V
FINANCIAL SECTOR

In the first quarter of 2002 the most extensive quantitative development in the financial sector took place on the securities market – triggered by the price increase, the market capitalisation grew by almost 8 billion kroons against the end of 2001 (see Figure 5.1). The growth of the banks' financial assets remained seasonally modest but gained momentum in April. The overall fall in interest rates and strengthening of competition on the credit market had an adverse impact on the banks' profitability, which compared with the year ago period deteriorated considerably, despite the larger income base. However, the banks' capitalisation remains good and their liquidity buffers strong.

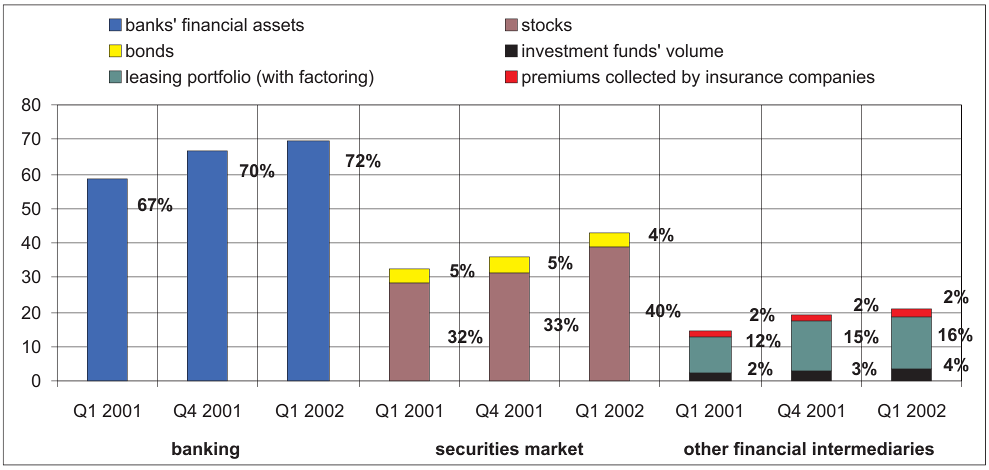

Figure 5.1. Estonian financial intermediaries (EEK billion and % of GDP)

Banking[1]

Size and Quality of Banks' Assets

Temporary acceleration in the growth rate of the banks' assets during the last months of 2001 subsided in the first quarter of the current year but then picked up speed again in April-May (see Figure 5.2). The banks' total assets grew by 2.8 billion kroons during the quarter – totalling 71.3 billion kroons (annual increase 17.5%). More than two thirds of the volume of the balance sheet, ie 51 billion kroons are represented by loans and client-issued bonds, held by the banks. On the other hand, claims to the real sector comprise most of the loan portfolio (65%).

The rate of the annual increase of domestic debt in the real sector (bank loans, bonds, leasing and factoring) reached record high of the recent years by the end of the first quarter. The growth of loan and leasing portfolios is attributable primarily to business undertakings whose financing from the banks' resources grew by more than one billion kroons during the quarter. The increase in lending and leasing to private individuals was only 55% of the growth in the fourth quarter of 2001, exceeding, nevertheless, 700 million kroons. By economic sectors, in the first months of the year the most active was lending to the industry and granting of housing

[1] Banking is dealt with also in the section on the leasing sector.

loans (see Figure 5.3), with annual growth of 23% and 41%, respectively. For the first time the volume of commercial real estate loans decreased.

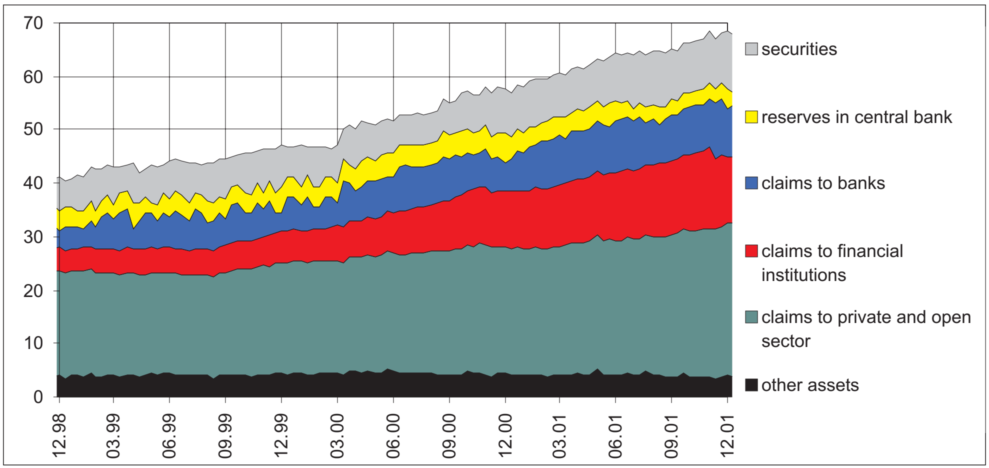

Figure 5.2. Bank's total assets (EEK billion)

