FINANCIAL STABILITY ASSESSMENT

The international financial environment

As inflation has been very low due to the weakness in the economic environment and the fall in commodities prices, many central banks maintained their accommodative monetary policy stances in the second half of last year and at the start of this. Because growth has been slow and interest rates have been low, investors are searching for yield. The prices of a lot of financial assets have risen in consequence to their highest ever levels, and the chances of a sharp fall in them have increased.

However, the riskiest financial assets could prove less liquid in a downturn in the market than is perhaps expected and this could amplify falls in prices if there is a loss of appetite for risk and a reallocation of investment. The appetite for risk could be reduced by a change in the outlook for the economy or by a widening of geopolitical tensions. A fall in the prices of financial assets would lead to a fall in the value of the assets held by companies, households and financial institutions and this could impact consumption, investment and economic growth.

Growth picked up slightly in several countries in the euro area at the end of last year, mainly because of an increase in private consumption. Further growth in the euro-area economy is getting encouragement from low commodities prices, monetary policy measures taken by the European Central Bank, and a depreciation of the euro. The recovery is fragile since many countries still need to deal with their high levels of debt and long-term problems of unemployment. Growth is also being restrained by continuing uncertainty surrounding the sustainability of Greek government finances and geopolitical tensions.

Banking in the euro area has been affected by uncertainty among investors about the capacity of banks to bear loan losses, because overdue loans have been running at a high rate. The profitability of euro-area banks is coming under pressure not only from loan losses but also from slow economic growth and low interest rates. The comprehensive assessment by the European Central Bank increased the transparency of the banks and showed that the majority of banks in the euro area are able to cope with negative developments.

The Estonian financial environment

The Estonian economy continued to grow steadily in the second half of 2014. Growth is still mainly supported by domestic demand, but exports started to increase in the second half of the year. The impact of the Russian sanctions and of the slowdown in growth on the Estonian economy has so far remained small. Exports to Russia have shrunk notably, but a large part of those exports was produced in other countries, and so the impact on the Estonian economy has been minor. Estonian companies have also succeeded in increasing their exports of goods and services to other countries.

Although corporate revenues were the same size last year as a year earlier, labour costs have increased and so profits have shrunk. The decline in profits meant that corporate deposits grew more slowly. The reduction in the internal funds available to companies has increased their need for external funding, and the indebtedness of companies increased slightly to 93% of GDP by the end of the third quarter of 2014. The financial standing of companies was slightly worse than it was in the preceding year and the share of companies facing payment difficulties and tax arrears has increased. The ability of companies to repay their debts can still be considered quite good, as their financial leverage remains low in comparison to their levels in the past decade or to those in other euro-area countries, and their liquidity is high.

Household incomes were raised by the favourable conditions in the labour market and by rapid wage growth. Low inflation boosted the purchasing power of consumers, and their confidence remained high. Rising incomes led deposits to grow quickly too, while household debts increased slowly at the same time. However, debt liabilities did not increase faster than incomes and so indebtedness did not increase in 2014 and was at the same level of 70% of household disposable income at the end of the third quarter of 2014 as at the end of 2013. The ability of households to service their loans remained good.

After real estate prices rose rapidly at the end of 2013 and in early 2014, the real estate market stabilised to some degree. The average transaction price rose more slowly, and part of the rise in prices was due to a change in the structure of transactions, as the share of transactions that were for new and more expensive residential space increased. As the rise in real estate prices has made development projects more profitable, real estate developers have started to focus more on developing residential property. There are markedly fewer plans to build new residences than there were when the economy was growing rapidly. On top of residential development there has been an increase in the development of retail space and particularly of office buildings.

The activities of the banks are affected by low interest rates and by uncertainty about the outlook for the economy. The loan and lease portfolio has grown steadily in value and in February it was 2.9% larger than a year before. Profitability was down a little in 2014, but it was still good against the levels seen in other euro-area countries. Profitability is supported by the good quality of assets, the low price of funds because the share of demand deposits in liabilities is large, and relatively good cost efficiency. As the fall in base interest rates has a negative effect on interest income, banks are actively looking for other ways to maintain their profitability.

The strong financial position of Estonian companies and households means that loan quality for the banks is good and it continued to improve in 2014, albeit at a slower pace than before. The baseline scenario of the forecast sees that the quality of the loan portfolio will continue to improve further. In the risk scenario, which posits an increase in problem loans for Estonian companies in connection with trade with Russia or with changes in economic activity, the banks earn less profit than in the baseline scenario, but their capitalisation remains strong. The ability of the banks to bear losses is good, because of their levels of profitability and capital.

