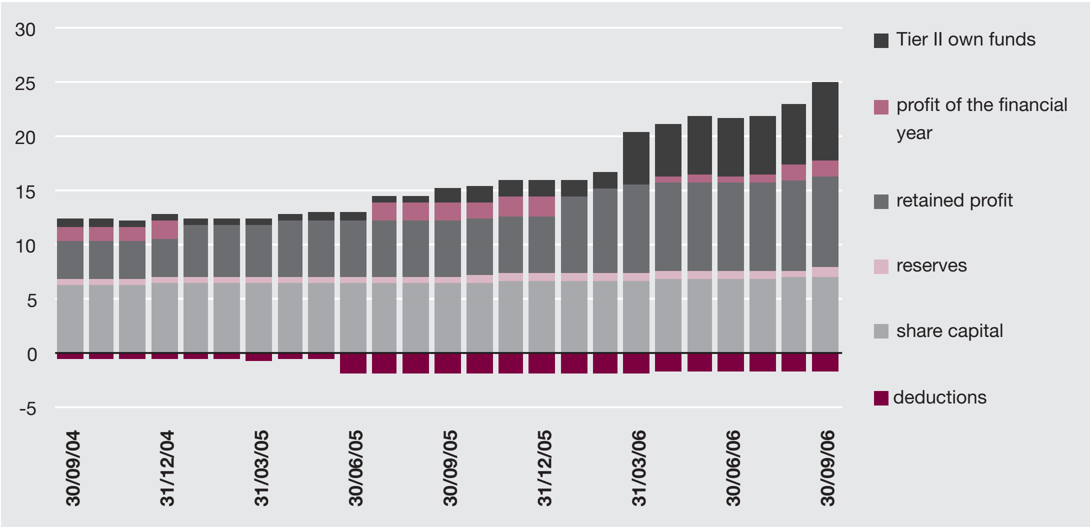

Figure 3.9. Structure of banks' own funds (EEK bn)

has continued to grow, reaching 14.1% by the end of September (12.4% in late March). On the other hand, the capitalisation rate of banks varies greatly: the lowest rate among banks at the end of September was 10.7% (see also background information "Capitalisation of banks").

As for future developments, one may nevertheless presume that non-resident parent banks are still interested in investing own funds in Estonia as long as the return on own funds in the Estonian market exceeds the return on alternative investment opportunities and they find the local risk-return ratio acceptable.

CAPITALISATION OF BANKS

Although in recent periods, the annual net write-downs of loans of banks as well as banking groups have remained below half a percent, it is important for the future sustainable operation of the banking sector that banks be able to cope with the impacts of a more unfavourable economic environment than today.

The banking sector data for the end of the third quarter of 2006 indicate that compared to the first quarter of 2006 banks' ability to absorb loan losses on an aggregate basis had improved, but the capitalisation rates varied greatly bank by bank. While at the end of the first quarter, meeting the capital requirement would have become problematic for the banking sector on an aggregate basis in the event of an over 4% additional write-down of loans, at the end of the third quarter the sector's aggregate would have fallen below the required minimum level (10%) in the event of an over 6% write-down. Meanwhile, the first bank whose capital adequacy indicator stood at 10.7% in late September would already have encountered problems in the event of a 1%

one-off additional write-down. The normative indicator of the next bank would decrease below 10% in the event of a more than 2% additional write-down.

The strength analysis of the housing loan portfolio recently carried out by banks indicated that the influence of a 1–2 percentage point key interest rate rise on the quality of banks' housing loan portfolios would be more severe than that of unemployment growth up to the highest level of the recent few years. The analysis also showed that the probability of becoming impaired is 1–2 times greater in the cases of loans granted within the past year than in the cases of loans issued earlier.

LIQUIDITY

Funding of banks

Banks' funding structure has been affected by rearrangements in intra-group financing schemes as well as by the inclusion of additional own funds owing to capital adequacy regulation amendments and the rapid growth of risk weighted assets.

