2. THE REAL ECONOMY AND LOAN QUALITY

2.1 THE CREDIT PORTFOLIO OF BANKS[15]

The total volume of **loans and leases** given by banks to the non-financial sector started to increase in the second quarter of 2014, having grown very slowly in the first quarter. At the end of August the credit portfolio stood at 15.5 billion euros and had grown by 3.3% over the year (see Figure 2.1.1).

The corporate loan portfolio grew more slowly year on year in the first quarter, mainly due to reduced borrowing from the logistics and infrastructure sector. Growth picked up again in the second quarter. The fastest growth over the year was in the loan portfolios of real estate and construction and the manufacturing sector (see Figure 2.1.2). Growth slowed in the loan portfolio of the primary sector, but it still remained quite fast, and relatively fast growth was also seen in loans to the trade sector from the second quarter. The largest growth was in long-term loans for investment, though there was also a significant increase in short-term loans to manufacturing and trade, particularly in the form of factoring and overdrafts. At the end of August the corporate loan portfolio stood at 8.1 billion euros and had grown by 4.9% over the year.

The household loan portfolio continued to expand in the first half of the year, and by the end of August its annual growth had reached 1.6%. Even though the real estate market stabilised in the second quarter, one fifth more new housing loans were issued during the first eight months of the year than in the same months of the previous year. Repayments of old loans meant that the total stock of housing loans grew only moderately, by 2.1% over the year. The decline in the stock of other household loans went into reverse this year. The car lease portfolio has been grow-

15 The credit portfolio contains loans, leases and factoring.

Figure 2.1.1. Annual growth rates of banking sector loans and leases to businesses and households

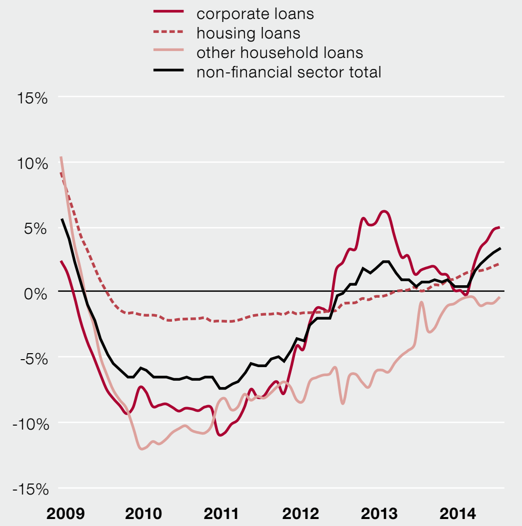
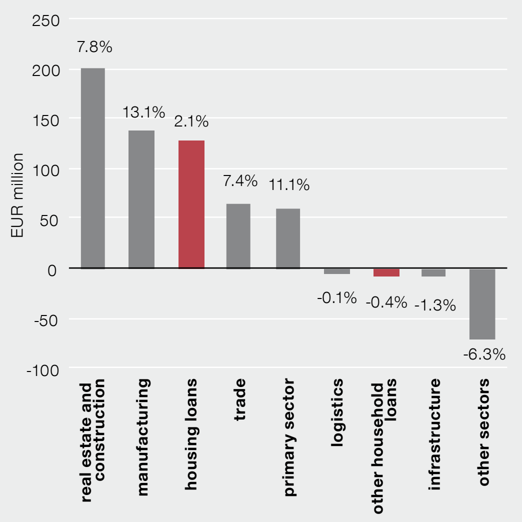


Figure 2.1.2. Annual growth in loans and leases to businesses and households as at 31/08/2014



ing for several years, but in the second quarter consumer loans started to increase gradually and so the total portfolio of other household loans has started to grow in recent months as a result. At the end of August the total portfolio was still 0.4% down on a year earlier, and overdrafts, credit cards and consumer loans were 3.1% down, but the stock of car leases was 8.5% larger over the year.

The structure of the credit portfolio of banks saw the share of corporate loans increase slightly, mainly due to increased lending to the manufacturing, real estate and construction, trade, and primary sectors. The share of housing loans in loans to households increased.

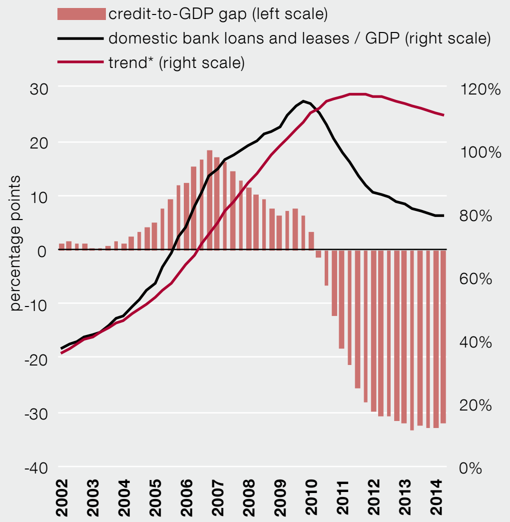
Eesti Pank's updated forecast released in autumn 2014 predicted that the credit portfolio of the non-financial sector will grow by 3.9% this year and this growth is expected to speed up to 4.5% next year.

