V OTHER FINANCIAL MARKETS

INVESTMENT FUNDS

Since the end of March 2005, the **yield** of investment funds has been mainly influenced by the increase of key interest rates and the greatest correction in recent years in the stock markets (see Figure 5.1). It primarily affected the yield of stock funds, which decreased by 15% as a moving average. The rise of key interest rates increased the average yield of money market funds, which stood at 2.1% at the end of September.

Owing to the high comparison basis on the one hand and the correction of stock markets on the other, the **asset growth of investment** funds that had lasted for several years **slowed down**, reaching a year-on-year result of nearly 37% by the end of September (see Figure 5.2). However, the asset growth of investment funds reached a record 16.8 billion kroons at the end of September. The correction had the strongest impact on stock funds as their volume growth decelerated five-fold within the half-year – down to 54%. The annual volume growth of money market funds accelerated to 30% owing to the rise of key interest rates, while the assets volume of interest funds has shrunk by a fifth during the year.

Similarly to the first quarter of 2006, the **share of foreign assets in the assets of funds** also decreased in the third quarter. At the end of September it encompassed 78% of the total (see Figure 5.3). The share of foreign assets has diminished mainly because investments in the shares of residents' and domestic deposits have shrunk. Investments in the markets of the EU rose to 65% of foreign assets by the end of the period (see Figure 5.4). During the past half-year, the greatest increase was experienced by investments in the markets of Russia and EU member states, particularly Austria, Luxembourg, France and Hungary, where 85% of the volume of new investments was channelled. The total volume of instruments issued to the Estonian stock, bond and fund markets continued to equal approximately 2.9 billion kroons, i.e. 12% of the assets of the investment and pension funds registered in Estonia. In nominal terms this is slightly over a tenth more than at the end of March

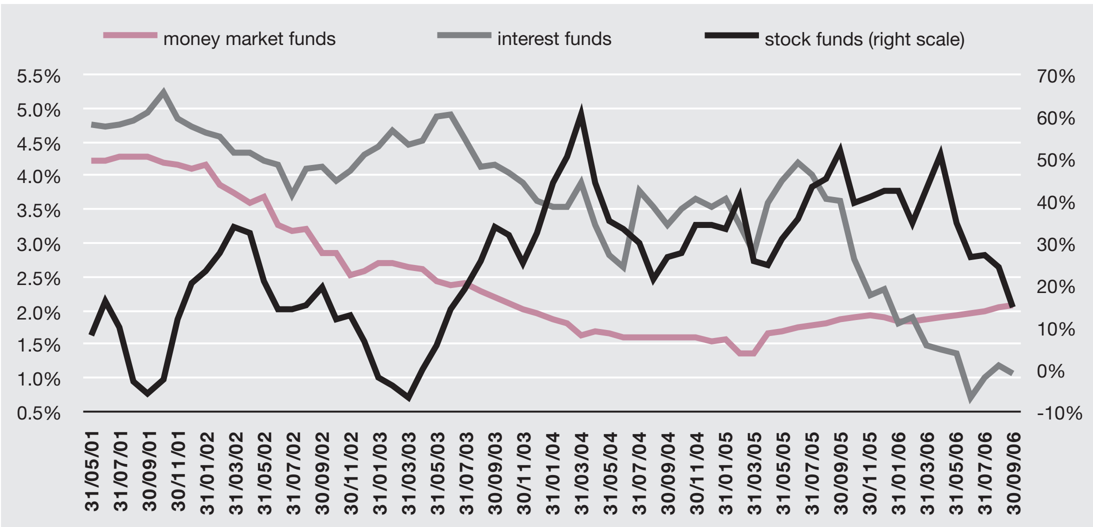

Figure 5.1. Average yield of investment funds (%)

