SUMMARY

MACROECONOMIC AND EXTERNAL ENVIRONMENT

The growth rate of the global economy remained favourable in the first half of 2006. This created preconditions for continuing a stricter interest rate policy in several major economic regions. The Euribor rates have risen by 1.3–1.6 percentage points within the year since the beginning of the upward cycle of interest rates in autumn 2005. Except for the sudden temporary drop of share prices in May and June 2006, the development of the global interest environment has not entailed any other significant changes in the risk behaviour of investors, the volatility of markets or risk premiums.

In the first half of 2006, the **Estonian economy** grew at the rate of nearly 12% and was influenced by growth in domestic rather than in external demand. The exceptionally rapid economic expansion has mainly been stimulated by the robust development of the real estate and construction sectors. Although economic growth is presumed to start slowing down gradually soon, according to estimates it will nevertheless remain quite high for the next two years. Therefore, the economic environment remains favourable for the financial sector both in terms of development as well as risks.

CORPORATE FINANCIAL BEHAVIOUR AND RISKS

The investment demand of companies increased due to the favourable economic environment. The growth rate of corporate **debt** has remained high (26% in June 2006), whereas the indebtedness rose to 66% of GDP by the end of June 2006. An increase in financial leverage causes higher vulnerability of the corporate sector.

Borrowing for real estate purposes is gaining more popularity besides financing primary activities of non-real estate enterprises. This, however, may undermine the corporate sector's competitiveness. Moreover, the rise in loan-servicing costs amplifies already higher operating costs and adversely affects the profitability of companies.

FINANCIAL BEHAVIOUR OF HOUSEHOLDS AND RELATED RISKS

The economic environment has fostered the growth of household incomes and this has created favourable conditions for rising optimism. Expectations about the continuation of current developments have played a key role in increasing the loan demand and risk appetite of households. The **loan growth rate of households** remained very high during the first nine months of 2006 (over 60%), whereas the growth in indebtedness has increased even more in ratio to GDP and disposable income compared to the end of 2005.

High price levels in the **housing market** have started to hinder the demand for housing loans. Apartment market activity has declined and so has the growth rate of prices. Unless any unexpected shock takes place in the near future, it is safe to presume that the real estate market is steadying. If this year's rapid price boost does not repeat itself, the further developments in the real estate market will be in line with the general economic development.

Along with rapid economic expansion the volume of **consumer credit** has also shown robust growth (105% in September 2006). Although, for the most part, the growth and structure of consumer credit may be explained by developments in the real estate market, the positive correlation between housing wealth and the consumption of Estonian households proved to be rather weak. This may be explained mainly by the negligibility of speculative effects in the housing market so far.

Since the volume of loans, as well as key interest rates, has increased, households' **loan-servicing costs** have also risen. However, the increasing net incomes of households have successfully offset the negative impact of the rise in interest rates.

Sustained income growth prospects have increased the risk appetite of households even though long-term loan contracts with floating interest rates are generally exposed to interest rate risks.

In line with favourable macroeconomic developments the current situation and growth forecasts of households' financial buffers may be considered relatively good. In 2006, the growth rate of **deposits** has been one of the fastest in recent years (over 30%), although the net financial position of households continues to deteriorate.

BANKING MARKET

Measures taken this year by Eesti Pank in order to hedge risks have caused the growth of banks' capital buffers, as expected. Among other things also the changes in banks' intra-group financing schemes have contributed to the improvement of capital adequacy ratios. The channelling of resources to non-resident subsidiaries by local banks has abated. Yet, the domestic banking sector is still strongly related to parent banks through the great share of resources intermediated by the latter. The role of parent banks in managing the local operations of groups has also become more substantial.

The growth rate of financing Estonian residents has not slowed down remarkably. **As for credit risk**, risks related to the developments of the real estate sector have increased even further – the quality of banks' loan portfolios increasingly depends on the real estate sector's development both in terms of corporate as well as household loans. So far, the quality of banks' loan portfolios has remained good, as income growth has enabled customers to cope with rising loan-servicing costs. Regarding credit risk, however, it is ever more important that banks consider the future loan-servicing capability of a borrower more significant than the current market value of the collateral involved.

The **share of liquid assets** in the banking sector's total assets without respect to changes in banks' intra-group financing schemes has remained at approximately 17%, i.e. at about the same level as half a year ago. As of 1 September 2006, a new higher reserve requirement came into force; thus also the share of highly liquid assets acceptable for meeting the reserve requirement has risen.

The rise in key interest rates is also reflected in banks' **profitability** indicators, since in Estonia the majority of bank loans have been granted with a floating interest rate and liabilities largely consist of demand deposits that depend less on the interest cycle. However, the profitability of banks has this year been influenced more by lower dividend income by subsidiaries – the profits were retained in the subsidiaries and not paid as dividends. The growth of fee and commission income has also slowed slightly, which partially stems from changes in accounting principles.

SECURITIES MARKET AND OTHER FINANCIAL INTERMEDIARIES

The number of securities traded in the **securities market** increased, while the growth of the bond and stock markets declined. The primary **bond market** and capitalisation grew in volume thanks to the increase in the volume of issues by resident banks. The secondary market expanded owing to a remarkable boost in the bond turnover of the non-financial sector.