Assessment of the need for a countercyclical buffer requirement

Countercyclical capital buffers are applied to increase the resilience of the banking sector and to reduce the impact of the economic cycle on the lending behaviour of banks. Countercyclical capital buffers need to be required if excessively fast credit growth is leading to risks building up and systemic risks increasing.

The starting point for assessing the need for a countercyclical capital buffer requirement is the credit-to-GDP ratio and its deviation from the long-term trend, the credit-to-GDP gap. The credit-to-GDP gap in Estonia has been negative at about 30 percentage points since 2012, and is calculated to remain negative for the next several years (see Figure 2.1.3). However, a negative

Figure 2.1.3. Ratio of domestic bank loans and leases to GDP and the credit-to-GDP gap



Sources: Statistics Estonia, Eesti Pank
* HP filter (lambda = 400,000)

Figure 2.1.4. Annual growth of the loan and lease portfolio of banks and nominal GDP

Sources: Statistics Estonia, Eesti Pank

credit-to-GDP gap does not make it impossible that increases in debt could start to create systemic risks sooner, and so other indicators also need to be considered in the assessment of the need for buffers. It is most important to observe changes in credit growth and how it differs from economic growth. Growth in the loan and lease portfolio to the non-financial sector has been relatively moderate this year and has remained slower than nominal economic growth (see Figure 2.1.4). The updated forecast released in September by Eesti Pank expects that credit growth in the non-financial sector will be slower than nominal GDP growth in 2015 and 2016, and so Eesti Pank does not consider it necessary to impose countercyclical capital buffers in the fourth quarter of this year or the first quarter of next.

2.2. THE LOAN REPAYMENT ABILITY OF COMPANIES

Although the financial results of companies in the first half of 2014 worsened somewhat, their repayment ability remained good. The relatively rapid improvement in their results in recent years, moderate borrowing, and a conservative approach to paying out dividends mean that the liquidity and capitalisation of companies have been good. Their ability to repay is also supported by very low interest rates and these factors together have allowed the payment behaviour of companies to improve too, and this has reduced the volume of problem loans[16]. The current financial buffers are very probably sufficient to prevent major payment problems arising if short-term difficulties crop up. In the longer term it is important when external demand recovers and how quickly, and whether the adjustment in wage costs to the reality of slower economic growth continues.

16 See also section 2.5 Asset quality

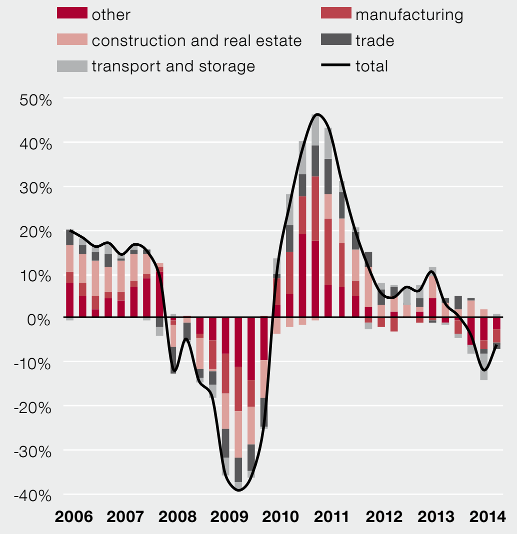
The general economic environment and corporate financial results

Developments in the external environment have remained uncertain. There was some recovery in growth in the euro area in the second half of last year and at the start of this, but growth ceased in the second quarter. Economic confidence worsened in the third quarter, and the sanctions imposed by Europe and Russia on each other added to this. While growth has continued to stall in Finland, it has remained quite fast in Sweden, Latvia and Lithuania, with support from domestic demand.

Like it did last year, **the Estonian economy** continued to grow modestly in the first half of this year. Growth was still barely noticeable in the first quarter, but in the second it picked up to 2.4% year on year. Growth is still mainly supported by domestic demand, and exports have remained at a fairly constant level for the past year and a half.

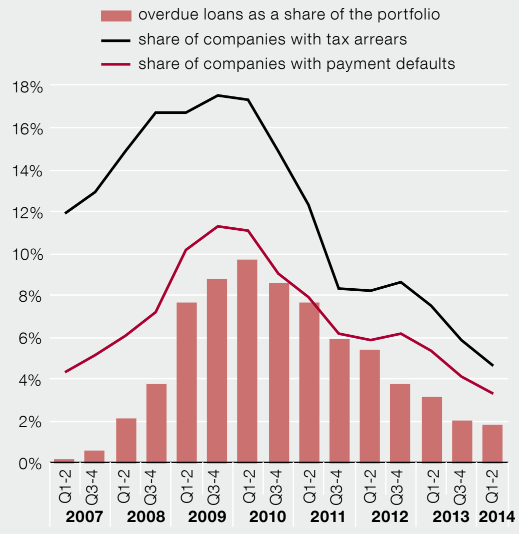
The financial results of Estonian companies are somewhat worse than they were last year. Corporate **sales turnover** was about the same in the first half of this year as it was a year earlier. Although the labour market has started to adjust to moderate economic growth, wage growth remained quite fast in the first half of the year despite slowing. Corporate **profits** are down on a year earlier as a result (see Figure 2.2.1). Profits have fallen in most sectors, including manufacturing, wholesale, construction, energy, and transport and storage. Profits have, however, increased in real estate, retail trade, finance and insurance activities, and accommodation and restaurants.

