FINANCIAL STABILITY ASSESSMENT

Financial markets

Most regions of the global economy started to recover from the recession in the second half of last year. Countries that used extensive national support measures to stabilise the financial system and stimulate their economy are facing higher government debt. In spring 2010 it emerged that debt financing has become complicated in some euro-area countries and the credibility gap in markets may spread to other European countries as well. Although measures to avoid it and also to alleviate financial-market tensions were agreed upon in the euro area with the support of the IMF, there persists a serious risk that the improvement in the liquidity of banks over the past half a year may suffer a setback.

The situation in international financial markets affects the financing of banks operating in Estonia by their parent banks. The parent banks' access to financing has improved relative to the same period a year ago and market participants view their investment in Nordic countries as more secure than average. However, should tensions in the European financial markets intensify, it may also complicate the financing of Nordic banks.

Since euro-area economic growth is gradually recovering and inflation is low, monetary policy interest rates are projected to also remain low in the course of the next half a year. The yield of stock and bond markets will probably remain volatile against the backdrop of high uncertainty and affect the value of investment of financial market participants, including banks, investment funds and insurance companies.

Although Estonia's emergence from the deep recession and improvement of the country's economic situation will take time, the assessments of international financial markets and analysts regarding our economic developments are more positive compared to autumn 2009. Risk premiums in the kroon futures transactions market have markedly contracted and rating outlooks have become more positive. Assessments are already reflecting Estonia's possible accession to the euro area at the beginning of 2011.

Real economy and loan quality

The sales turnover and profitability of mostly exporting-sector companies has started to pick up this year. However, its effect on improving the solvency of enterprises is modest for the time being. In order to be prepared for a new growth cycle, companies need to make even more adjustments to their balance sheet. Here the business sector benefits from the key interest rates, which continue to be low, although it may happen that problems in some euro-area countries are damaging the confidence of companies and households there. Thus, the Estonian exporting sector is facing a real threat that external demand, which is currently on the mend, will suffer a setback.

Recovering from the recession, companies with unutilised capacity continue to keep their expenditure in check, which means that increasing production volumes will not be accompanied by rapid employment growth. Labour-market problems are the main factor holding back the confidence of households in 2010, although it is likely the current cycle will not undergo such an upsurge in unemployment as it was experienced during the recession. The financial standing of people without a job is going to deteriorate markedly after they stop receiving the unemployment insurance benefit.

Improvement in the credit portfolio quality of banks will take time, depending on economic growth and labour market situation. Although it is assumed that problems with repaying loans peaked last year, Eesti Pank's forecast expects the share of loans overdue by more than 60 days to remain at a relatively high 6% level in 2010 and decline rather slowly also in the years to come. This is partly related to more extensive use of repayment holidays and loan restructuring as from the second half of 2009, so part of repayment problems is distributed over a longer period of time. If borrowers in temporary solvency difficulties resume meeting their liabilities once economic activity recovers, the positive impact of loan restructuring will soon manifest itself in the improving loan quality of banks. At the same time it is likely there are borrowers who will not be able to continue meeting their liabilities even after a repayment holiday.

Strength of financial institutions

Banks continue to write down loans, since the volume of problem loans may still increase in some sectors this year. The volume of new provisions will be notably smaller compared to 2009 and, according to Eesti Pank's forecast, it will withdraw to the level of 2008. The expected decline in loan losses in the second half of 2010 is presumably the main factor supporting profitability growth in the banking sector.

Since the balance sheets of banks are dominated by floating interest rate and euro-based loan contracts, low interest rates have, on the one hand, exerted a negative impact on net interest income, but, on the other hand, contributed to interest income earning by enabling better repayment ability. The pronounced curtailment of kroon deposit interest rates has this year contributed to net interest income growth. With economic recovery being slow, positive effects on banks' profitability arising from this development are not expected to show within the next half a year. Though payment intermediation may increase somewhat, lending activity will remain sluggish and provide no considerable support to banks' income growth.

The capitalisation of both the banking and insurance sector is good. If the assumptions of Eesti Pank's forecast materialise, capitalisation of the banking sector will remain sufficient throughout 2010. At the same time, it is important for banks to be ready to cope with a less favourable situation than projected in the forecast base scenario. Banks need to consider the risks listed above in their risk management and in securing their liquidity and capital buffers.

The credit market has been most affected by weak demand. In addition, uncertainty and possible amendments to legislation may inhibit the willingness of banks to establish new customer relations and offer favourable credit conditions for financing projects. In addition to the stricter liquidity and capital requirements planned to be laid down in Europe, the behaviour of banks operating in Estonia depends also on the legislation on restructuring households' debt. From the point of view of credit market developments and financial stability it is important that the provisions of the new act would neither deteriorate borrowers' repayment discipline nor increase transaction costs related to debt liabilities.

Settlement systems

The liquidity of Eesti Pank's settlement systems has been sufficient owing to the high reserve requirement. However, there will be changes in banks' short-term liquidity management, since the reserve requirement will be reduced to the level applicable in the euro area. Since larger banks operating in Estonia belong to the liquidity management framework of their parent banks, the changes they have to undergo will mainly be of technical nature. In addition, the adoption of the euro will contribute to further centralisation of liquidity management.

Summary

Although several risks observed in autumn 2009 have decreased, recent developments in the external environment have increased uncertainty also for banks operating In Estonia. If the external environment deterioration continues, it is possible that assessments of the financing possibilities of banks and of the materialisation of a credit risk, which have improved over the past half a year, will worsen again. Thus, the reasonable thing to do is to ensure there are sufficient financial buffers in place.