In the first half of 2006, the share of **liabilities received from foreign banks** in the banks' structure of liabilities increased even further. With the rearrangement of intra-group financing schemes, the financing of subsidiaries through the Estonian banking sector was significantly reduced.[6] Therefore, in June and July 2006, liabilities to foreign banks decreased by over a fifth (see Figure 3.10). The impact of these changes on the banking sector may be regarded as positive as it ties the banking sector's funding more explicitly to the domestic economy and decreases the risks related to neighbouring countries.

Hence, despite the ongoing active borrowing the share of **institutional foreign borrowing** in total liabilities was also not much greater at the end of September 2006 compared to the same period last year. It has remained at a similar level of 39%. After effecting the changes, however, the volume of liabilities to parent banks has begun to increase again.

Customer deposits have continued to provide a favourable source for funding banks' lending. Their annual growth has decelerated compared to last year's fourth quarter and this year's first quarter, but still remains over 30%. The growth of customer deposits has not been accompanied by an increase in time deposits. Although the share of customer deposits has increased, the same cannot be said about time deposits. Their share accounts for less than a fifth of all customer deposits.

The volume of loans granted to the non-financial sector has grown faster than customer deposits. This has entailed steady growth in the **loan-deposit ratio**[7], which reached the level of 1.35 in September 2006 (see Figure 3.11). Thus, lending to the non-financial sector is less and less funded by customer deposits.

[6] The total volume of the redirected financing of subsidiaries amounted to about 20 billion kroons, half of which reached non-resident subsidiaries directly while the rest went through loans granted to intra-group financial institutions by banks. Since then, the funding of non-resident subsidiaries has been continued to some extent by offering short-term liquidity as well as long-term funds. At the end of September, claims against Latvian and Lithuanian banks comprised nearly 2% of the total assets of banks.

[7] Unlike in the previous issue of the Financial Stability Review (May 2006), loans granted to financial institutions have been excluded from loans, as financial institutions are increasingly funded directly by their group's parent banks.

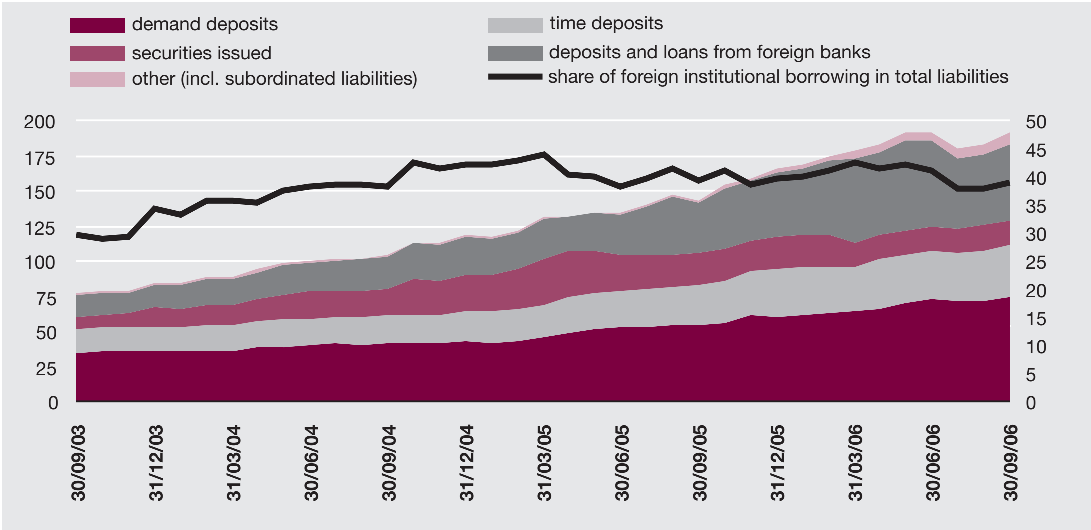

Figure 3.10. Structure of liabilities (EEK bn; left scale) and share of foreign institutional borrowing in liabilities (%; right scale)