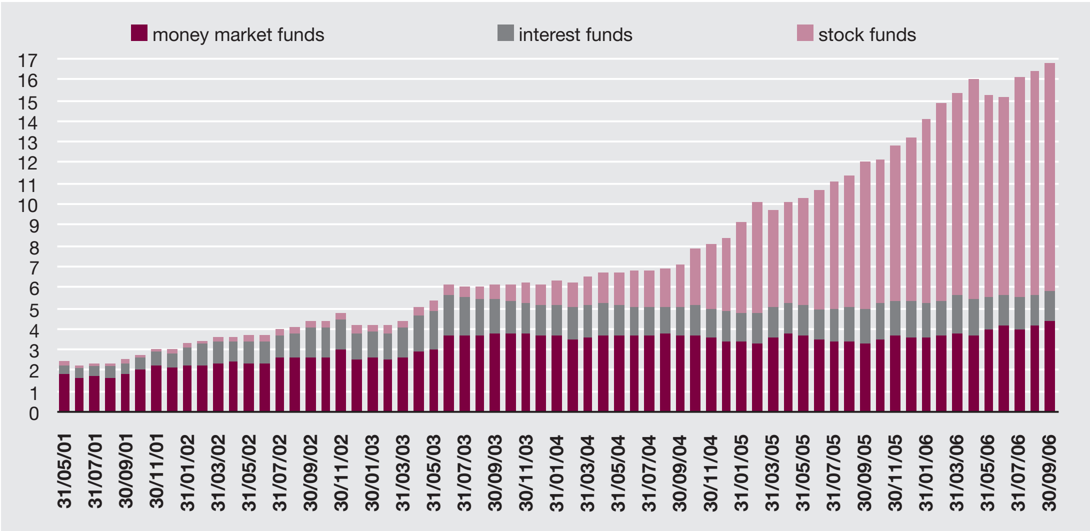

Figure 5.2. Volume of investment fund assets at end-month (EEK bn)

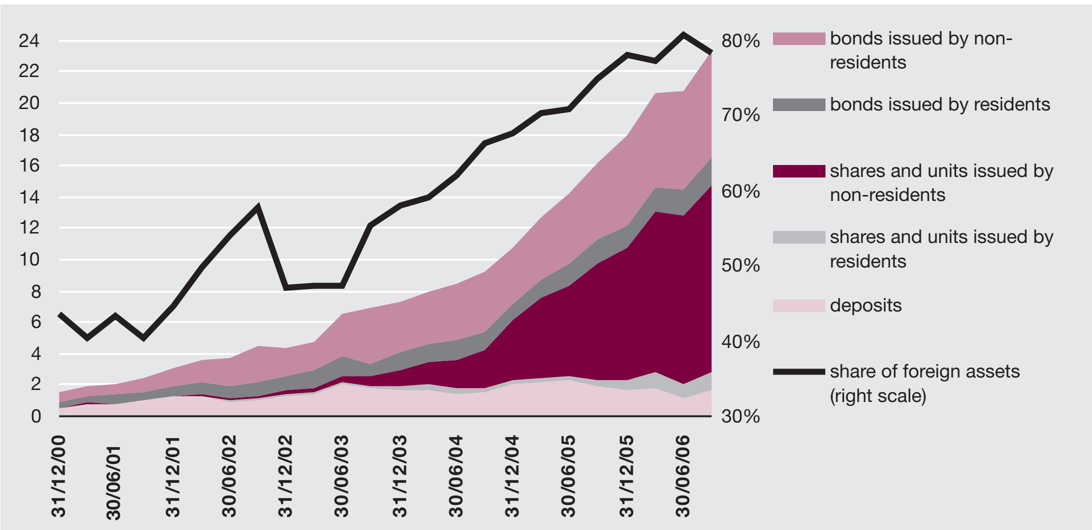

Figure 5.3. Structure of investment and pensions fund assets (EEK bn) and share of foreign assets (%)