Figure 2.2.1. Profit (operating surplus and mixed income) growth by sectors



Source: Statistics Estonia

Figure 2.2.2. Payment behaviour of companies



Sources: Krediidiinfo, Eesti Pank

Payment behaviour of companies and bankruptcies

The payment behaviour of companies continued to improve in the first half of the year. The shares of companies with **payment defaults** and **tax arrears** both fell to the lowest levels seen in the past eight years (see Figure 2.2.2). These shares fell for companies of all sizes in almost all the main sectors. The share of companies with payment defaults and tax arrears is still highest in accommodation and restaurants and in construction.

Although the **number of bankruptcies** has risen slightly, it is still very low at around the level it was during the boom.

Financial status and payment capacity of companies

Slower nominal economic growth and somewhat increased borrowing mean that the decline in

Figure 2.2.3. Indicators of the ability of companies to repay loans

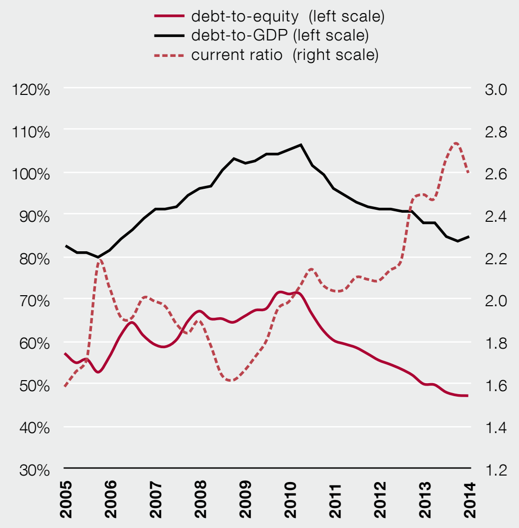
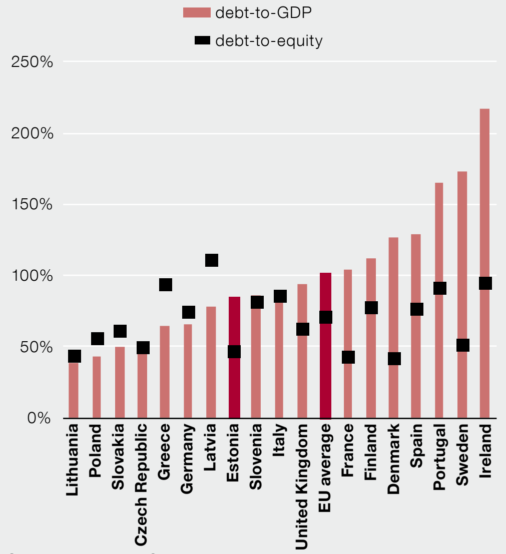
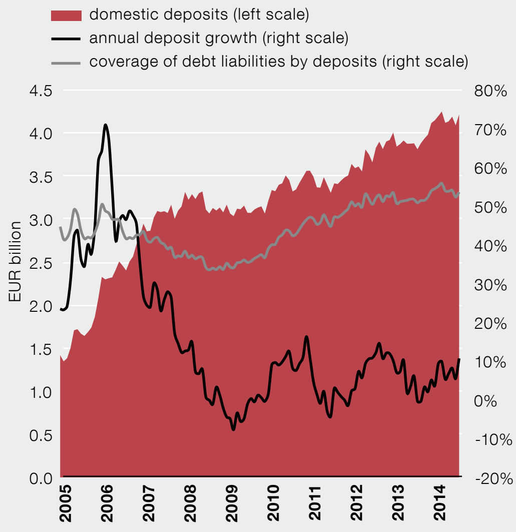


Figure 2.2.4. Corporate indebtedness and leverage in selected European Union countries at end 2013



Source: European Central Bank

Figure 2.2.5. Volume and growth of corporate deposits



corporate **indebtedness**, or debt as a ratio to GDP, has stopped. Corporate **financial leverage**, or the ratio of corporate debt to equity, still fell further at the start of this year as companies reinvested the lion's share of their profits, meaning the growth in corporate equity was again relatively fast (see Figure 2.2.3). The indebtedness and financial leverage of Estonian companies is relatively small in comparison to the past decade and to other member states of the European Union (see Figure 2.2.4).