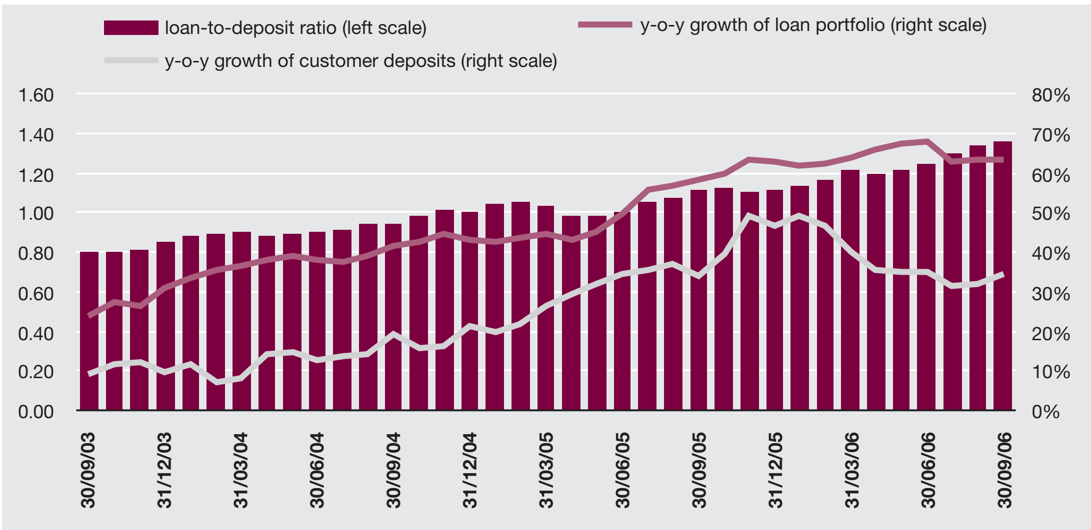

Figure 3.11. Loan-to-deposit ratio and annual growth of loan portfolio and customer deposits

Due to the capital adequacy regulation amendments and in order to alleviate capital needs accompanying the high lending activity, banks have increased **subordinated liabilities**. Their share of total liabilities has increased from 1% the year before to 4% by September 2006.

Together with the key interest rates of the European Central Bank, all average interest rates on funds included by banks have also risen (see Figure 3.12). Among other things, banks have continued to raise the interest rates on time deposits. Compared to other funds, the **average interest rate of funds** received from other banks has grown at a slower pace. Moreover, since the second quarter of 2006 it has been even slower than the average interest rate of customer deposits that was so far considered the cheapest.

Liquid assets

Banks' liquidity position has also been largely affected by changes in intra-group financing schemes. While at the end of last year, the **share of liquid assets in total assets** grew considerably owing to an increase in claims related to banks' financing of subsidiaries; in June 2006 claims against foreign banks decreased and the share of liquid assets diminished to 18.6% (see Figure 3.13). Excluding claims related to financing subsidiaries, liquid assets comprised approximately 17% of total assets at the end of September 2006 and as a 12-month average. This means that their volume remained relatively stable in relation to total assets.

Changes in liquid assets have also influenced the **coverage of current liabilities by liquid assets**. Excluding claims related to financing subsidiaries, it has nonetheless remained quite steady at the average level of the past 12 months, i.e. at 33% (32% in September 2006). Thus, the liquidity position of banks has not deteriorated compared to last year.