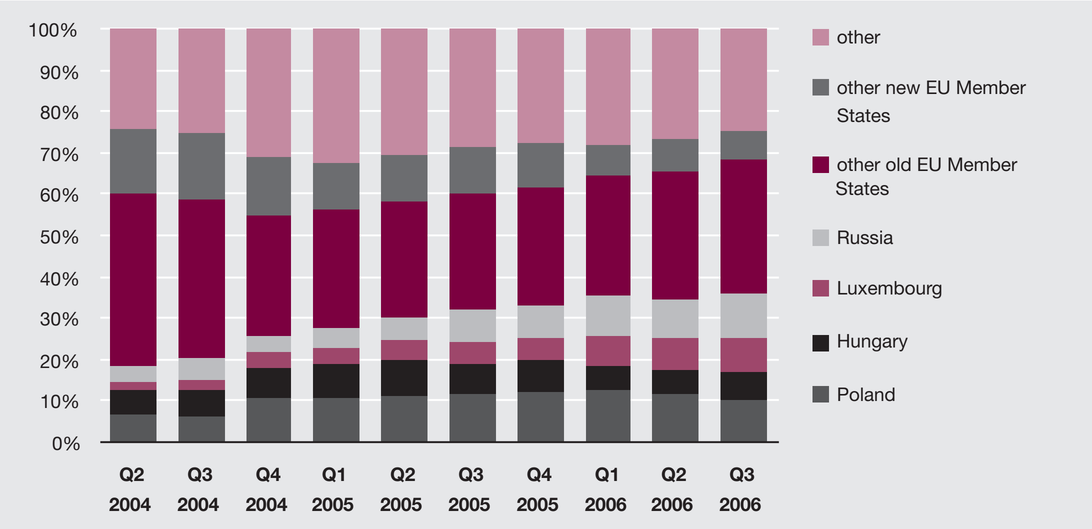

Figure 5.4. Foreign investments of investment and pension funds by residency at end of period

2006. As the number of securities listed on the stock exchange has grown recently, investments in domestic stocks and shares have increased by a quarter, exceeding 1.1 billion kroons at the end of September.

In the past half-year, **two new stock funds** were added to mutual funds – Hansa Central Asia Equity Fund and Hansa Eastern Europe Real Estate Equity Fund. At least 50% of the assets of the Hansa Central Asia Equity Fund will be invested in Central Asian[1] stocks or similar tradable rights, with the rest invested in the deposits and money market instruments of issuers from the same region. The assets of Hansa Eastern Europe Real Estate Equity Fund will be allocated to the securities of Central and Eastern European[2] countries, including at least 50% to the real estate sector. The base currency of both funds is the euro.

By the end of October, 113 funds providing services all over the Baltic States had joined the **Baltic Fund Centre, a fund information environment created in the spring of 2006 and administered together by the stock exchanges of the Baltic States**[3]. In addition to the funds registered in the Baltic States, the Fund Centre also provides access to data concerning 33 funds registered in Luxembourg and 27 funds registered in Finland. The Baltic Fund Centre was created in order to provide information in comparable form and on common grounds about funds that publicly offer investment fund units in the Baltic States.

PENSION FUNDS AND INSURANCE

At the end of October 2006, the number of subscribers to the **second pillar of the pension system** amounted to approximately 517,000 persons, i.e.

1 Incl. Kazakhstan, Azerbaijan, Russia, Georgia, Uzbekistan, Armenia, Kyrgyzstan, Tajikistan and Turkmenistan.
2 Incl. countries that joined the European Union in 2004 as well as the current and future candidate countries.
3 For further information, see http://www.baltic.omxgroup.com/market/?pg=funds.

about 64% of the labour force. The total volume of the second pillar's funds increased by 58% (by 2.4 billion kroons) within the past year and stood at 6.6 billion kroons at the end of September. At the end of the third quarter, the total volume of the second pillar's pension funds comprised 27.6% of the financial assets invested in investment funds by households (compared to 25% a year ago; see Figure 5.5).

