II REAL ECONOMY AND LOAN QUALITY

CREDIT PORTFOLIO OF BANKS

At the end of March 2010, the financing portfolio of banks totalled 261 billion kroons, or almost 6% less than a year before. The stock of loans and leases granted to households and companies has decreased by 8% and 4%, respectively.

The loan environment has not changed significantly over the past six months and has remained conservative and inactive. Structural changes in the loan portfolio have primarily been shaped by the varying maturity of loan contracts in different loan segments. With the year, the share of housing loans in the credit portfolio has grown the most, by 1.5 percentage points. Although banks have curbed the financing of new real estate developments during the last two years, it has not entailed a sudden drop in their loan stock due to the specific nature of financing contracts in the real estate sector[1]. Though the loan positions of banks have diminished significantly in the construction sector, the percentage of all real estate related loan sectors[2] has increased by 1.4 percentage points to 60% (see Figure 1).

Investment demand, which has contracted in the light of economic uncertainty, has expectedly the least impact on infrastructure companies, whose total loan stock increased by 3.2 billion kroons, or 72%, compared to a year ago.

According to the baseline scenario of the spring 2010 forecast of Eesti Pank, the banks' loan and leasing portfolio will shrink around 2.4% by the end of this year. The growth rate of the loan stock will remain smaller than GDP growth also in the coming years (see Figure 2).

Based on the forecast presumptions, domestic demand will recover with a lag compared to

[1] Some of the loans issued to the real estate sector are bullet loans.

[2] The household sector – housing loans; the business sector – real estate, construction and business services (as at 30 April 2010).

Figure 1. Structure of banks' credit portfolio as at 31/3/2010 and change y-o-y

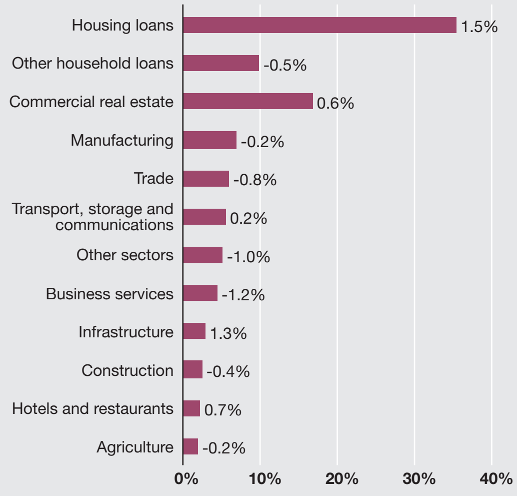
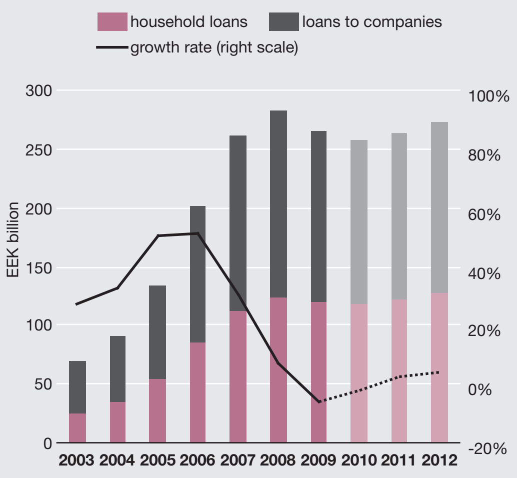
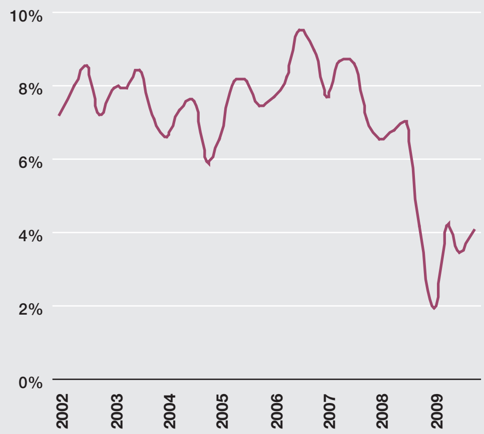


Figure 2. Value and growth rate of banks' credit portfolio and expected growth in 2010–2012



export revenues. This will also affect the growth and structure of banks' financing portfolios in the next few years. In the near future the loan stock will be mainly boosted by external-demand oriented business areas, whereas banks' risk positions will nevertheless include also a large share of loans issued to real-estate related sectors. In case of more positive economic developments, the housing market will probably recover faster, and so will also the issuance of household housing loans. Consequently, banks' credit risk will still largely depend on the developments in the real estate market. However, considering the experience gained from the boom, both creditors and borrowers are presumed to remain conservative in their risk appetite and the risk of another boom in the near future is marginal.

Figure 3. Profit margin



Source: Statistics Estonia

COMPANIES' LOAN REPAYMENT ABILITY

After covering all operating expenses, the remaining cash flows must be used for covering outstanding loan interest and principal repayments. After a steep drop in 2008, companies' revenues did not experience as robust a decrease in 2009. As domestic demand is weak and external demand is recovering more rapidly, stronger growth in the turnover of manufacturing enterprises can be expected first. In domestic demand oriented sectors, on the other hand, rapid recovery of revenues to earlier peaks is not anticipated.