On 1 September 2006, Eesti Pank raised the **reserve requirement** of banks from 13% to 15%. This means that instead of 13%, banks have to hold 15% of their required reserve base in the central bank or own highly liquid securities. Based on the data for September 2006, banks have reduced their so-called voluntary liquidity buffers simultaneously

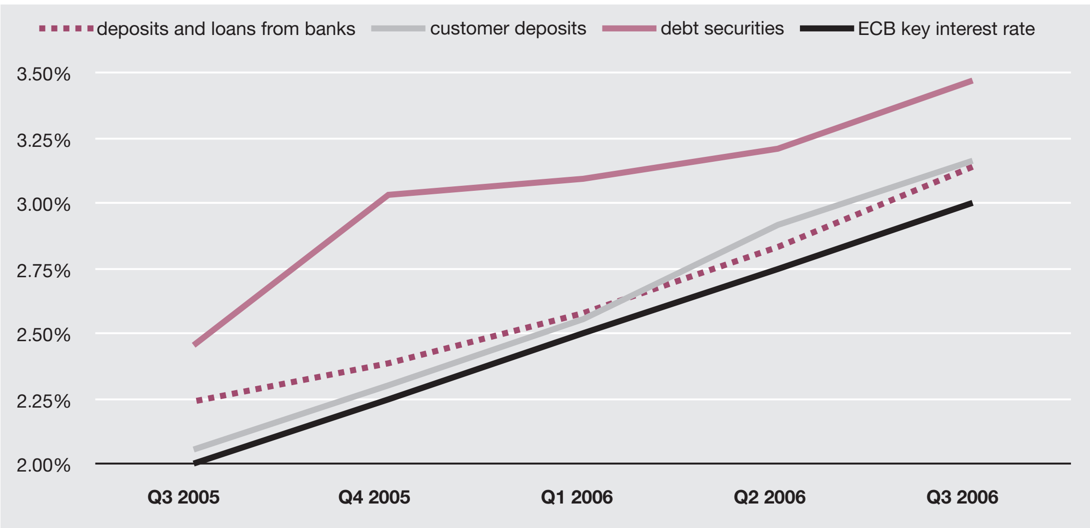

Figure 3.12. Structure of liquid assets (% of total assets) and ratio of liquid assets to current liabilities

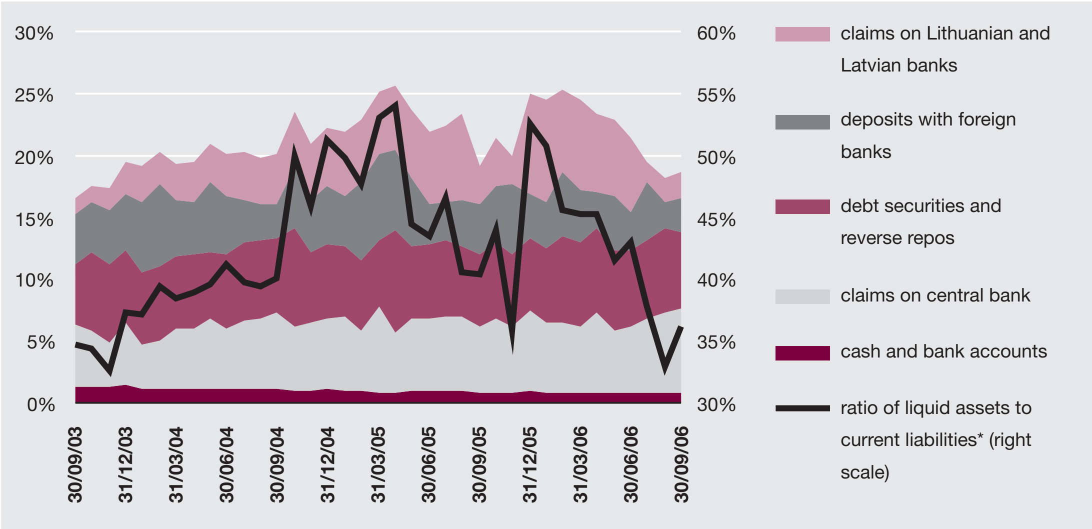

Figure 3.13. Structure of liquid assets and their share in current liabilities (% of total assets)

* current liabilites – remaining maturity of up to one month

with fulfilling the new reserve requirement. Thus, although the share of highly liquid assets in the structure of liquid assets has increased, total liquid assets have grown less than the reserve requirement.