The financial buffers of companies continue to increase. Rapid growth in deposits means that the ratio of deposits to debt liabilities is high by the standards of the past decade, despite some acceleration in growth of the corporate loan portfolio (see Figure 2.2.5). The corporate **interest burden** is being held down to an extent by very low base interest rates, as it was earlier.

2.3. THE LOAN REPAYMENT ABILITY OF HOUSEHOLDS

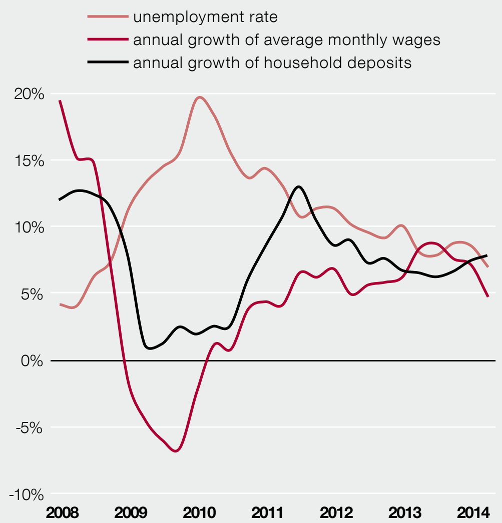
Consumer confidence in both Estonia and the euro area remains higher than its long-term level, but in recent months it has declined slightly (see Figure 2.3.1). This is borne out by data from the Estonian Institute for Economic Research, which show that the main reason for a fall in the confidence of Estonian residents has been worries about the outlook for the economy. At the same time, expectations for savings and the labour market have not changed much. The consumer price index has remained very stable this year and that has lowered consumers' expectations about inflation.

Rises in gross monthly wages slowed in the second quarter of the year to 4.8% from 7.3% in the first quarter (see Figure 2.3.2). Rapid wage growth was not in line with lower levels of economic

Figure 2.3.1. Consumer confidence indicator

Sources: Estonian Institute of Economic Research, European Commission

Figure 2.3.2. Unemployment rate and average gross wage and deposit growth



Sources: Statistics Estonia, Eesti Pank

activity as the profits of companies were eroded in the difficult external environment. Labour costs have so far increased at the expense of profit margins, and so a correction in wage growth was to be expected. As consumer prices have risen only moderately over the year, real wages increased by 4.8% in the second quarter.

Unemployment fell year-on-year for the second quarter in a row (see Figure 2.3.2) and in the second quarter it stood at 6.9% and was below the euro area average. The fall in unemployment was affected by the decline in labour force participation. The employment rate increased slightly to 63% of the working-age population, which is close to where it was in 2007 and 2008.

Annual growth in household deposits started to pick up at the end of last year and by the second quarter of this year it had reached 7.9%. Growth in deposits was aided by rapid wage growth, though it was probably also raised by falling

Figure 2.3.3. Household deposits

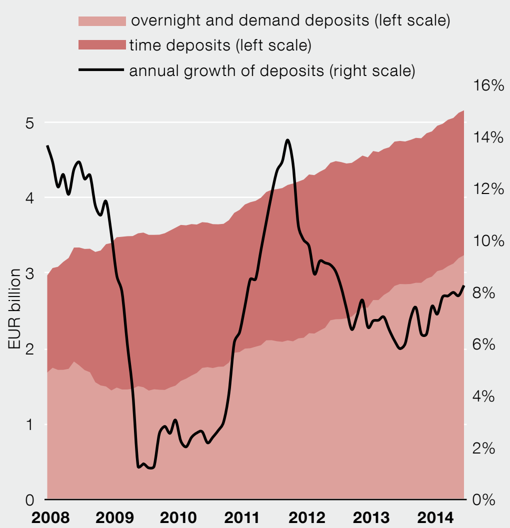


Figure 2.3.4. Household indebtedness

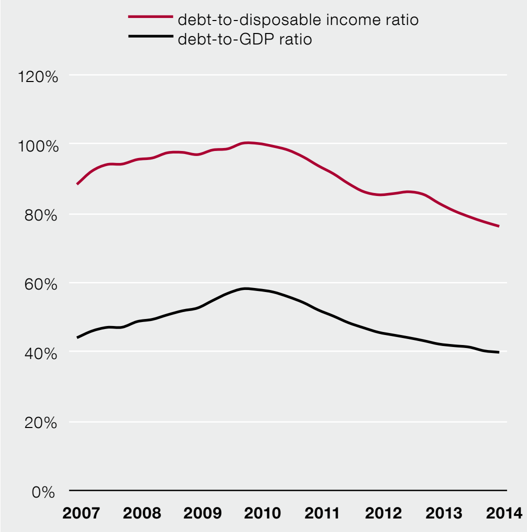
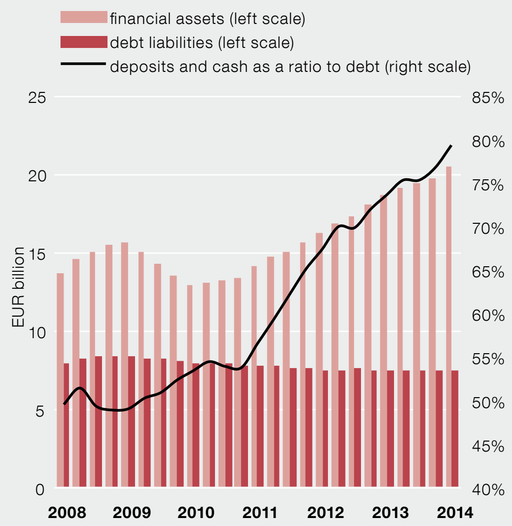