The business statistics of Statistics Estonia show that the drop in overall profitability came to a halt in the second half of 2009. While profitability remained in a range of 7–8% prior to the global financial crisis, the decline stabilised during the year, with profitability amounting to 4% (see Figure 3).

The situation varies by sectors, but there are clearly some areas of activity where profitability started to recover already in the fourth quarter of 2009. This is partially due to increased efficiency after the restructuring of activities; furthermore, there are sectors which make good use of price formation opportunities stemming from their monopolistic status. Nevertheless, as the extent and speed of cutting expenses was lower than the drop in revenues, companies recorded lower profits in 2009. Consequently, their loan repayment ability diminished, and the number of companies in financial distress increased.

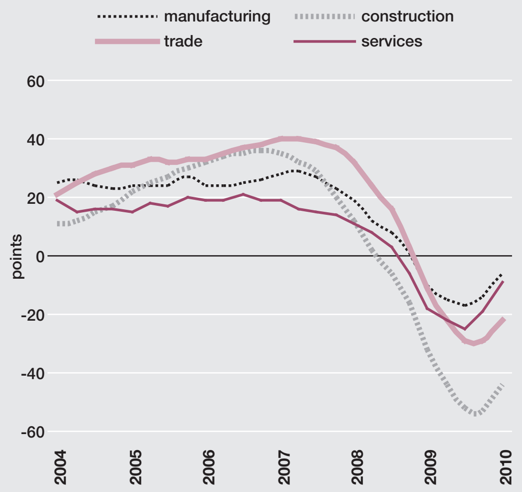
At the same time, companies' estimates of current and future demand had improved by the beginning of 2010 (see Figure 4). The amount of new orders in the manufacturing sector in March had grown by approximately 18% compared to last year, with the growth primarily bolstered by export orders. Domestic demand oriented sectors, such as construction, services and commerce, are still declining in terms of profitability, but the decrease in profits will likely come to a halt based on projections of demand. Recovery of sales volumes, decrease in warehouse inventories and growth in orders can also be seen in trading companies, where the downturn is coming to an end. Deflation expectations have abated in both commerce and the services sector. Seasonal factors are contributing in part to the increased confidence and solvency in the months ahead. In the construction sector, the number and volume of building permits issued more than doubled in the first quarter, compared to the same period last year, although they have failed to return to the pre-crisis levels seen in 2008. Profitability in the manufacturing sector, the sector most impacted by external demand, can even be expected to increase in the near future.

The amount of **payment defaults and tax arrears** indicates some easing of financial problems. According to Krediidiinfo, the net increase in payment defaults has slowed after rapid growth in the second half of 2009. The increase in corporate tax arrears has slowed as well (see Figure 5). Yet the level of payment defaults continues to be very high: in the past six months, one-fifth of companies had tax arrears[3], with nearly one-third of all companies having high credit risk according to Krediidiinfo. A pattern of behaviour noted among Estonian companies is that tax liabilities are the first to be deferred, followed by payables to suppliers; companies are most reluctant to have outstanding liabilities to banks. As growth in tax arrears and payment defaults has slowed, it can nonetheless be presumed that, compared to last year, this year will bring a much smaller crop of companies unable to fulfil their liabilities to banks.

The number of **bankruptcies** peaked in 2009 at 536; twice as much as in 2008 (see Figure 6). Unlike many other indicators that are forward looking, the number of **bankruptcy petitions** is not showing signs of decrease, as a result of which a large number of bankruptcies can be projected yet again for 2010. Considering the time-consuming nature of the bank-

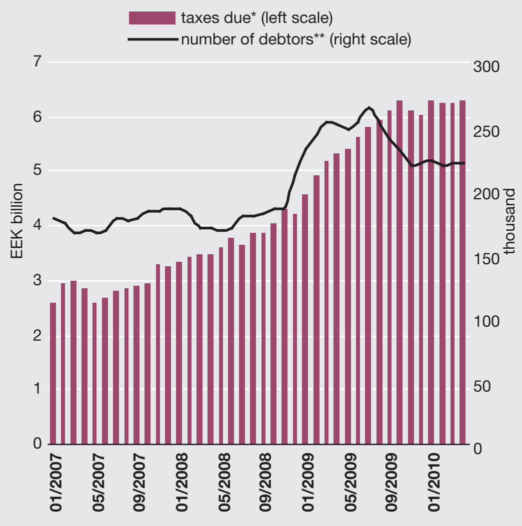
[3] Tax arrears with a value of over 10,000 kroons are taken into account.