The number of subscribers to the **third pillar** reached nearly 100,000 persons by October 2006, comprising approximately 12.3% of the labour force. The year-on-year growth of the third pillar funds was 75%, i.e. 251 million kroons (in September 2005, it was 140% and 195.6 million kroons, respectively). Including pension insurance, by the end of the second quarter of 2006 the volume of the third pillar was nearly 2.2 billion kroons, of which pension funds comprised 25%. The share of pension insurance is on the rise again – half a year ago it constituted 70% of the third pillar's structure (see also Figure 5.6).

The **structure of pension fund assets** has changed slightly within the year. The share of investment fund shares and units in the asset structure of the second pillar pension funds has increased remarkably. A year ago they comprised 26%, while this year 35% of assets have been invested in the funds. Meanwhile, the importance of stocks and shares, as well as bonds, has decreased but compared to earlier periods, the percentage of residents' stocks and shares has increased.

As at the third quarter, the importance of investment fund stocks and shares had also increased in the investments of third pillar pension funds – from 33% to 50%. They gained primarily on the account of bonds, the importance of which decreased by 14% compared to the same period last year. Furthermore, the importance of stocks in the structure of assets decreased by 5%.

Similarly to second pillar investments, investments in resident stocks, shares and bonds have also increased in the third pillar. This was caused by recent issues in the domestic stock and bond market. To compare, in September 2005 the total volume of residents' stocks, shares and bonds

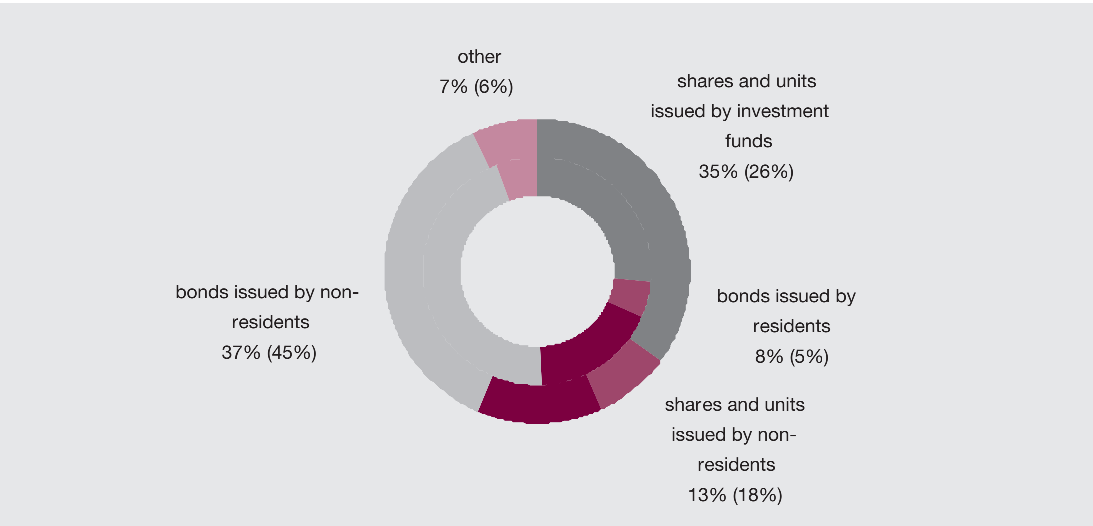

Figure 5.5. Structure of II pillar pension fund assets as at 30 September 2006 (position on 30 September 2005 indicated in brackets)