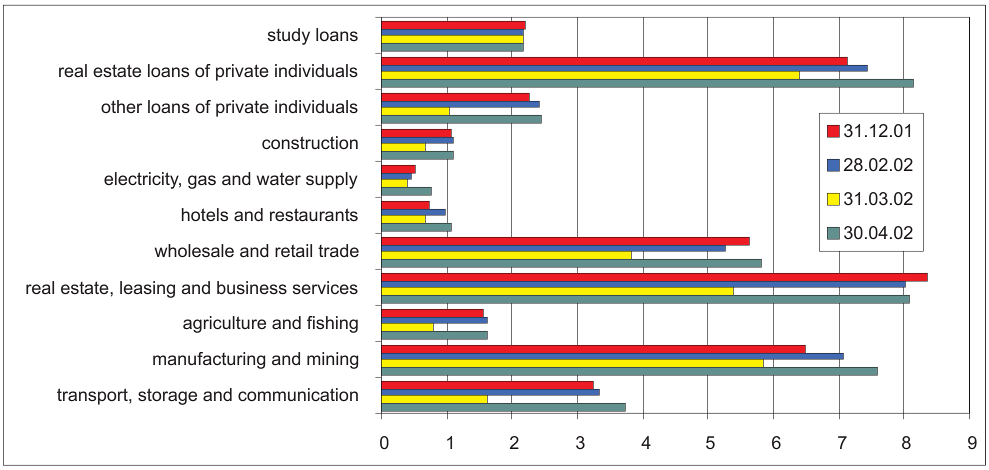

Figure 5.3. Banks' loan portfolio by sectors of economy (%)

In the structure of the **leasing portfolio,** which was mostly financed through the banks, the share of the retail products grew rapidly as compared to March 2001. Although in the private individuals' segment real estate leasing accounted for the largest share of the volume, the growing demand for consumption-supporting leasing products has been the most striking development in the last six months. The popularity of real estate leasing has gone up also in the business sector where its share has grown, first and foremost, at the expense of financing of commercial vehicles operating and capital lease (see Figure 5.4).

Despite the slackening of the economic growth rate and fierce competition on the credit market, **the quality of the loan portfolio** has not deteriorated significantly (see Figure 5.5). The average level of provisions and overdue loans remained unchanged throughout 2001. The trend was sustained in the first quarter of 2002. A third of loans were up to ten days overdue. At the same time, loans overdue more than 60 days constituted less than 3% of the loan portfolio.

The quality of loan portfolios decreased a little in almost all sectors of economy, with the exception of construction and commerce (see Figure 5.6). In case of commercial real estate loans, the larger proportion of overdue loans was caused rather by a shrinking lending volume at the beginning of the year, than an increase in the quantity of overdue loans. However, in industry

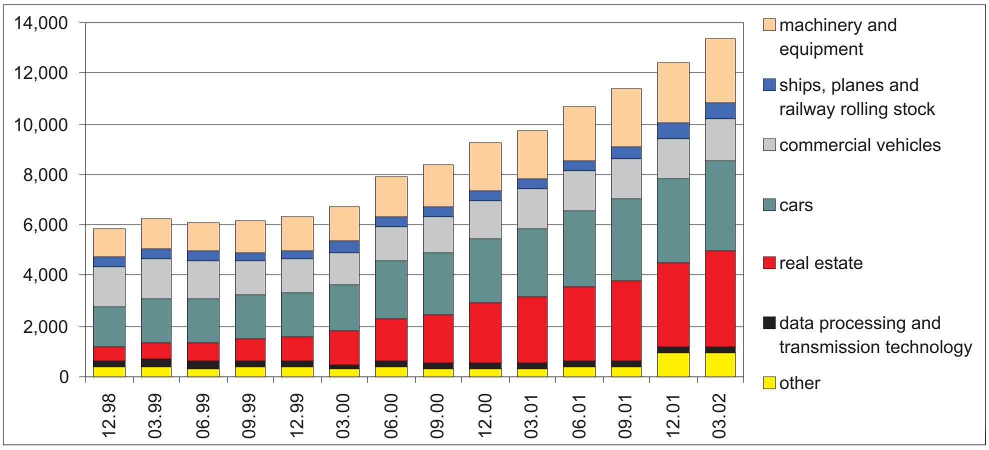

Figure 5.4. Volume of leasing companies' portfolios and structure by leasing objects (EEK m)