Figure 4. Expected demand in the next three months*



* monthly data, 12-month moving averages
Source: Estonian Institute of Economic Research, Eesti Pank's calculations

Figure 5. Stock of taxes due at end-month and number of debtors



* Earlier data are not directly comparable owing to changes in the accounting of due taxes in 2009.
Source: Estonian Tax and Customs Board, Eesti Pank's calculations

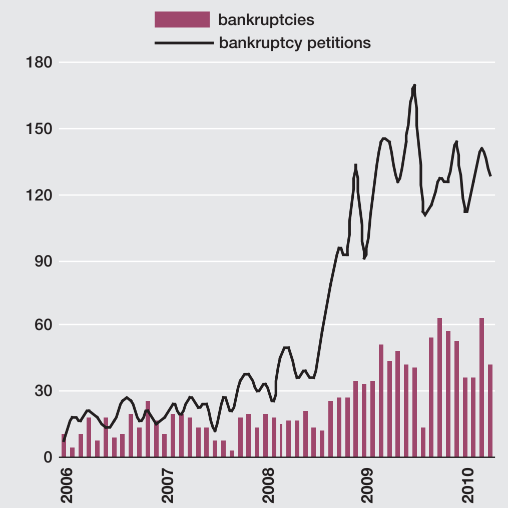
ruptcy process, the number of bankruptcies may even prove greater than last year. Indeed, the number of bankruptcies in the first quarter of 2010 exceeded last year's level by one-sixth, and most of the bankruptcies continue to occur in the construction sector. At the same time, bankruptcies reflect financial problems that emerged previously; that is, the realisation of loan losses that have already been accounted for by banks, not so much the occurrence of new and unexpected problems.

Due to the fall in key interest rates, **interest expenses** related to corporate domestic bank loans have dropped continuously, easing the stressful financial situation of companies by an estimated 3 billion kroons in 2009, or more. As the drop in key interest rates has ceased and has largely already passed on to existing loans, no sizeable decline in interest expenses is expected in the near future. It can rather be presumed that interest expenses will remain at a stable level as long as key interest rates remain low.

The **interest coverage ratio**[4] continued to drop in the first three quarters of 2009 in spite of the extensive shrinking of interest expenses. In the fourth quarter, however, the indicator ceased to fall, as profitability stabilised and interest expenses decreased. This means that companies' ability to pay bank loan interest – after covering operating expenses and depreciation – did not deteriorate any further (see Figure 7). In domestic demand oriented sectors, the interest coverage ratio dropped in the second half-year as well. On the other hand, the manufacturing sector was boosted by the recovery of global markets and the solvency of the sector improved in the last quarter of the year.

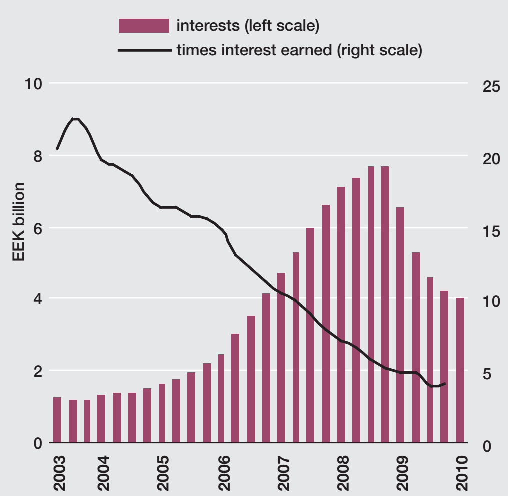
[4] Interest coverage ratio or TIE (times interest earned) = ratio of total profits to domestic bank loan interest. Actual corporate interest expenses are larger due to the addition of interest expenses on intra-group and foreign loan finances. Thus the interest expense ratio should be treated on the basis of development rather than level.

Figure 6. Bankrupt companies and bankruptcy petitions submitted to courts on a monthly basis



Sources: Estonian Enterprises Register, Courts Information System

Figure 7. Companies' estimated interests on domestic bank loans and the interest coverage ratio



Sources: Statistics Estonia, Eesti Pank, Eesti Pank's calculations

In most sectors other than the manufacturing sector, corporate cash flows will likely not improve in the near future. At the same time, cash flows should not decrease significantly either, as the economy is slowly recovering. Corporate budgets are still stretched thin and, in particularly, domestic demand oriented sectors may encounter problems repaying loans.

Aggregated balance sheet data indicate slightly improved corporate liquidity and solvency. Corporate **deposits** grew by around 10% to 56 billion kroons by the end of the first quarter of 2010. At the same time, corporate short-term financial liabilities decreased by a total of more than 17 billion kroons. This was, above all, conditioned by repayment of loans and trade credit. Thus corporate **liquidity** – short-term solvency – had improved slightly in the fourth quarter of 2009 (see Figure 8).

For the same reasons, the long-term indicator of corporate solvency, the **financial leverage**[5] ratio, improved over the course of last year, approaching the levels of 2006. This demonstrates that companies have reduced their excessive indebtedness and that the entrepreneurial sector as a whole is engaging in cautious financial behaviour.