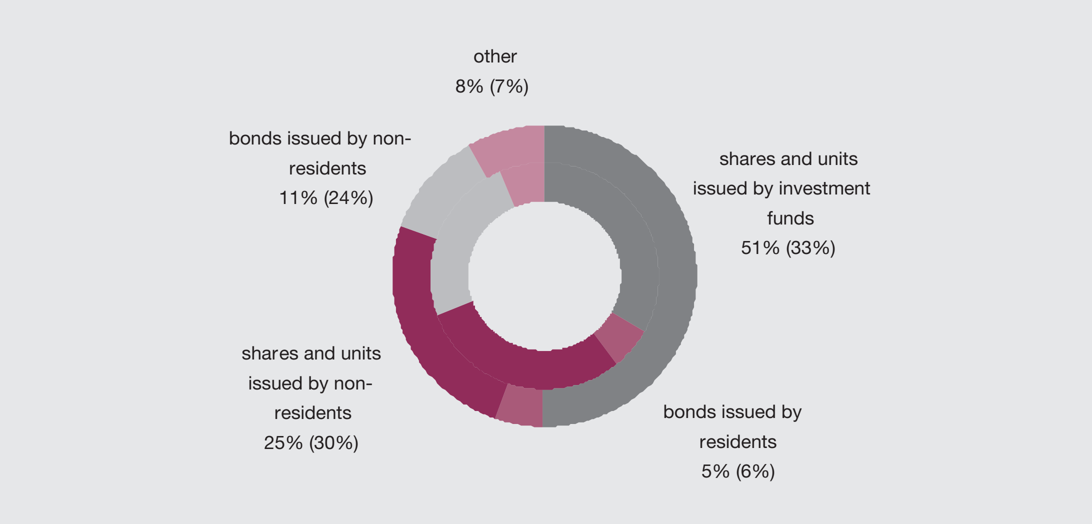

Figure 5.6. Structure of III pillar pension fund assets as at 30 September 2006 (position on 30 September 2005 indicated in brackets)

in the third pillar pension fund assets amounted to 39 million kroons, while in September 2006 it reached 85 million kroons (incl. the stocks and shares of domestic investment funds). The share of Western Europe in the investments of third pillar pension funds continued to rise, increasing from 39% a year ago to 51% by the third quarter of 2006.

As expected, the correction of stock markets in May exerted the greatest influence on the changes of high-risk funds and **net values of the shares of supplementary funded pension funds**. However, despite a slight decrease, the net value of the stocks of most funds reached their pre-correction level after four months (see Figure 5.7).

The impact of events in May can also be clearly discerned in the **annual yield** indicators of pension funds. While the yield indicators of low and medium-risk funds that had started to drop in May started to rise again slightly in August, the yield indicators of high-risk and supplementary funded pension funds continued declining as at the end of August (see Figure 5.8).

LIFE INSURANCE

During the past year (from the third quarter of 2005 until the second quarter of 2006), life insurance companies earned a **profit** of 82.8 million kroons, which is half less than the previous respective indicator. The primary cause of this decrease in profits is the stock market correction that occurred in May of this year, which also had a negative impact on the investments of life insurance companies. Owing to this, most Estonian life insurance companies ended the second quarter with a loss. The return on equity of life insurance companies stood at 9% (30.3% at the end of 2005), which is the lowest level since 2003.

The year-on-year growth of **gross premiums** (from the fourth quarter of 2005 until the second quarter of 2006) in the life insurance market stood at 30%. The total amount of collected gross premiums amounted to 1.46 billion kroons (see Figure 5.9). The greatest contribution to their volume growth was made by gross premiums collected by unit-linked life insurance contracts, which had an annual growth of 53%. Meanwhile, it should be mentioned again that this