EFFICIENCY AND PROFITABILITY

The **banking sector's profitability indicators** again reflect the importance of the share of profits earned from subsidiaries in the revenues of the banking sector (see Table 3.1). Namely, the profitability of banks has decreased[8] since the second quarter of 2006 primarily due to lower dividend income from subsidiaries than in earlier years.[9] The increase in key interest rates, on the other hand, has had an expectedly positive influence on the profitability of the banking sector, as the majority of bank loans in Estonia have been granted with floating interest rates. Thus, the **average interest income on interest-earning assets** has increased in 2006. Although the **average interest paid on interest-bearing liabilities** has also risen, this increase did not match the income growth. This is reflected in the growth of the **spread** and the **net interest margin** during this year (see Figure 3.14).

While the growth of **net interest income** accelerated, the growth rate of **net fee and commission income** earned by banks has decelerated. In addition, the ratio of fees and commissions to assets has slightly declined. The ratio of fees and commissions to interest income has decreased from its peak of 54% in the third quarter of last year to 42% in the third quarter of 2006, while the ratio of net fee and commission income to average assets declined from 1% to 0.9% (see Figure 3.15). The slowdown in the growth of fees and commissions may have been partially caused by changes in the accounting principles[10], but this does not explain the decrease fully.

[8] As the average aggregate ratio of four consecutive quarters.
[9] Contrary to earlier volumes, subsidiaries did not pay out earned profit as dividends.
[10] The reason for that is the application of an effective interest rate principle according to which a significant part of loan fees and commissions is spread out over the entire loan period and reflected as interest income.

Table 3.1. Banks' profitability on solo basis (%)

	2002	2003	2004	2005	Q1 2006	Q2 2006	Q3 2006
Asset utilisation	9.3	7.9	7.4	6.7	6.4	6.0	6.2
Return on assets	1.6	1.7	2.1	2.0	1.9	1.5	1.6
Profit margin	16.8	21.7	28.8	29.4	30.3	25.5	25.7
Equity multiplier	7.3	7.9	8.8	9.9	10.1	10.5	10.6
Return on equity	14.7	14.1	20.0	21.0	21.3	17.1	18.0
Cost-income ratio	61.6	53.0	45.8	45.6	45.0	49.6	48.4
Net interest margin	3.6	2.9	2.4	2.0	2.0	2.0	2.1
Spread	3.4	2.8	2.3	1.9	1.9	1.9	2.0