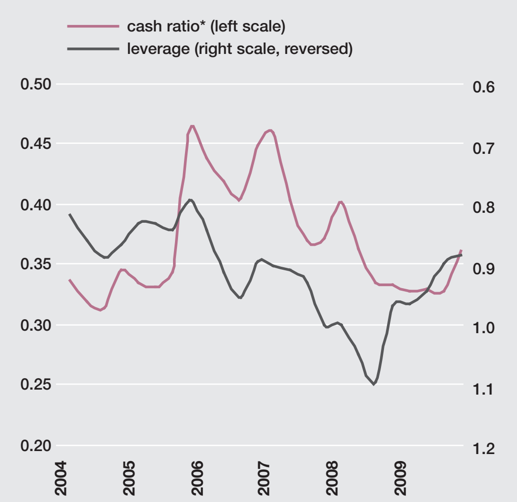
Looking at financial leverage ratios comparatively for European countries, we see that at the end of 2007 Estonia was near the average for the EU (see Figure 9), regardless of the higher than average corporate indebtedness in terms of GDP. The relatively low financial leverage of Estonian enterprises was due to higher equity, probably the relatively high levels of foreign equity investment.

HOUSEHOLDS' LOAN REPAYMENT ABILITY

Over the last year, consumer **confidence** has been mostly affected by fear of job loss and

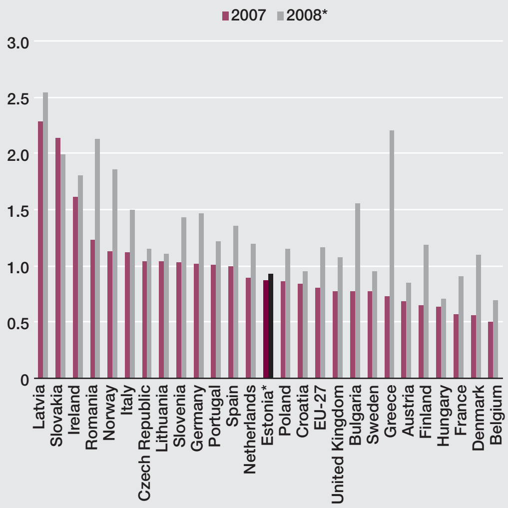
[5] Financial leverage = debt-to-equity ratio.

Figure 8. Corporate sector's liquidity and solvency ratios



* Money and short-term securities in ratio to short-term financial liabilities.
Sources: financial accounts, Eesti Pank's calculations

Figure 9. Corporate sector leverage in European countries*



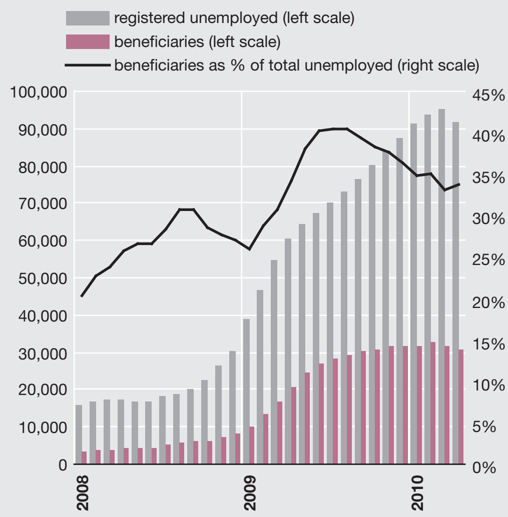
* 2008 data for Estonia are based on Eesti Pank's estimates.
Sources: Eurostat, Eesti Pank's calculations

lower income. High and increasing unemployment took an especially heavy toll on consumer confidence at the beginning of 2009. In the last six months, confidence has seen stable improvement. Fear of unemployment has dropped to the level seen in the first months of 2008, which was significantly lower than the average for 2009. The improvement in confidence has been supported by the assessment of the country's present economic situation and also the outlook for the next twelve months. Even though the economic situation of households has somewhat deteriorated over the last year, there is stronger belief that it will improve in the next twelve months. Price levels have risen as a result of global growth and administrative factors, decreasing incentives for postponing consumption on grounds of expected deflation. Little by little, purchases of durables are being slated for the near future, which boosts demand for consumer loans.

In spite of increased confidence, developments in households' budgets are and will be shaped by the **labour market situation**. In the first quarter of 2010, the unemployment rate in Estonia was 19.8%, according to the Statistics Estonia labour force survey. The statistics for April show that registered unemployment has somewhat declined. According to the Unemployment Insurance Fund, registered unemployment amounted to a total of 91,668 people, or 14.1% of the working-age population, at the end of April, around one-third of them receiving unemployment benefits. The share of benefit recipients among the unemployed has started to drop, as there is a greater number of unemployed whose benefits period has run out. Even though the number of registered unemployed in April was already decreasing, it will remain higher than average in years to come (see Figure 10).

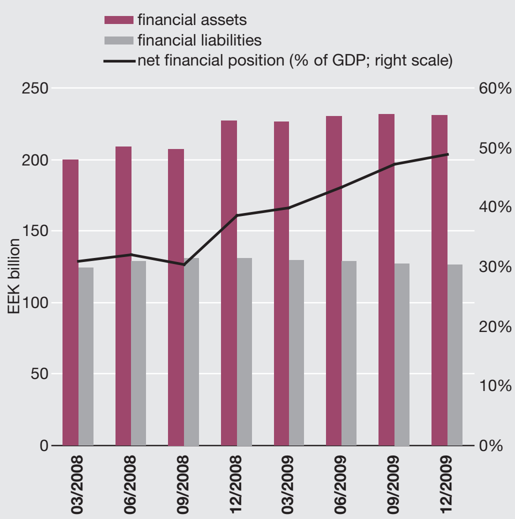
Besides the drop in total employment rate, the drop in wages also decreased households' disposable income. Last year average gross wages fell around 5%, and the drop continues this year