Figure 2.3.5. Financial position of households



confidence. As interest rates on term deposits are low, the main growth has been in overnight and demand deposits, which increased in value to 3.2 billion euros. The value of term deposits has remained at 1.9 billion euros for more than a year by now (see Figure 2.3.3).

The household debt burden has fallen steadily since 2010 and debt as a ratio to disposable income fell below 80% in the second quarter of 2014, while the debt burden fell to 40% of GDP (see Figure 2.3.4).

The financial position of households is generally good as debt liabilities have not changed much while household financial assets have increased at the same time (see Figure 2.3.5). Household deposits and cash as a ratio to total debt are at a high level, climbing to nearly 80% in the second quarter.

The household interest burden remained low in the first and second quarters of this year (see

Figure 2.3.6. Household interest burden

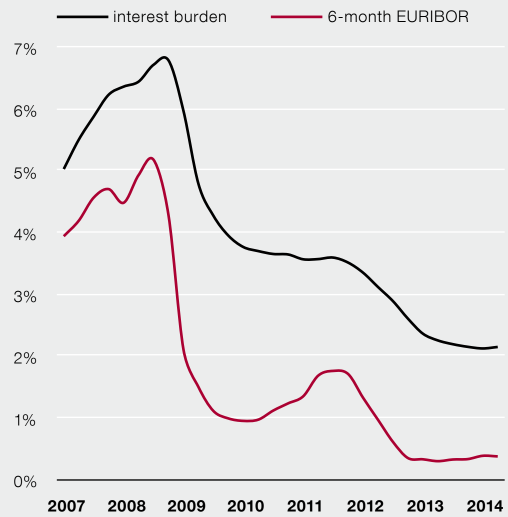


Figure 2.3.6). This was helped by slow growth in the loan and lease liabilities taken on. Interest rates on loans and leases have remained low at the same time and household disposable income has increased.

As wage growth has slowed but remains positive and the labour market is generally favourable, there is no reason to doubt the continued ability of households to repay their loans.

Box 3: Macroprudential requirements for housing loans

Changes to the Credit Institutions Act that came into effect on 19 May 2014 gave Eesti Pank the right to set requirements for loans issued by credit institutions. Among these were limits on the loan-to-value (LTV) ratio, the borrower's debt service-to-income (DSTI) ratio, and the maximum maturity of loans. Unlike many other European Union member states, Estonia has not previously set these limits as a numerical value in regulations or in the supervisory guidelines. The banks operating in the credit market have set their own internal limits on these ratios and have defined the principles for the calculation of reasonable debt burdens for borrowers in line with the EFSA's guidelines for responsible lending.

The requirements for loans are an important part of those macroprudential tools that aim to prevent excessive loan growth and financial leverage and to increase the resilience of credit market participants to any negative events. As the LTV and DSTI limits restrict the loan amount available to borrowers, they help to reduce demand for real estate financed with loans during the upswing of the real estate cycle, and help reduce upward pressure on housing prices.

Demand for loans from Estonian households has been modest in recent years and the lending standards of banks are generally appropriate for the current macroeconomic environment, so the new requirements for lending can be introduced in such a way that they do not significantly affect the current credit environment. Setting these limits is important for avoiding credit booms, as they help stop standards being loosened if competition between the banks increases in the housing loan market. If risks start building up significantly in the real estate market and the risk behaviour of lenders and borrowers amplifies the cyclical upswing, then Eesti Pank will be able to tighten the requirements that are already in place. It is assumed that this would lead to a reduction in lending and would lower the chances of a housing bubble inflating.

Eesti Pank plans to introduce three limits concurrently to regulate the issuance of housing loans (see Table B3.1). The requirements will apply for housing loans issued in Estonia by all banks operating in Estonia, including the branches of foreign banks. The requirements will apply from the start of 2015. The baseline for deciding where to set the limits will be the banks' lending standards in the autumn of 2014. Macroprudential requirements for mortgage lending have also been applied to most of the parent banks of banks operating in Estonia, and there is, for example, an LTV limit of 85% in Sweden and Norway.