The most influential events on the **Tallinn Stock Exchange** in the past half-year were the correction in the global stock markets in spring/summer and the listing of the shares of two new companies (AS Eesti Ehitus and Olympic Entertainment Group) on the primary list of the stock exchange. As the value of share prices decreased substantially owing to a decline in the stock markets, the year-on-year growth of the Tallinn Stock Exchange index OMXT reached only 7% by the end of October.

The correction in various European stock markets also affected other parts of the financial sector –

investment and pension funds – and the **insurance sector**, whose yields shrunk considerably. The yield of money market funds, on the other hand, was affected positively by the rise in key interest rates. Although two more new stock funds were added to the list of investment funds, growth in the volume of investment and pension fund assets decelerated substantially owing to stock market developments and the high basis of fund assets.

The development of the **non-life insurance market**, which has been growing steadily during recent years, has been primarily influenced by loan growth and the generally favourable economic environment. On the other hand, growth in the **life insurance market** decreased to the year-ago level in the third quarter. This confirms that what happened in between was a one-off event.

PAYMENT SYSTEMS

According to the overseer, failures in the settlement systems of Eesti Pank did not endanger the sustainable operation of the systems or financial stability.

In the **Real-Time Gross Settlement system (RTGS)** the main change was the elimination of the limit on large-value payments. In order to improve the efficiency of the **Settlement System of Ordinary Payments (ESTA)** the settlement day was extended by three hours and the settlement cycle was made more frequent. Instead of the former three times, beneficiary banks are informed of received payments nine times a day, i.e. on every full hour. Consequently, payments made from one bank to another usually reach the beneficiary in no later than in an hour and a half.

In order to incorporate the EP RTGS system managed by Eesti Pank with the euro area's payment settlement system **TARGET** and adopt the euro in Estonia, the European System of Central Banks assessed the compliance of the EP RTGS system and the securities settlement systems operating in Estonia with the requirements of the Eurosystem. Based on the results of the assessment, these systems were deemed eligible for the Eurosystem and the connection of the EP RTGS with the TARGET system on 20 November 2006 was approved.

No major changes have **occurred in the environment of retail payments** within the past year. According to a survey conducted by TNS Emor on payment habits, the usage of non-bank channels for payments has decreased further. One-third of households pay for purchases in cash, while two-thirds use payment cards.

CONCLUSION AND FINANCIAL STABILITY RISKS

Within the past half-year, no such events or developments have occurred in the condition or behaviour of the Estonian financial sector that would change the financial stability assessment rating of "good", which was conferred on Estonia in spring.

According to forecasts, the rapid growth of Estonia's economy will start to decelerate gradually and moderately over the next two years. Therefore, no significant problems with financial stability are to be expected, at least in the near future. The capitalisation and liquidity of the banking sector are sufficient under current economic conditions and the banking sector's short-term risks are well managed with the support of parent banks. Strong economic expansion secures strong income inflow for households as well as companies.

The capability of households and companies to withstand long-term risks, however, has deteriorated due to the rising debt burden. Though the peak of economic growth should be at hand or even over, there are no signs of a sudden deceleration in the accumulation of long-term loan-servicing risks yet. Neither are there any signs of a significant decrease in borrowing activity. Moreover, signals that might have changed borrowers' attitudes as expected (e.g. rises in interest rates, signs of stabilisation in the apartment markets of major cities, the postponement of the adoption of the euro, suspicions about the overheating of economy, etc.) have not reduced the optimistic future expectations. This may be caused by the strong inertia in the behaviour of borrowers, which shows especially clearly in the case of companies initiating new real estate development projects as well as households planning to take a housing loan.

The excessive share of financing real estate development and investment in the loan portfolio of banks might become the main threat to the banking sector. So far, this has offered creditors an excellent combination of risks and return and has enabled them to increase their revenue base rapidly. However, high dependence on the development of only one market segment (the real estate market) increases banks' vulnerability to the possible negative trends of that market.

The growth potential of the loan market is not infinite. For instance, growth might slow down faster than expected due to changes in the international liquidity environment. As an unexpected and unpleasant surprise, the loan market may be struck by a sudden drop in investors' confidence. Households that have borrowed during the past few years are most likely to face solvency problems should the abovementioned events occur. These are often the households that have purchased real estate at the highest market price and taken loans to the ultimate limit of their financial capabilities. Thus, after the present peak of economic growth is over, borrowers as well as creditors should review their current optimistic attitudes and adjust their future savings, investment and loan decisions to meet the needs and risks of the future economic cycle.

Measures taken by Eesti Pank in 2006 (increasing the risk weighting for housing loans to 100% in calculating the capital adequacy and raising the reserve requirement to 15%) and a strong fiscal policy have helped to increase the credibility of Estonia's economic policy in the eyes of external experts and investors. During the three-year transition period within the framework of the new capital adequacy accord (Basel II), which takes effect in 2007, Eesti Pank decided to preserve the 100% risk weighting for housing loans in calculating the floor for the capital adequacy ratio and adhere to the current 10% capital requirement as regards credit risk as a whole for the three-year transition period.