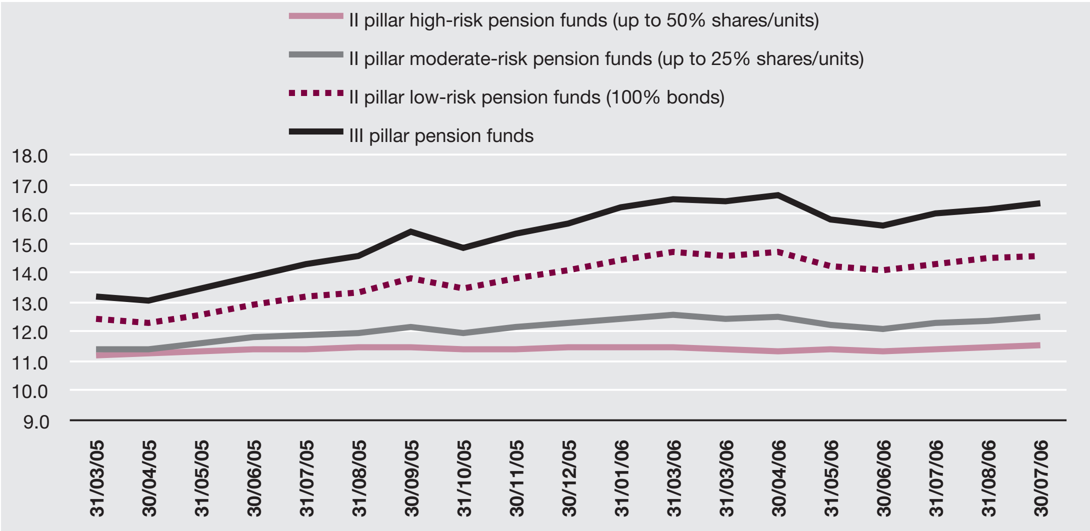

Figure 5.7. Net asset value of pension fund shares and units at end-month

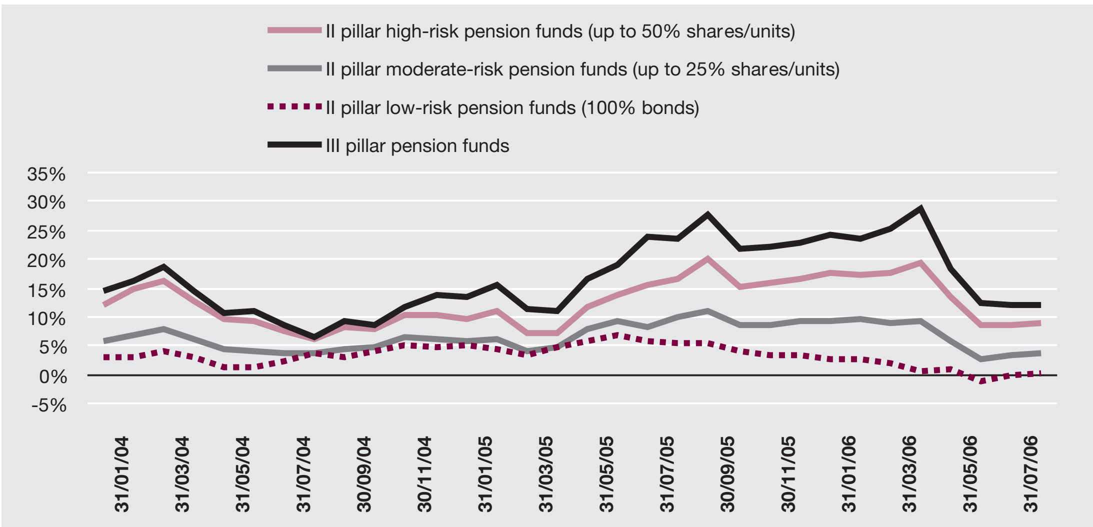

Figure 5.8. Annual yield of pension funds at end-month

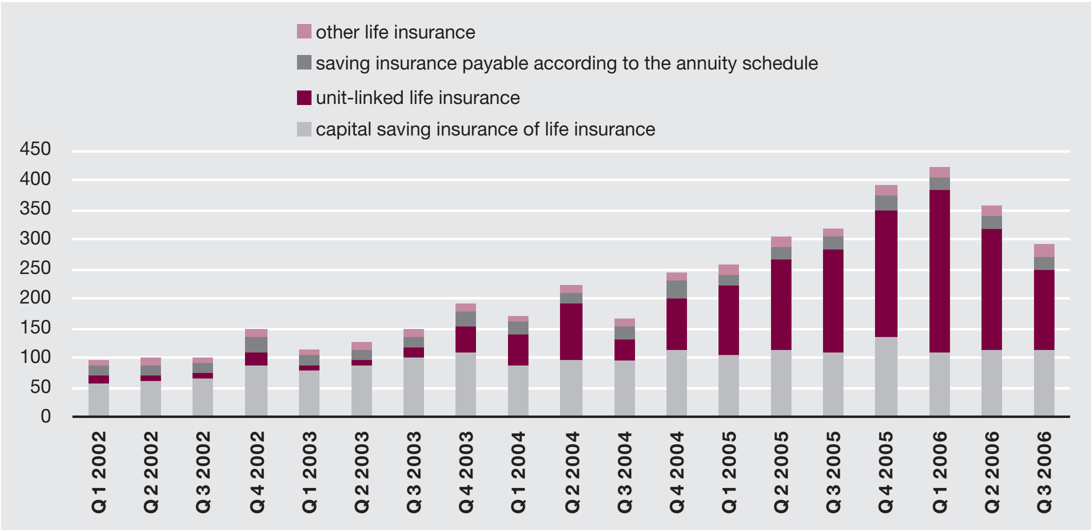

Figure 5.9. Gross premiums collected by life insurance companies (EEK m)

growth stems primarily from the extraordinarily dynamic growth in the volume of gross premiums during the first quarter. While in the previous Financial Stability Review we left the question of whether the sudden increase in volume of gross premiums was an isolated event or a long-term trend unanswered, we can now conclude with certainty that their boost in spring was a one-off event.

The **investments** of life insurance companies are divided into two parts on the balance sheet – the investments of unit-linked life insurance contracts and investments made for covering other insurance contracts (see Figure 5.10). The structure of investments made for covering other insurance contracts has not undergone any significant change during the past several quarters. As at the end of the second quarter of 2006 the total volume of these investments stood at 2.31 billion kroons, which comprised 55.4% of the balance sheet total (as opposed to 69% at the end of the second quarter of 2005). Compared to the respective indicator a year ago the role of stocks and other securities has increased, mainly on account of bonds. However, the share of stocks has started to decrease slightly in the past quarter, which is most probably a result of the stock market adjustment.

At the end of the second quarter, the volume of unit-linked life insurance contract investments comprised 38% of the balance sheet total of life insurance companies (27% in the previous year). Most of the unit-linked life insurance contract investments were channelled into investment fund stocks (84%), followed by shares (9%).

NON-LIFE INSURANCE

A new property insurance provider entered the non-life insurance market in the third quarter of 2006 – Hansa Varakindlustus. According to Hansapank, property insurance is a strategic field which they intend to develop vigorously over the next few years. The primary success factor is the fact that in Estonia, the average volume of collected insurance premiums per resident is twice smaller than elsewhere in Europe, demonstrating that this field is considered to have promising growth potential.