Table B3.1. Eesti Pank's proposed requirements for housing loans

	Requirement	Maximum permitted level
1	**Loan-to-value (LTV) limit for housing loans** Limit on the ratio of a housing loan to the value of the real property used as collateral	85%*
2	**Debt service-to-income (DSTI) limit** Limit on the ratio of total loan and interest payments of a new housing loan and all current loans of a household to the net income of the household	50%
3	**Maximum length of a housing loan**	30 years

* For housing loans guaranteed by state foundation KredEx the maximum limit of the LTV is 90%
Allowed exceptions: up to 15% of the amount of housing loans issued in a month

To ensure that banks have sufficient flexibility in making decisions about lending and in assessing the risks associated with it, and thus to help make sure that the credit market operates as efficiently as possible, Eesti Pank plans to add another regulatory option that would permit banks to issue a predefined share of housing loans that breach the limits.

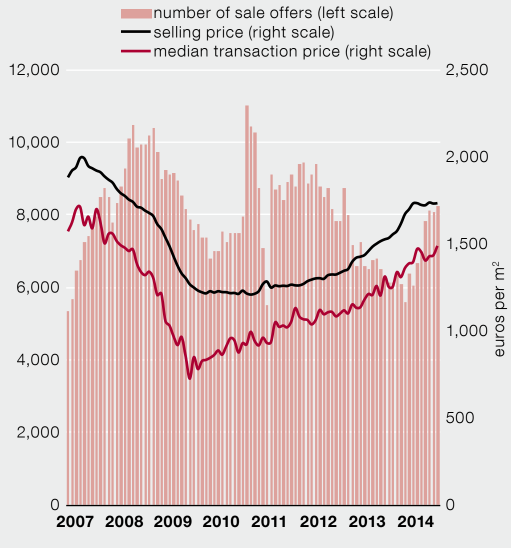
2.4. THE REAL ESTATE MARKET

The housing market

The Estonian real estate market has started to stabilise as prices are rising more slowly and the number of transactions has clearly fallen. At the start of the year the number of apartment transactions was 13% up on the year, but in the third quarter the number of transactions was down 12% on average for the whole of Estonia, and down 10% in Tallinn. Both resident private people and foreigners made fewer real estate transactions in the third quarter for the first time. At the same time, the number of properties on sale on the real estate website KV.EE has been increasing since the middle of last year (see Figure 2.4.1). The price index for apartments stopped rising in the second quarter of this year (see Figure 2.4.2). The price index for land with buildings, which sees around half the number and value of transactions that apartments do, rose slightly, as did that for land without buildings.

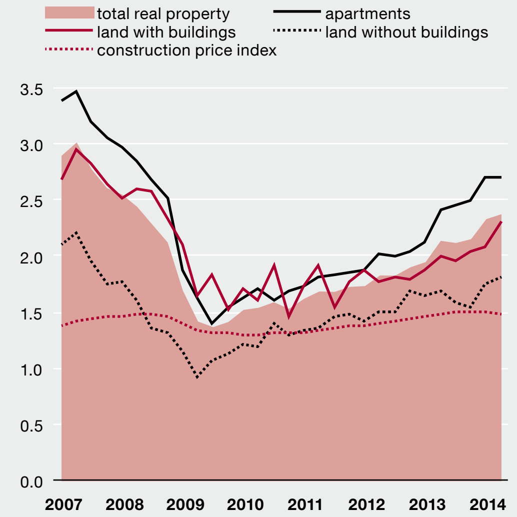
The median apartment price in Estonia rose by 8% in the third quarter of 2014, which is less than in the first half of the year, and prices are rising more slowly in all the larger towns in Estonia (see Figure 2.4.3). The median price of a square metre in an apartment in Tallinn has been between 1300 and 1400 euros since the start of the year,

Figure 2.4.1. Selling and transaction prices of Tallinn apartments and number of sales offers



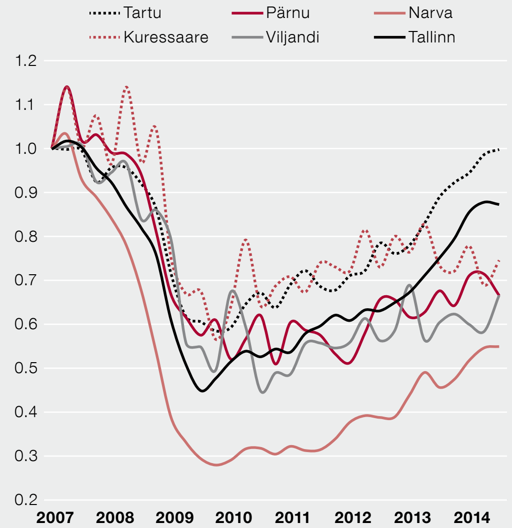
Source: KV.EE

Figure 2.4.2. Real property price indices, Q2 2003 = 1



Sources: Estonian Land Board, Statistics Estonia, register of construction works

Figure 2.4.3. Growth in median square metre price for apartments, Q1 2007 = 1



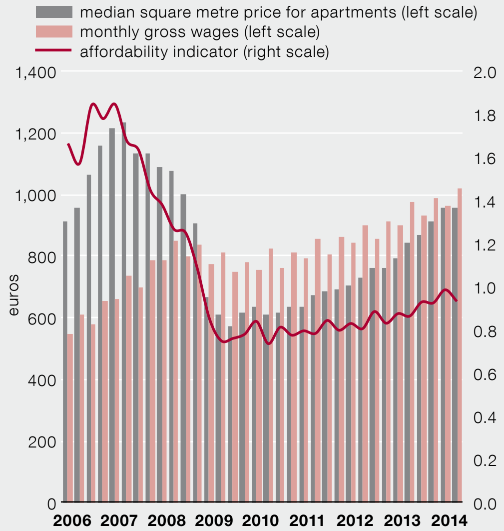
Source: Estonian Land Board

and this is 15% below the peak reached at the height of the boom in 2007.