Figure 10. Number of registered unemployed and unemployment insurance beneficiaries



Source: Unemployment Insurance Fund

Figure 11. Household financial assets and liabilites



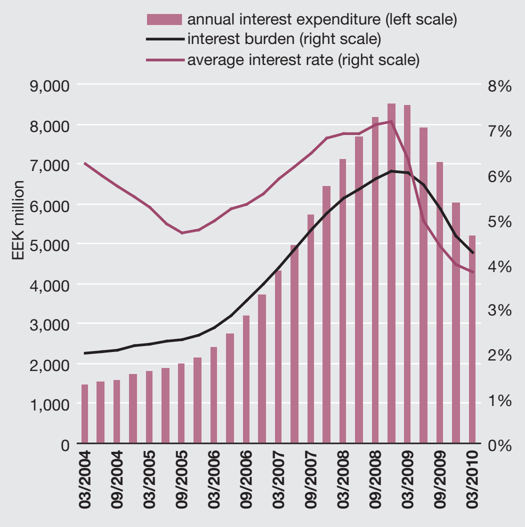
as well. Given the combined effect of unemployment and decreased income, Eesti Pank forecasts household disposable incomes to be as much as 10% lower in 2010 compared to 2009.

Households' uncertainty about the future was clearly reflected in their financial behaviour. The **net financial position** of households increased from 37% of GDP in 2008 to 49% of GDP in 2009 (see Figure 11). The improvement of financial positions was affected by the decline in financial liabilities and also by the fact that, regardless of the decreasing income, the stock of household financial assets increased 2% in 2009. The rise in financial assets was facilitated by the improved situation on capital markets and households' increased willingness to invest into higher-risk investment instruments. Household deposits grew by 1 billion kroons to 55.8 billion kroons. Time deposits accounted for 58% of total deposits at the end of March 2010. As interest rates on time deposits dropped significantly, so did households' interest in investing into time deposits.

Household **credit demand** was extremely low in 2009; transactions with major financing practically came to a standstill. As a result of very low credit demand and amortisation of the existing loan portfolio, the stock of loans issued to households shrank by 4% to 116 billion kroons. Households have responded fairly rapidly to the recession, as evident from the fact that their liabilities to banks have dropped since the beginning of 2009. As the situation became more challenging, households focused, above all, on meeting their existing liabilities, with major spending being postponed. New borrowing activity was hindered by tightening of lending conditions and also the unfavourable situation on the labour market.

Even though the stock of loans has decreased, **indebtedness** of households remains fairly high. According to Eesti Pank's spring forecast,

Figure 12. Annual interest expenditure and interest burden of households



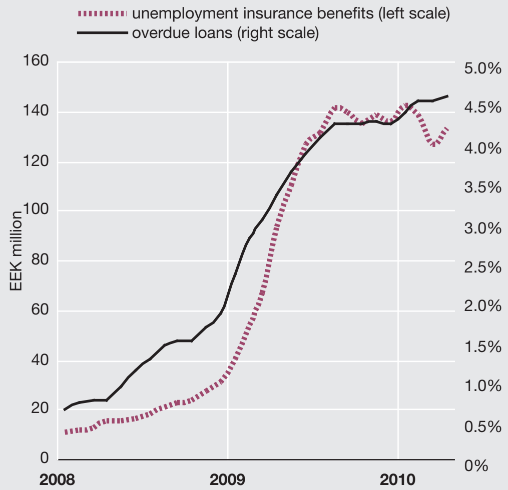
indebtedness is expected to decline only in the first quarter of 2011. The impact of the considerable fall in disposable income will, however, diminish over a longer period of time. As the spring forecast expects no growth in the stock of household loans in 2010 and to grow only marginally in 2011, household budgets are constrained mainly by the existing loans.

Very low key interest rates have contributed to meeting the liabilities of households, significantly decreasing their **interest payments**. The annual amount of households' interest payments in the first quarter of 2010 was 5 billion kroons, which is comparable with the figure for the second half of 2007 (see Figure 12). The modest increase in borrowing and the continuously low key interest rates mean that households' expenses related to repayment of loans will not increase in the near term.

The loan repayment ability of households is affected by developments in the labour market. Although compared to the autumn, the percentage of companies that desire to reduce their workforce in the months ahead has declined, and unemployment will peak in the second quarter of 2010 as set out in the Eesti Pank spring forecast, it will take time for the labour market to normalise.

The portfolio of household loans will shrink also in 2010, meaning there will be little new liabilities taken. At the same time, unemployment benefits will end for most recipients. Those unable to find a job will lose most of their current income. In part, temporary difficulties in loan repayment can be alleviated by a loan grace period. Still, considering the relatively high number of unemployment benefit recipients (see Figure 13), developments in the labour market may lead to a slight decline in the loan repayment ability of households.