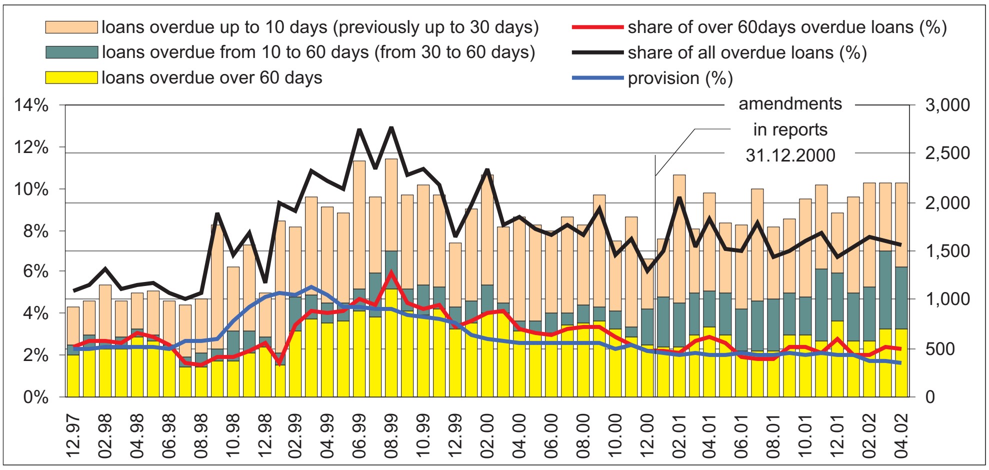

Figure 5.5. Volume of overdue loans (EEK m, the left scale) and their share in public and real sector loan portfolio (the right scale)*

* Due to amendments in reports on 31.12.2000, periods overdue of the repayment date changed. The previous period up to 30 days was replaced by the period up to 10 days, and the period from 30 to 60 days by the period from 10 to 60 days.

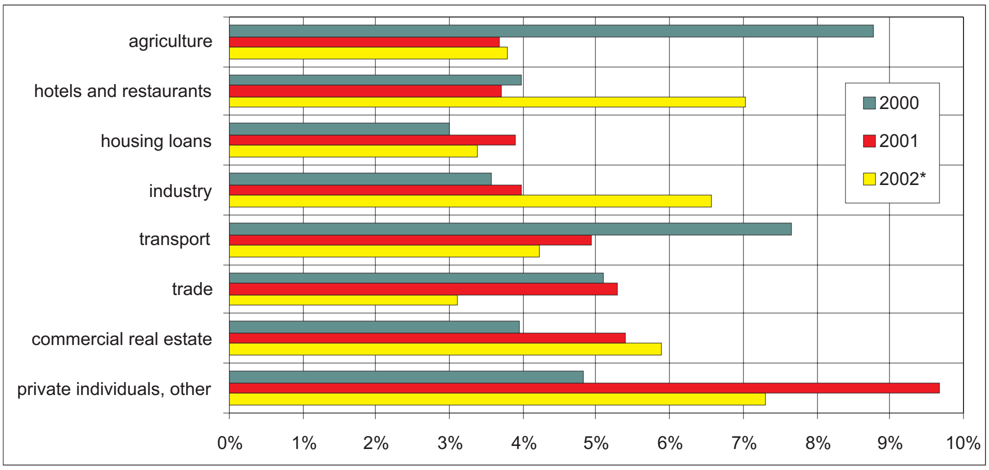

Figure 5.6. Share of overdue (over 10 days) loans in banks' loan portfolio by sectors of economy

* 3 months average

and transport sectors both the lending volume as well as the quantity of overdue loans grew, indicating quality problems.

The securities portfolio grew in the first quarter by more than 600 million kroons due to the increasing liquidity portfolios of the banks. Since the beginning of 2001, when it became possible to use liquid bonds to meet the reserve requirement, the banks have actively done so and, consequently, the percentage of bonds in the securities portfolios of credit institutions has increased at the expense of the shares kept for trading purposes. As of end-March the bonds accounted for 68% of the total securities portfolio (see Figure 5.7).