The housing affordability index, which shows the relationship between the median price of apartment transactions and average gross wages, has been rising for a long time. This indicates that real estate prices are rising faster than gross monthly wages (see Figure 2.4.4). The affordability indicator averaged 0.94 in Estonia in the second quarter of the year and was slightly higher in Tallinn, as usual, at 1.16. The worsening affordability of apartments has probably also driven the rise in the index for rents, which was up 13% over the year in July, when the index hit an all-time record peak and stood 75% higher than in 2005.

Low interest rates and the rise in real estate prices in the past quarters have made real estate development projects more profitable. This is reflected in the number of permits issued for

Figure 2.4.4. Real estate affordability



Sources: Estonian Land Board, Statistics Estonia building residential space, which jumped to over 1300 in the second quarter (see Figure 2.4.5). Although it is some time since so many building permits were issued, looking back further there was a point when over a thousand building permits were commonly issued in a quarter, and during the boom some 4000 building permits were issued per quarter.

The commercial property market

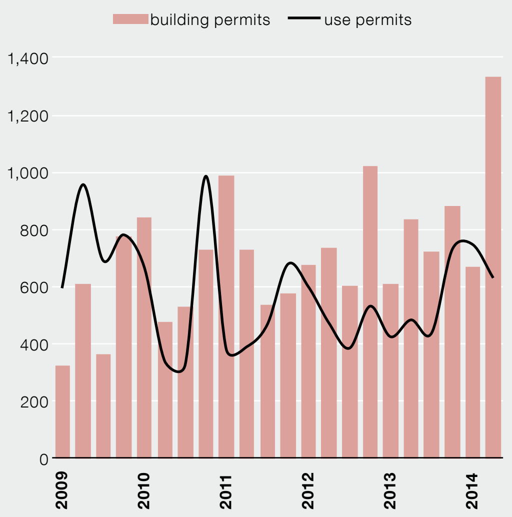
The average usable area of the new non-residential buildings to be built under the building permits issued was 30% larger in the second quarter of this year than a year earlier. The usable area of retail premises where work has started was notably bigger, increasing from the 10–20,000 square metres a quarter that has been typical in recent years to around 137,000 square metres.

Real estate administrators variously put the available office space in the second quarter at 3–7%, though the occupancy rate for high-quality office buildings in central Tallinn was almost 100%. As the usable area of office space with building permits increased both at the end of last year and in the first half of this, the amount of available space may soon start to increase somewhat once the development projects are completed (see Figure 2.4.6).

2.5. QUALITY OF ASSETS

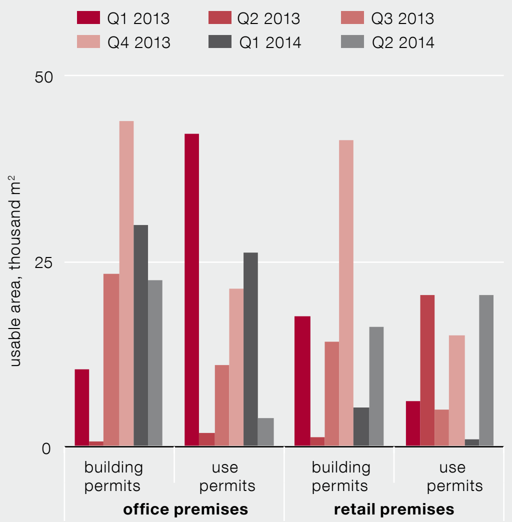
The quality of the loan portfolio of the banks continued to improve in the first half of 2014, but more slowly than before. **The stock of loans overdue by more than 60 days** fell to 251 million euros by the end of August and was 28% smaller than a year earlier. Overdue loans made up 1.8% of the total portfolio, which was 0.8 percentage point less than a year before (see Figure 2.5.1).