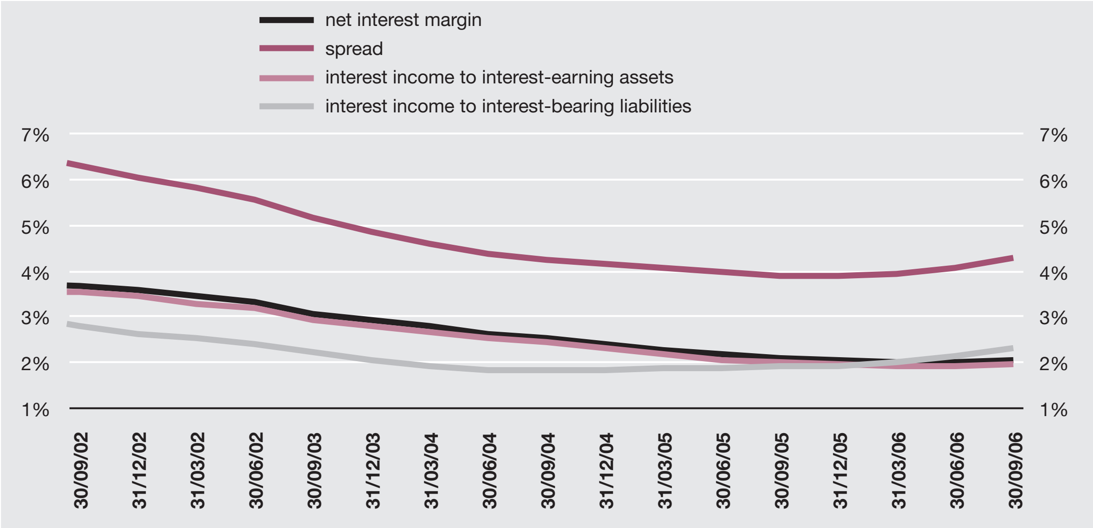

Figure 3.14. Banks' aggregate net interest margin and spread

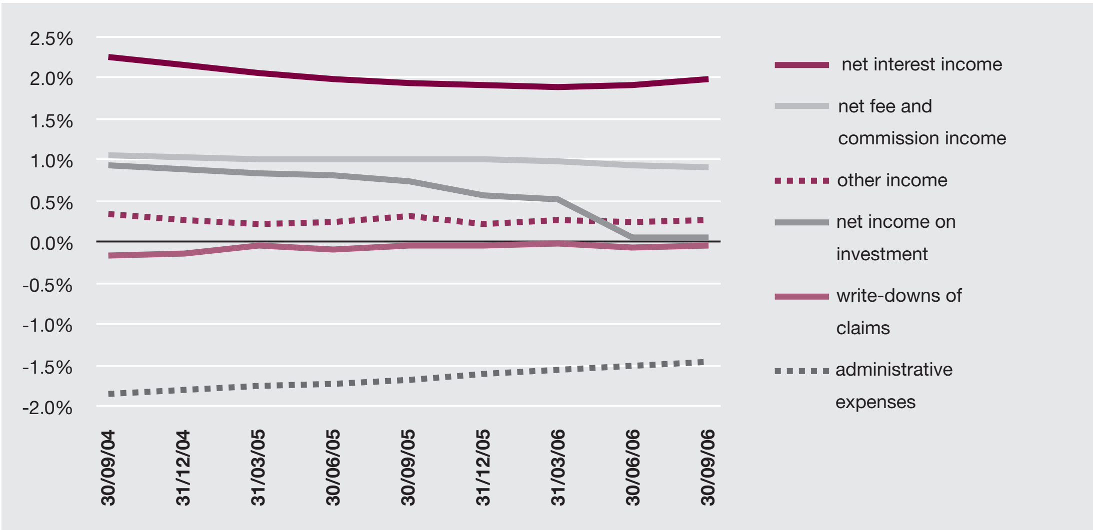

Figure 3.15. Income and expense items by type (% of total asstes)

In addition to a growth in interest margins the banking sector's profitability has continuously been supported by keeping the increase of costs under control as well as the good quality of assets. Though in the last two quarters the **cost-income** ratio of the banking sector was higher than in the respective period last year, the ratio of costs to total assets has kept on shrinking. The Estonian banking sector's cost-income ratio (48% in the third quarter of 2006) is lower than the average indicator of European banking sectors (60%). A comparison with Nordic countries, however, suggests that our banking sector's cost-income ratio (1.5%) may not have reached its potential minimum level yet (e.g. 1% in Sweden and Denmark in 2005)[11].

Regarding the future profitability of banks, it may be presumed that should the increase in key interest rates continue it would also be manifested in the growth of net interest margins. Especially considering that despite tough competition in the banking sector there does not appear to be much room left for a further decrease in loan interest margins. The dynamics of interest costs, at the same time, largely depend on the price asked for funds by parent banks. Although customers' loan demand may decrease if interest rates continue to rise (this may be reflected in the income earned on issuing loans), at the same time the appreciation of key interest rates may increase customers' interest in changing loan terms and conditions. In regard to fee and commission incomes, the possibilities of enhancing incomes from payment intermediation and investment services may not be exhausted yet either. Future dividend incomes from subsidiaries, however, greatly depend on the development of those markets where the subsidiaries are operating and on their potential need for additional capital. Moreover, international comparison shows that the possibilities for a further decrease in the cost-asset ratio may not yet be exhausted.

[11] Source: "EU banking sector stability" (2006).