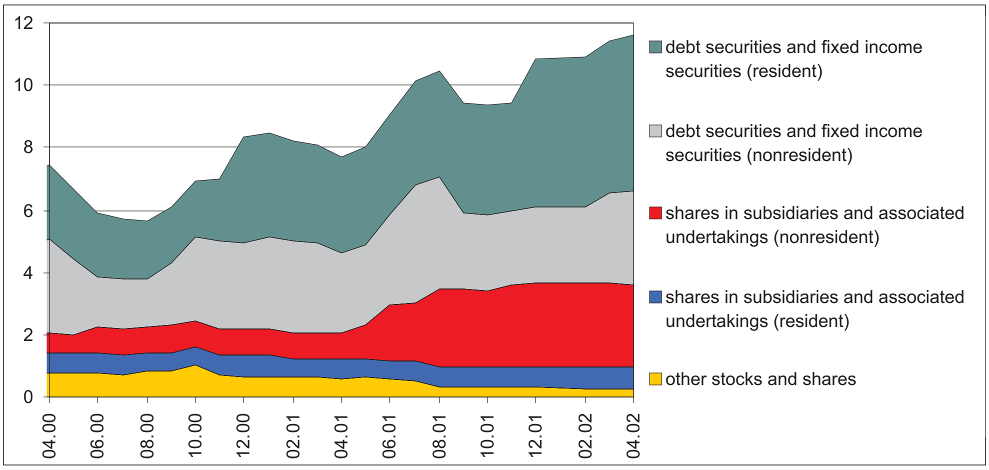

Figure 5.7. Banks' securities portfolio (EEK billion)

Liabilities and Equity

Towards the end of 2001 both private and corporate deposits grew rapidly on the banks' liabilities side. However, in the first quarter of 2002 the deposit growth was one of the most modest in recent years. However, it was a temporary trend – in April the real sector deposits grew by 1.5 billion kroons, only the December 2001 indicator was bigger. In general, the annual increment of deposits was restored to the 20% level by April (it had stayed at 18–19% in the first months of the year).

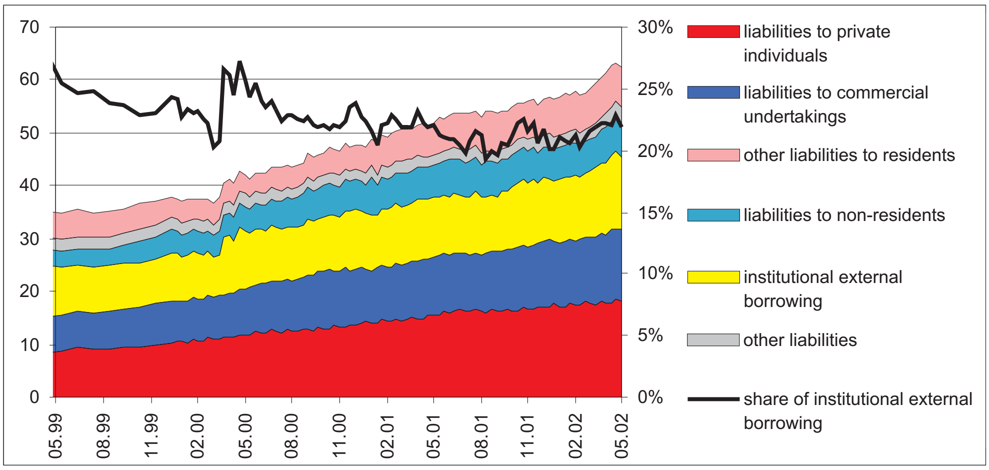

Figure 5.8. Banks' external liabilities (EEK billion, the left scale) and share of institutional external borrowing (the right scale)

Thanks to the deposit accumulation in 2000, domestic deposits have been able to cover the real sector debt increase in recent years. At that, the percentage of **institutional external borrowing** in the liabilities' structure has diminished. In the first quarter of 2002, due to the modest growth of deposits and relatively high credit demand, it was necessary to borrow funds from abroad. Institutional external borrowing that had accounted exactly for one fifth of all liabilities in the end of 2001 increased by 2 percentage points in March-April (see Figure 5.8).

Due to the ongoing rapid growth of long-term loans and a remarkable increase in demand deposits, the open maturity positions in the banks' assets and liabilities have grown. Due to an increase in demand deposits, the liabilities' net position amounted again to one third of total assets for the period under review.

Improvement of the banks' capitalisation continued in the first quarter of 2002 as well. In March the capital adequacy ratio was almost 12% above the same period in 2001, ie it had risen from 14.2% to 15.9%.

Return on Equity

In the first quarter the banks' net profit was 524 million kroons, ie more than 90 million kroons below the same period in 2001. Due to somewhat more moderate profit margins and whilst the revenue base grew, the **return on equity** in the first quarter of this year was the lowest for all quarters of 2001 (see Table 5.1).