Figure 2.4.5. Building and use permits issued for residential real estate



Sources: Stiatistics Estonia, register of construction works

Figure 2.4.6. Building and use permits issued for commercial real estate



Source: Statistics Estonia

Figure 2.5.1. Share of overdue loans and provisions in the loan stock

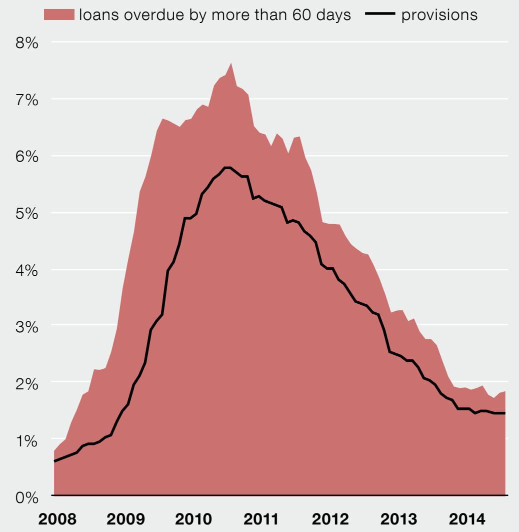
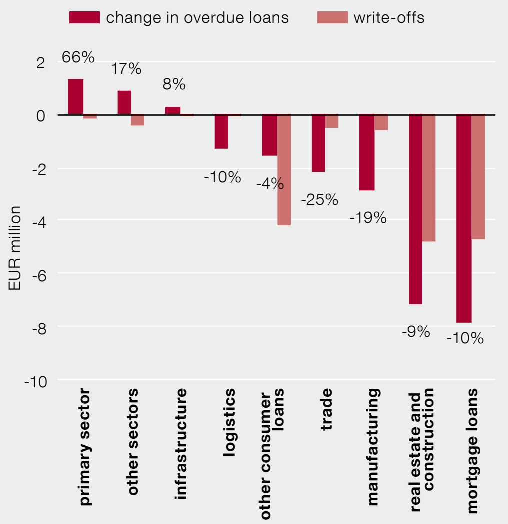


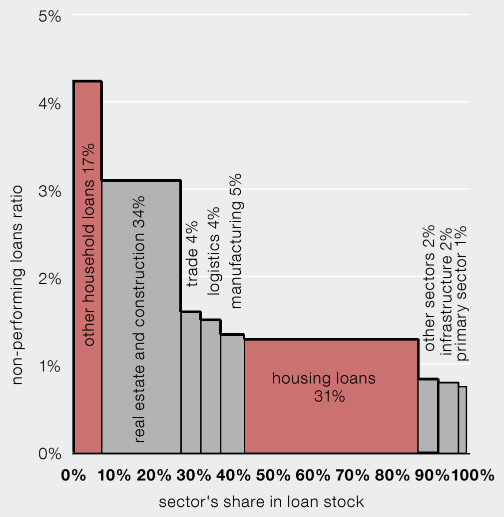
Figure 2.5.2. Change in loans overdue by more than 60 days and write-offs in the first half of 2014



Although the value of overdue loans increased slightly in the first quarter, it started to shrink again in the second. This was primarily driven by write-offs, which accounted for about 75% of the reduction in overdue loans in the first half of the year. The amount of write-offs can vary quite widely, and for example they only accounted for less than half of the reduction in overdue loans in the second half of last year.

The main reduction in overdue loans in the first half of the year came in loans to the real estate and construction sectors and in housing loans (see Figure 2.5.2). Loan quality also improved substantially for trade, manufacturing and logistics companies. Although there was an increase in overdue loans to the primary and infrastructure sectors in the first half of the year, these small sectors continue to be among the best for loan quality as fewer than 1% of loans were overdue in August (see Figure 2.5.3). There is no direct threat to financial stability from any of these changes.

Figure 2.5.3. Structure of the loans overdue by more than 60 days as at 31/08/2014*



*Area represents sector's share in loans overdue by more than 60 days

The quality of the loan portfolio also improved because of a reduction in the number of **loans restructured** because of repayment problems. The stock of loans restructured but overdue by less than 60 days fell to 208 million euros by the end of August and was down 64 million euros or 24% on the year. Such loans accounted for around 1.5% of the portfolio at the end of August, at which point 3.4% of the loans in the portfolio were restructured or long overdue, which was 1.3 percentage points fewer than a year earlier

Together with the fall in overdue loans there was also a reduction in **provisions**, which stood at 199 million euros at the end of August, which is one quarter less than a year earlier. The ratio of provisions to overdue loans remained high at around 80% in August and 1.5% of the loan portfolio was covered by provisions.

The **securities portfolio** of banks operating in Estonia was more than twice as large at the end of August as it was a year earlier at 1.5 billion euros. Although most of the increase in the securities portfolio came last year, it increased by another 15% this year and accounted for 7.2% of the assets of the banking sector. A large majority of 80% of the securities in the portfolio are sovereign bonds and bonds of credit institutions and other financial institutions. The largest increase has been in the holdings of sovereign bonds, and mainly in those issued by large Western European countries like France, Germany and the Netherlands. There has however been a decline in the stock of securities of financial institutions since the start of the year, particularly those of firms from Germany and Luxembourg, though the holdings of securities from French credit and financial institutions have increased significantly.

The conflict between Ukraine and Russia has increased the risk of securities from those countries, but this does not have a major impact on banks operating in Estonia as there were no holdings of Ukrainian securities at the end of August and Russian securities accounted for about one thousandth of the total securities portfolio of the banking sector.