Figure 13. Unemployment insurance benefits and share of loans overdue for more than 60 days



Real estate market

Due to the extensive cash flows of banks into sectors related to real estate and private housing loans during the period of rapid loan stock growth, banks' credit risk largely depends on developments in the real estate market. Developments in the real estate and construction market and the probability of the materialisation of risks are mainly determined by Estonia's macroeconomic growth outlook. The recovery of markets can be hindered by the fact that the loan repayment ability of borrowers has not started to improve yet, and this may be accompanied by an increase in the forced sales of the collaterals of mortgage loans and bankruptcy estates.

Housing market

After more than two years of decline, the fall of the housing market stopped at the end of last year. Although the market will probably improve slightly in 2010 along with the recovery of the general economic situation, no rapid growth in activity is expected. Demand is primarily inhibited by the slow recovery of the labour market. The developments in the real estate market are also affected by the structure of the existing housing stock and the continuous need for dwellings.

In 2009, 32% less construction permits and 70% less permits for use were issued in Tallinn, and no new major projects were released to the market. At the end of April 2010, nearly 6,000 apartments were still on sale, 20% of which have been built in recent years[6]. In addition to the fact that demand on the real estate market has weakened due to uncertainty and shrinking incomes, the relatively high number of sales offers could indicate that the location, size, price or quality of the apartments on sale does not meet the requirements of buyers. Given the needs of buyers and much lower land and construction

[6] Source: City24, Ober-Haus, Tallinn real estate market 2009–2010.

prices compared to the boom, several real estate developers have disclosed new housing development projects.

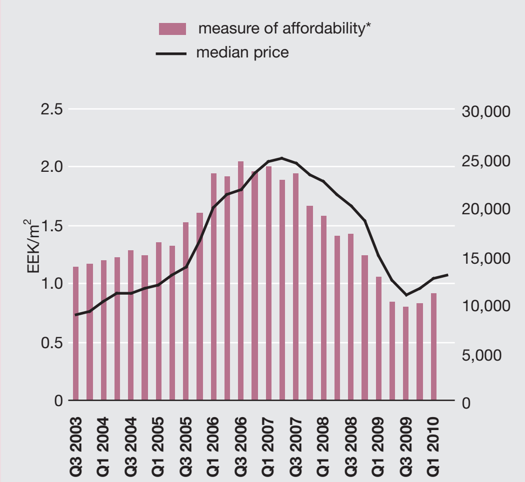
The median price of apartment transactions in Tallinn is comparable to the level of 2005, that is 12,800 EEK/m2. The real estate purchasing power of households has improved significantly in comparison with the last six years as a result of real estate price drops. During the real estate boom, the average price per square metre of apartment deals in Tallinn was over twice larger than the average gross monthly wages of the residents of Tallinn, whereas in the first quarter of 2010, the affordability indicator[7] stood at 0.9 (see Figure 14). Although the price drop has made real estate more affordable to average wage earners, the number of people, whose incomes have declined and whose uncertainty about their future personal budget has increased, has grown over the year.

Meanwhile, the stock of deposits has grown in recent years, which contributes to meeting banks' loan requirements. Despite that, the availability and conditions of loan money continue to be the key determinants of financing housing purchases.

Tighter credit terms have increased the importance of the rental market. The rental market gained momentum at the beginning of 2009, when the number of vacant apartments for rent grew by 40% within three months since the end of the year. However, in the first quarter of 2010, the market stabilised at a slightly lower level along with the average price offers per square meter of rental apartments (77 EEK/m2). Further developments in the rental market greatly depend on how fast the confidence of people is restored and how the potential housing purchasers and banks assess their loan repayment ability.

[7] The ratio of the median price per square metre of apartments in Tallinn to the average gross monthly wages of the residents of Tallinn, based on the data of the Land Board.

Figure 14. Affordability of real estate in Tallinn with average wages



* The ratio of average gross wages to median square metre price of an apartment in Tallinn.
Sources: Land Board, Statistics Estonia, Eesti Pank's calculations

Office and commercial premises market

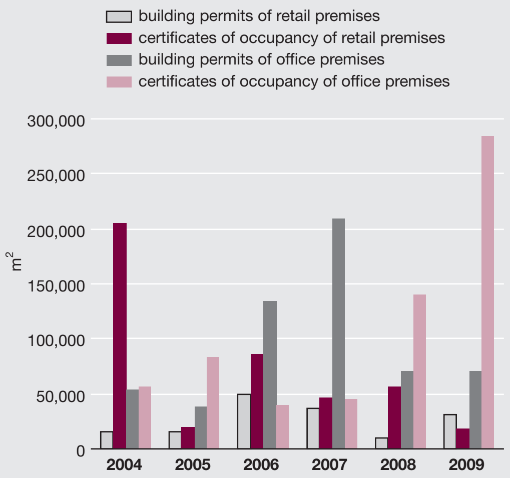
Developments in the business real estate market occur with a slight delay, which is why this sector is likely to face greater difficulties in 2010, as the incomes of real estate owners are shaped by the drastic fall in rental prices and the rising number of vacant office premises.