Table 5.1. Banks' profitability indicators

	Q1 2000	Q2 2000	Q3 2000	Q4 2000	Q1 2001	Q2 2001	Q3 2001	Q4 2001	Q1 2002
Equity multiplier	6.27	7.01	7.34	6.75	6.65	6.78	6.80	6.60	6.20
Return on equity	3.24%	2.55%	2.45%	4.74%	4.62%	3.62%	4.15%	13.63%	2.71%
Return on assets	0.52%	0.36%	0.33%	0.70%	0.69%	0.53%	0.61%	2.07%	0.44%
Profit margin	0.19	0.14	0.12	0.22	0.22	0.19	0.24	0.50	0.17
Assets utilisation	2.75%	2.67%	2.71%	3.26%	3.16%	2.81%	2.51%	4.10%	2.53%
Net interest margin	1.23%	1.16%	1.15%	1.30%	1.17%	1.17%	1.10%	1.08%	1.00%
Price difference	1.26%	1.22%	1.20%	1.30%	1.15%	1.16%	1.08%	1.07%	0.97%

The main reason for a decline in the banks' profitability was the downturn in interest margins. Due to the seasonal slowdown of economic activities (decline in credit supply reduced the banks' income base) and suspended decline in factor price, the asset price deflation pushed the net profit margin as well as the price spread below the 1% level for the first time within quarterly estimates (see Figure 5.9).

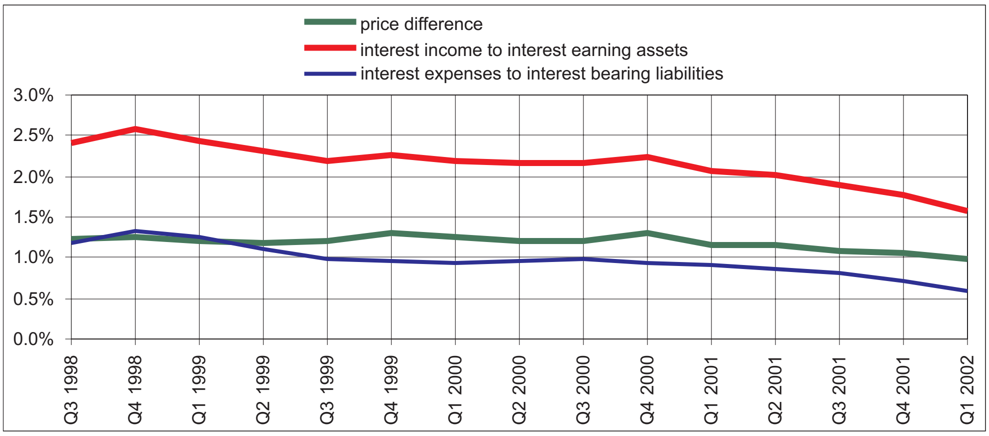

Figure 5.9. Price difference between banks' assets and liabilities

The likelihood of further factor price deflation is to date practically over. If throughout the year 2001 the banks' net interest income was augmented by the delay between the decrease in factor cost and credit cost, then in 2002 shrinking interest income can curb profit. Although tougher competition on the credit market exercises downward pressure on interest rates, the upward trend of the interest rates in the euro area would rather restrain the above fall. Should interest income remain stable, there will be no grounds to expect any abrupt backlashes in net interest rate income either because the banks will continue to finance themselves as usual through less costly kroon-denominated demand deposits.

Securities Market

Stock Market

A turnover as well as a price rise on the stock market has marked the last year, although there was a five-month-long recession period also. The turnover and share prices peaked by June 2001. Slight loss of confidence and the reduction in trading caused by the September terrorist attacks against the United States was notable during the subsequent decline period, but since the fourth quarter of 2001 share prices have been climbing up steadily (see Figure 5.10).

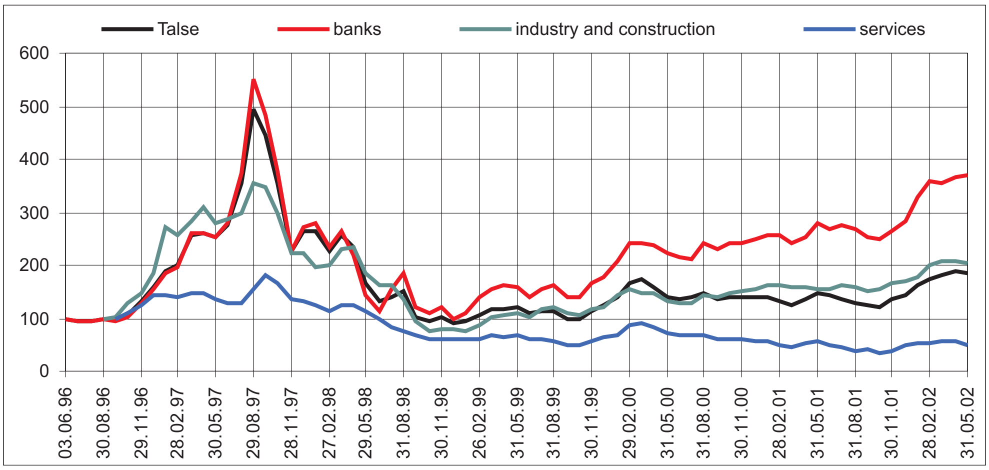

Figure 5.10. Talse and indices of stocks traded on the Tallinn Stock Exchange by sectors of economy (points, 3 June 1996 = 100)