The Eesti Pank report on the Financing of the Economy 2015 found that the use of non-bank consumer credit has increased in recent years. Non-bank lending, or shadow banking, has grown in many countries around the globe as the requirements for banks have tightened and the liquidity in financial markets has been high. The volume of assets of Estonian shadow banking is not known exactly, but indirect estimates suggest that it is small.

The Estonian insurance market was supported in 2014 by steady economic growth and higher household incomes. Like banks, life insurers are finding their profitability restricted by low interest rates and if these circumstances endure, insurance companies may invest more in riskier assets, which could make their financial results more volatile.

Payment and settlement systems

The Eesti Pank gross transfers system TARGET2-Eesti worked without incident last year, while banks had sufficient liquidity buffers for making settlements without any disturbances. Intra-day liquidity loans were only needed occasionally and overnight credit was not required.

Eesti Pank assessed how the securities settlement system met the oversight requirements in 2014 and continues to monitor now how the recommendations of the Estonian Central Securities Depository are implemented. Eesti Pank also monitors the success of the Central Securities Depository following changes in the market. Compliance with regulations on securities settlement and central securities depositories are monitored, together with the introduction of the X-stream settlement platform that will cover all of the Baltic states, the harmonisation of the work of the depositories to improve the efficiency of their work, and the accession to T2S. These changes have an impact on the settlement of securities and so they are becoming ever more relevant.

Risks to financial stability

The risks to Estonian financial stability in the next half year are small at present, in spring 2015. Risks are being reduced by the recovery of the economy in the euro area, by the strong financial position of Estonian companies and households, and by the high capitalisation of the banking sector. A lack of confidence remains around the continuation of the conflict between Russia and Ukraine and around the decline in the Russian economy, so uncertainty about the external environment remains high. A prolongation of an expansive monetary policy in the euro area will support the investments that are needed for long-term economic growth. However, low interest rates could change the financial behaviour of banks, companies and households, and this could increase the risks to financial stability in the financial sector and the real estate market.

The Eesti Pank assessment of financial stability in spring 2015 sees three main risks.

1. A deterioration in the external environment could lead to an economic downturn in Estonia and worsen the loan quality of banks.

The economies of Estonia's main trading partners are developing in very different ways, but mostly worse than was expected. Although growth accelerated at the end of last year in Sweden, Estonia's biggest trading partner, rapidly rising real estate prices and high household debt levels are threatening the economy there. Estonia's other main trading partners are being affected by the slow recovery in the euro area and by the Russian economy, meaning that no rapid recovery in external demand is foreseen.

The effect of Russian sanctions on the Estonian economy and banks has been modest so far and although some sectors have been affected by the sanctions, companies have generally managed to cope despite the reduction in income. The quality of the loan portfolio of the banks has not deteriorated. At the same time, both Estonia and our main trading partners remain exposed to the volatility in trade with Russia.

Although the increase in the speed of wage growth due to the shortage of qualified labour is having a positive impact on household incomes and confidence, the rapid rise in labour costs has started to affect the profitability of companies more and more. However, a small and open economy largely bases its long-term growth on exports, and so rapid wage growth at a time of constantly weak or falling external demand may start to restrict competitiveness and long-term economic growth and may also negatively affect the ability to repay loans.

2. A reassessment of the risks to the Nordic economies and banks by financial markets will increase the financing and liquidity risks of the banks.

Swedish real estate prices climbed continuously both last year and at the start of this, and real estate price rises in Norway and Denmark started to accelerate last year. Although price rises in the Nordic countries are being driven by rising incomes, low interest rates, restricted supply, and the popularity of interest-only loans, the strong growth in prices and debt levels is raising the risks to financial stability.

The Nordic banks are made more vulnerable because they are largely financing the growth in their loan portfolios with funds from the financial markets. Investor confidence in the banks has remained high so far. If real estate prices should fall for some reason, confidence in the banks may drop sharply, making it more expensive and more complicated for the banks to obtain funding. On top of this, a fall in real estate prices could lead to lower economic activity levels because of a reduction in private consumption and investment, and this could worsen loan quality.