At the beginning of 2009, the supply of **office premises** in Tallinn grew significantly, as the stock of administrative premises grew by 11% (see Figure 15). This increased the number of vacant objects in the suburbs up to 50%. By the year-end, the number of vacant office premises in Tallinn had grown to 15–18% on average. The number of vacant premises increased owing to bigger supply and also because companies wanted to optimise costs due to solvency issues and moved to smaller spaces. Given the oversupply of office premises on the market, it is likely that few new projects will be launched in the next couple of years. It may take years for all the existing commercial real estate to be taken into use.

The great supply of office premises has, in turn, exerted pressure on rental prices, which dropped by an average of 30% in 2009[8]. In 2010, the rental prices of vacant premises have remained relatively stable and will stay in the average range of 80 EEK/m2 also in the coming quarters.

Last year, the demand for new **retail premises** still exceeded the supply and the fill rate of major shopping centres was 100%, whereas in 2010 real estate developers are likely to face bigger difficulties in finding lessees. Consumption has dropped considerably, which will bring about changes in rental prices and in the number of lessees, and a rise in the number of vacant plots, especially as some commercial premises[9] will expand further in 2010. The market of commercial premises is likely to stabilise in the second half of 2010, but growth is not expected before 2011.

Figure 15. Retail and office buildings with building and use permits in Tallinn



Source: register of construction works

[8] Source: Statistics Estonia.
[9] Kristiine shopping centre, Tähesaju City.

QUALITY OF ASSETS

Although the situation in the non-financial sector is still tense, overdue loans no longer increased in the past six months, stabilising in all loan segments. The share of **loans overdue for more than 60 days** rose by 0.3 percentage points to 6.7% of the portfolio (see Figure 16) but this was mainly due to decreasing loan portfolio. The increasing share of overdue loans in total loans points to the fact that the problems of companies and households in financial difficulty persist, and resolving them will take time.

The sectors related to real estate have the most overdue loans, with their share of problem loans being greater than their share in the banks' loan portfolio. The loans issued to the real estate-related sectors constitute 60% of the portfolio, while the stock of overdue loans of these sectors accounted for 72% of total overdue loans in April 2010 (see Figure 17). Consequently, the quality of the banks' loan portfolio depends to a great extent on the well-being of the real estate market, in particular as regards corporate loans.

Growth in overdue loans stabilised in the second half of 2009, but banks continued making loan loss **provisions**. In the first quarter of 2010, around 1.2 billion kroons of additional provisions were made (see Figure 18). Total provisions for covering potential loan losses amounted to

Figure 16. Share of loans overdue for more than 60 days

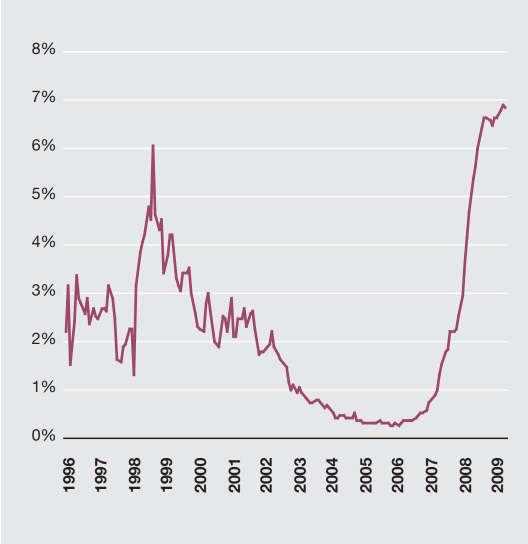
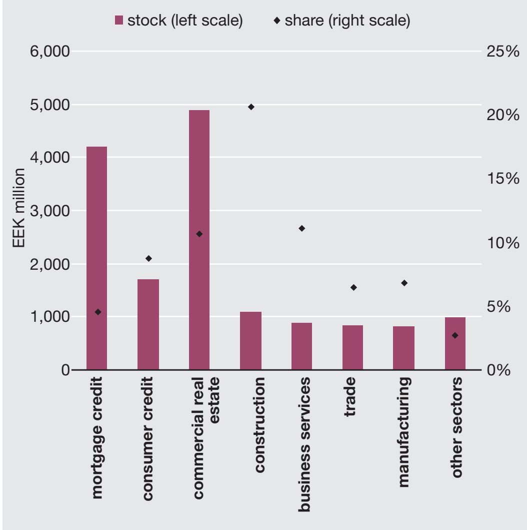


Figure 17. Stock of loans overdue for more than 60 days and their share in total loan portfolio as at 30/4/2010



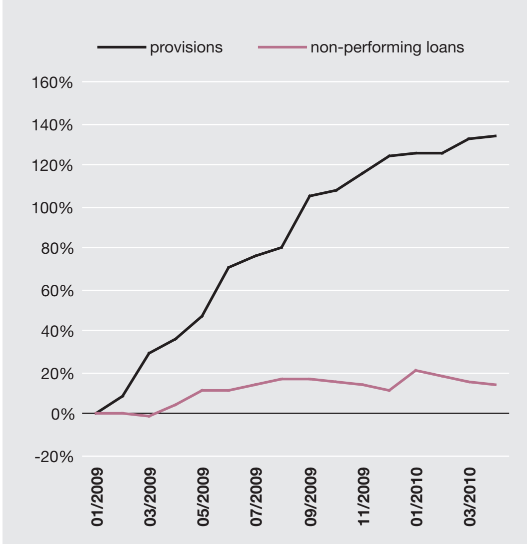
12.2 billion kroons, of which specific provisions for corporate loans made up 7.5 billion kroons, specific provisions for household loans 2.1 billion kroons and general provisions 2.6 billion kroons (see Figure 19).