The Tallinn Stock Exchange, acquired by Helsinki Exchange Group (HEX) in February 2001, started to trade Estonian securities in the HEX trading system on 25 February 2002. This led to a major change: share prices are now quoted and official trading is conducted in euro, although payment for transactions is still done in kroons. Adoption of the HEX trading system calls for thorough amendments to the rules and regulations of Tallinn Stock Exchange that should, in turn, enhance the transparency and credibility of the stock market.

Like other emerging markets, the Tallinn Stock Exchange experienced a rising cycle in the end of 2001. The index TALSE grew by 4.7% in 2001 – to 144.7 points, another 23.9% in the first quarter of 2002 – to 179.3 points and by late April surpassed the 190 point level. During this period share prices of the banks as well as industrial and construction companies rose the most – by 42 and 36%, respectively. Share prices of the service sector companies, led by Eesti Telekom (Estonian Telecom), have not, in fact, changed much as the relatively rapid rise during the last six months has offset the preceding fall (see Figure 5.11).

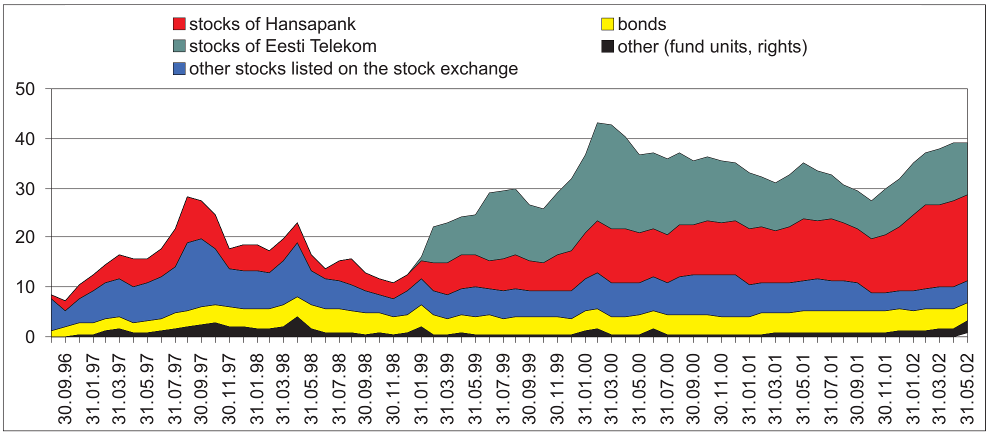

Figure 5.11. Securities market capitalisation (EEK billion)

Price increase at Tallinn Stock Exchange has been partly influenced by speculations about potential effects of the Stock Exchange's merger with HEX. Moreover, dividends distributed by the listed companies were slightly higher than investors' expectations, which, among other things, have lead to an increase in the OTC sales. According to analysts' estimates, prices of common stock at the Tallinn Stock Exchange are discounted in comparison with similar share quotations on other Central and Eastern European exchanges.

Although through the restructuring of the stock exchange operations, the number of market participants has increased (four securities brokers from Finland and one from the UK have received licences for the provision of transboundary investment services), the turnover of Tallinn Stock Exchange has not increased while the OTC sales seem to have grown initially. Positive results expected in connection with the creation of a common trading environment are not likely to manifest themselves immediately and many processes that affect investment decisions take time.

Bond Market

By the end of the first quarter of 2001 the capitalisation of the bond market exceeded 4 billion kroons and was sustained above this level until the beginning of 2002. In 2001 the volume of issues – more than 6.56 billion kroons – was almost two times higher than in 2000. The corresponding 1.5-billion-kroon volume of issue was sustained also in the first quarter of 2002.