As subsidiaries and branches of the Nordic bank groups have over 90% of the Estonian banking sector, and Swedish banks have over 80%, then there would also be a significant impact on Estonian financial stability if this risk were to be realised. The big Estonian banks have reduced the share of funding that they get from their parent banks in recent years, but it remains significant. The share of liquid assets related to the parent banks has increased at the same time, making the banks more vulnerable to any liquidity shocks originating with the parent banks. Changes in the funding conditions and liquidity of the parent banks could in this way have a perceptible effect on the funding and liquidity of the biggest banks operating in Estonia.

The Nordic central banks and supervisory authorities have taken various measures to reduce the build-up of risks and to increase the resilience of the banks, but their impact on credit growth and real estate prices has been limited so far.

3. Rising incomes and low interest rates will accelerate the rise in Estonian real estate prices, which will increase the risks to the financial system.

Real estate prices rose rapidly in early 2014, but have since stabilised. The rise in prices for residential property has so far been in line with rising incomes and the growth in housing loans has remained moderate. However, continuing rises in incomes and low interest rates will raise the readiness of households to buy real estate and take on additional debt. Rapidly rising wages could lead households to expect that future rises will be as high, and so they may overestimate their capacity to borrow. As a result, both lenders and borrowers should consider the risks of investments in real estate and of credit carefully.

The rise in real estate prices has allowed developers to increase construction of residential property, retail space and office buildings, though there is still less being built than there was when the economy was growing rapidly. If a large amount of real estate comes onto the market all at once, the cash flows of real estate companies might come under pressure, as it may not be possible to sell all of the completed projects fast enough and start them earning income. This may increase the credit risk of real estate developers. Although the banks issued new loans last year to real estate development companies, their share of the total loan portfolio has not increased significantly.

The main risks to Estonian financial stability

A deterioration in the external environment could lead to an economic downturn in Estonia and worsen the loan quality of banks	↓
A reassessment of the risks to the Nordic economies and banks by financial markets will increase the financing and liquidity risks of the banks	→
Rising incomes and low interest rates will accelerate the rise in Estonian real estate prices, which will increase the risks to the financial system	→

1 = minor risk and 8 = major risk. The arrow indicates changes in the risk level from the assessment of October 2014

≥1	≥2	≥3	≥4	≥5	≥6	≥7	8

Measures to reduce the risks to financial stability

As the macroprudential supervisor, Eesti Pank monitors and analyses the risks to the stability of the financial system and where necessary takes measures to reduce the build-up of such risks.

Eesti Pank introduced a 2% systemic risk buffer from 1 August 2014 for banks and banking groups licensed in Estonia, in order to increase the resilience of the banks to non-cyclical risks. Introducing the requirement for a systemic rick buffer returned the capital requirements to where they had been before 2014.

Eesti Pank may introduce a countercyclical capital buffer requirement to reduce the risks from loan growth. This would increase the resilience of the banking sector if it were faced with losses caused by risks building up because of the credit cycle. As the debt levels of Estonian companies and households have not increased significantly and credit growth is currently forecast to be lower than nominal economic growth this year, and considering other indicators of the credit cycle, Eesti Pank does not find it necessary to set a countercyclical buffer for banks in the second or third quarters of 2015. Eesti Pank will publish a framework for assessing and calculating the countercyclical buffer this autumn.

A macroprudential instrument introduced by Eesti Pank from 1 March this year is the requirements for mortgage loans issued by credit institutions. These requirements set limits on the loan-to-value (LTV) ratio of new housing loans, a limit on the debt service-to-income (DSTI) ratio, and a limit on the maximum maturity of loans. As the requirements were set at a levels where the lending conditions of the banks for mortgages already were, they should not have any notable impact on the credit supply at present. The purpose of the requirements is to ensure that the conditions on mortgages from the banks continue to take sufficient account of possible risks in the future. If the risks around mortgages increase, Eesti Pank will be able to tighten the requirements to reduce those risks.

The instruments used by Eesti Pank for macroprudential supervision

Instrument	Rate	From
Systemic risk buffer	2%	01/08/14
Countercyclical buffer	–*	2016
Limits for mortgages**		1 March 2015
loan-to-value (LTV)	85%***	
debt service-to-income (DSTI)	50%	
maximum maturity	30 years	

* Eesti Pank will apply the framework for assessing and calculating of the countercyclical buffer and take a decision on the rate for it in autumn 2015.
** The limits may be breached by 15% of the volume of mortgages issued each quarter.
*** Up to 90% for loans guaranteed by KredEx.