At the end of April, provisions had been made for nearly 80% of loans overdue for more than 60 days. As the dynamics of growth in overdue loans and provisions for potential loan losses is quite different, banks have presumably changed their principles for handling overdue loans.

In August 2009, banks began dealing more actively with customers in loan repayment difficulties by restructuring their loan liabilities and granting grace periods. Thus, the stabilisation of the stock of overdue loans does not only stem from lower emergence of new non-performing loans but also from the preventive actions of banks. In case of a functioning customer relationship, banks have already taken into account the problems that have arisen, and have made the necessary write-downs.

As regards the **banking groups**, the share of

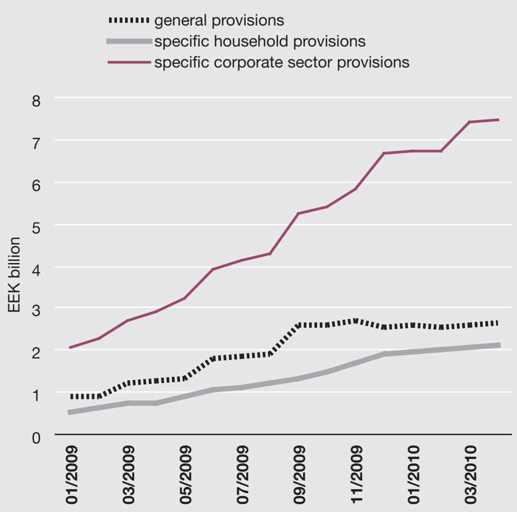
Figure 18. Cumulative growth in provisions and non-performing loans



loans overdue for more than 90 days in the portfolio rose by 1.8 percentage points to 10.6% over the last six months. At the same time, credit institutions have made large-scale provisions for covering potential loan losses: at the end of April, provisions had been made for 94% of loans overdue for more than 90 days. The provisions of groups accounted for 9.9% of their total loan portfolio.

The realised **loan losses** have increased in recent quarters, but the volume of write-offs is still very small. From the beginning of 2009 to the end of March 2010, banks wrote off a total of 1.3 billion kroons of loans, or 0.5% of the loan portfolio. At the same time, banks recovered 371 million kroons of written-off assets. In 2010 and also 2011, loan write-offs are likely to grow further.

Figure 19. Stock of provisions



The impact of the Debt Restructuring and Debt Protection Act on the financial sector

One factor with a significant impact on the operating environment of financial institutions is the draft Debt Restructuring and Debt Protection Act which is being deliberated in the Riigikogu. When it enters into force, the Act will result in changes in the relations between lenders and borrowers. The purpose of the legislation is to enable individuals in financial difficulty to restructure their debts, thus offering an alternative to personal bankruptcy. The Act is expected to enter into force on 1 January 2011 and it is planned to have retroactive force with regard to claims incurred before it enters into force.

The draft Debt Restructuring and Debt Protection Act submitted for the first reading calls for extensive debt restructuring, including reduction of principal claims. Such an amendment could have significant implications on the functioning of the economy and socio-economic relations, as in general a reduction in the debt obligation of a debtor must be covered by other service consumers of the same undertaking or economic branch. This problem does not only pertain to banks, but rather a very broad swathe of the economy, ranging from public utilities to money-lending. A radical change in creditor-debtor relationships could result in more passive behaviour on the part of banks and other financiers, impairing financing opportunities and postponing economic recovery to an even later date.

From the perspective of financial stability, it is to be expected that, if the legislation is supplemented in the form of the initial draft law, the risks for banks will increase and, as a result, interest margins on private loans will increase. For instance, in Finland and Sweden, individuals enjoy no similar debt relief option, and this helps keep interest margins lower. This stems from better financial discipline and a legal space that encourages better financial discipline.

From the perspective of the debtor, the debt restructuring method proposed in the draft legislation is costly and requires expert consulting. Thus, analysis should be devoted to determining how large a debt must be in order for the savings thereby achieved to exceed the procedural costs, and how many individual debtors would be willing to and could afford to carry out debt protection proceedings in this form. Undoubtedly, it would benefit a greater number of debtors, were the reorganization procedure to provide only a few more easily implemented options, such as deferral of debt. As an additional measure, personal bankruptcy proceedings could be made more flexible. Yet another factor that must be considered is the burden placed on courts by proceedings.

To sum up, the provision for debt restructuring for natural persons is a significant new feature in Estonian law. In the opinion of Eesti Pank, such fundamental changes to property law will require additional analysis and a longer transition period. It is preferable to defer debts or recur to other, more feasible ways of restructuring debt, since reduction of principal claims may result in general deterioration in financial behaviour and higher cost of transactions related to debt obligations.