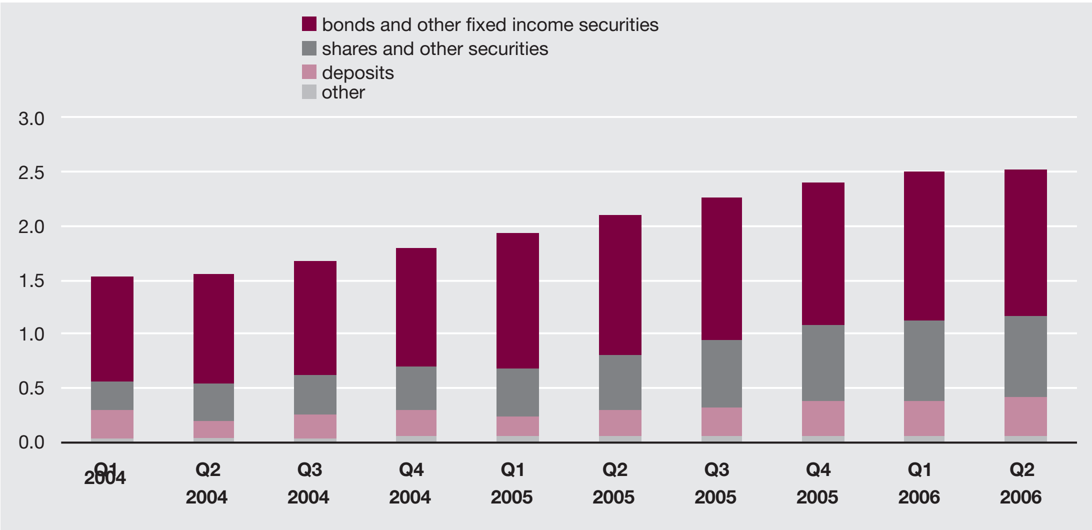

Figure 5.10. Investment structure of life insurance companies (EEK bn)

The year-on-year **profit** of non-life insurance companies in the second quarter of 2006 stood at 625 million kroons, exceeding the previous year's indicator by 40%. Return on equity was 36.6% in the first half of 2006. As the new non-life insurance company has been operating for only a few months, the structure of the non-life insurance market has not changed significantly during the year.

The **gross premiums** collected by non-life insurance companies this year have reached 3 billion kroons. The volume of these premiums has grown by 15.4% compared to the same period last year (see Figure 5.11). As the greatest contributors to the growth of gross premiums were the insurance of land vehicles, private property insurance and third party motor liability insurance, the increase of gross premiums may still be explained by the generally favourable economic situation and the rapidly increasing volume of loans.

At the end of the second quarter of 2006, the **investments** of non-life insurance companies amounted to 3.1 billion kroons, which comprised 87% of the balance sheet's total (84% a year ago; see Figure 5.12). Due to the nature of the operations of non-life insurance companies, their investments are mainly channelled into liquid assets. Based on this line of argument, the share of bonds and other securities with fixed return rates increased even further during the last year. Therefore, the general growth in interest rates is going to have a perceptible negative impact on the non-life insurance companies' profitability and on the yield of their investments.

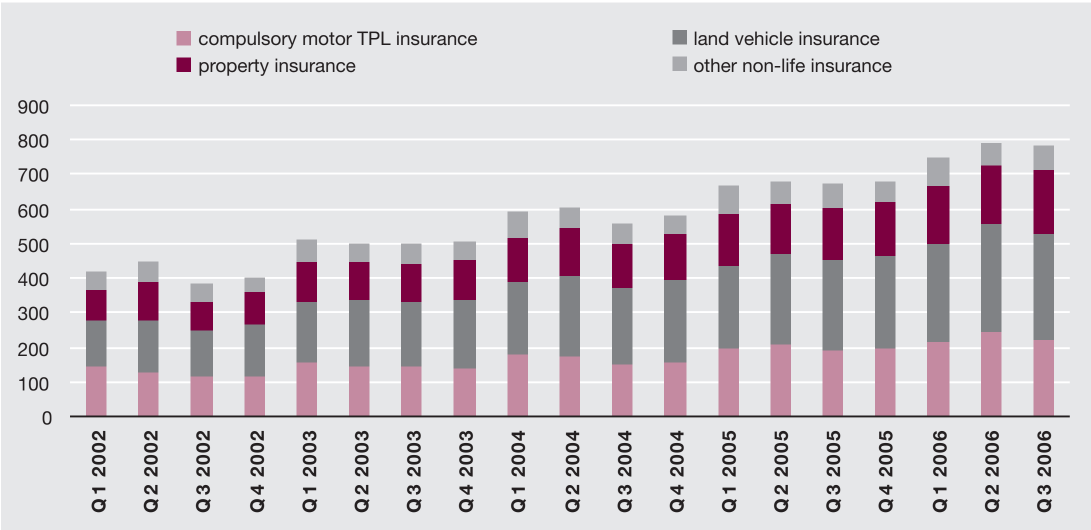

Figure 5.11. Gross premiums collected by non-life insurance companies (EEK m)

Figure 5.12. Investment structure of non-life insurance companies (EEK bn)