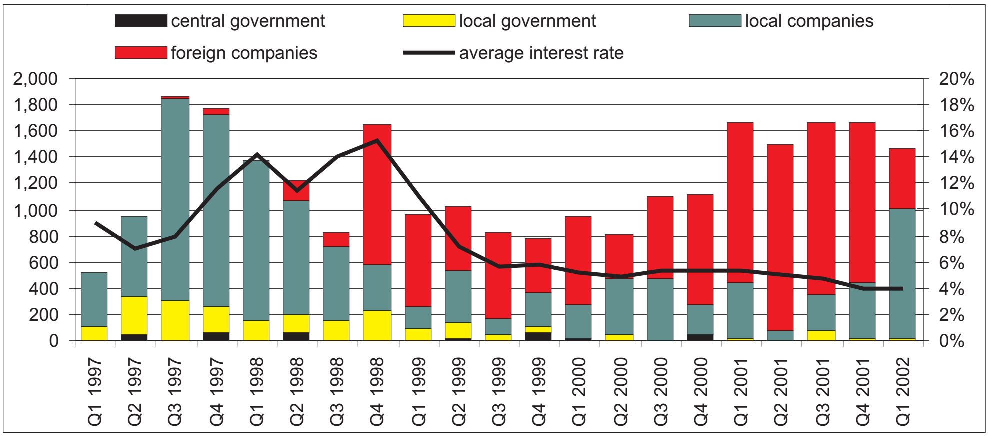

Figure 5.12. Volume of bonds issued in a quarter by issuers (EEK m, the left scale) and average interest rate of kroon bonds (the right scale)

The biggest group of issuers were foreign residents (over 50% of the volume), one fourth were local financial and real sector companies and the rest were local governments and the central government together with the Compensation Fund. In early-2002 the number of debt instruments issued by local companies increased primarily at the expense of the Nordic financial institutions (see Figure 5.12).

The average interest rate has dropped in just one year and three months from 5.3% to 4.0%, although its further fall during the above time period was curbed by a clear shift towards the preference of longer-term bond issues. Due to lower interest rates, new resident issuers have returned to the market after 1997–98.

The development of the bond market is still hampered by less active trading on the secondary market. However, the ever-growing number of issuers and investors should stimulate it. The extension of the debt securities redemption dates should also help to revive the market. With the exception of the Compensation Fund issues and one of Estonian Telecom's public issue, all other issues have been rights issues and therefore bonds were traded on the OTC market. Going public and organising IPOs is a relatively costly undertaking for companies and even lower interest rates cannot offset related additional expenses.

Other Financial Intermediaries

Insurance

In comparison with developed countries, the growth rate of the Estonian insurance market has so far been modest. Especially in life insurance (incl pension insurance), the basic roots of considerable disparities lie in the short history of the Estonian insurance market as well as consumer behaviour under lower living standard of the population.

When in the late 1990s the recession in the economy affected the structure of the financial sector, the Estonian insurance market was the last to change. No significant changes have taken place on the life insurance market within the last year, whereas the non-life insurance sector was subject to restructuring that resulted in the acquisition of Nordika non-life insurance portfolio by the Nordic financial services group NORDEA. Due to changes in the ownership structure, more than 80% of the non-life insurance market now belongs to insurance companies with a strategic non-resident partner.

In 2001 seven non-life insurance companies collected 1.4 billion kroons in premiums, 14% more than a year before. In the beginning of 2002 the premium collection rate stepped up even more – in the first quarter 18% more premiums were collected than during the same period last year. The voluntary motor insurance segment enjoyed the biggest growth and accounted for 34% of gross premiums. Despite the expanding real estate market and intensive borrowing, the volume of property insurance premiums has not increased essentially (see Figure 5.13).

The life insurance market has stabilised. The premium inflow grew moderately throughout the year 2001 and grossed 360 million kroons, which is 17% more than in 2000. The growth rate accelerated a little in the beginning of 2002 and 20% more premiums were collected against the first quarter of the previous year. The fastest-growing sector was pension insurance, its contribution to the total premiums collected by life insurance companies rose from 14 to 21%. Among other types of insurance most popular were endowment assurance and life insurance with investment risk that accounted for 56% and 14% of gross premiums in life insurance, respectively.

Although efficiency and profitability of insurance companies has posed a problem in recent years, the risks of the insurance market are under the control of the supervision authority. The

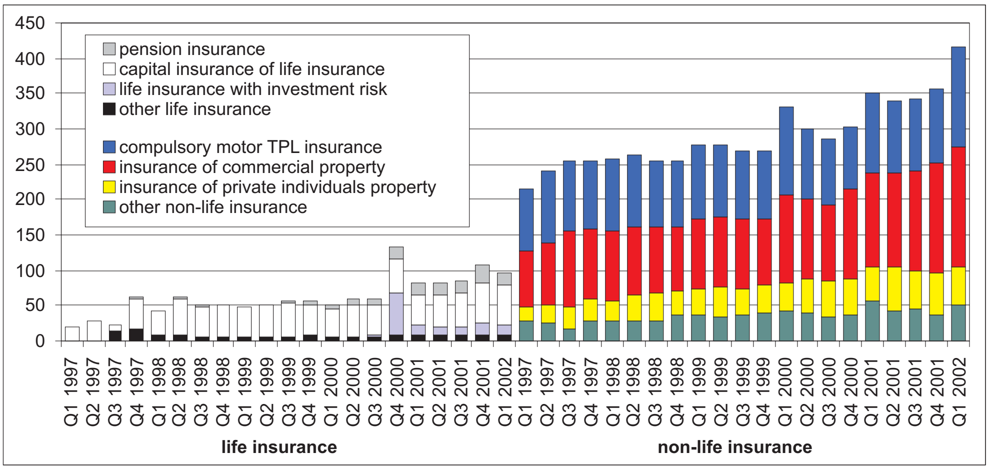

Figure 5.13. Gross premiums collected by insurance companies (EEK m)

increase in profits testifies to the improvement of the market situation: in 2001 non-life insurance companies earned 81 million kroons in profit, ie 30 million kroons more than in 2000. Thus consolidation has helped to enhance efficiency. The share of indemnities paid for damage against premiums decreased from 52% in 1999 to 49% in 2001. Due to small volumes on the life insurance market, half of the insurance companies still operate at a loss, which has had an adverse impact on their solvency[2].

Investment Funds

In the beginning of 2001 the investment fund market entered a rapid growth phase during which the funds' assets doubled and reached 3 billion kroons by the end of the year. In the first quarter of 2002 the volume grew yet by more than half a billion kroons. While in the previous year the growth was attributable mostly to money market funds and, to a lesser extent, interest rate funds, then this year it derives solely from interest rate funds (see Figure 5.14). By the end of the first quarter money market funds gave 65% and interest rate funds 28% of the market volume. The role of stock and pension funds has been relatively modest. Although the latter grew by 200% in just a year, due to their one-per cent market share this growth has not substantially influenced the market structure.

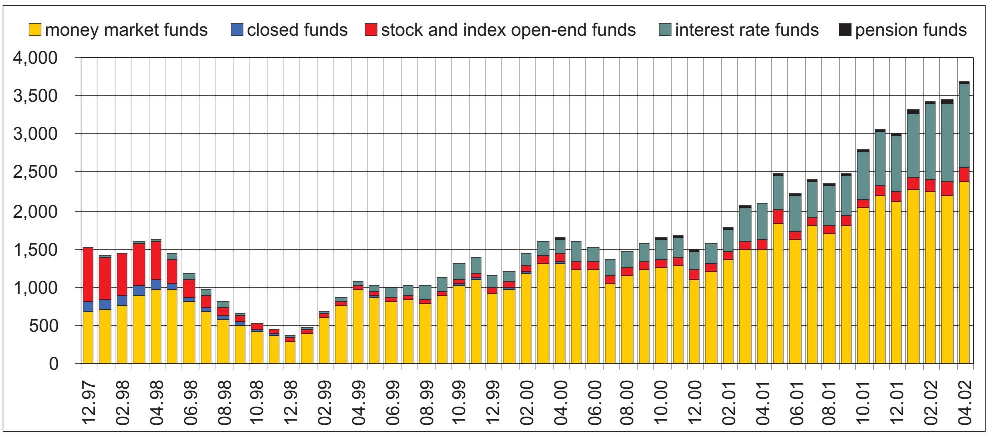

Figure 5.14. Volume of investment funds (EEK m)

[2] Financial Supervision Authority imposed a three-month special regime on Nordika Elukindlustuse AS as of 12 May 2002 and, following the report of the special regime manager has initiated preparations for the transfer of the insurance portfolio to some other insurance company.

The growth potential of funds is nurtured by relatively low interest rates, which force enterprises to swap their short-term bank deposits for investments in funds. The yield of funds, which invest in debt instruments, has fallen only by 0.2 percentage points over the year, whereas the fall of the yield curve of money market and interest rate funds gained momentum in the first quarter. The yield of stock funds has fluctuated together with the stock exchange index within +30% and -10%.

The establishment of new funds accompanied the growth of investment funds. This was stimulated by the adoption of the Funded Pensions Act. The latter defined further development trends of pension funds. In 2001 five new investment funds were established. Two of them operate on the basis of USD-denominated debt instruments, the other two as voluntary pension funds and one fund was founded on the basis of stock markets operating in the Baltic Sea region. In the first quarter of 2002 yet another investment fund was added to the list which targets mainly small and medium size enterprises in Eastern and Central Europe.

In connection with the pension reform, two insurance companies have entered the market as fund managers: Seesam and ERGO Kindlustus together with Trigon Capital. Six pension fund management companies and 15 pension funds with variable risk levels are related with the second pillar of the pension reform. In the coming years the implementation of the second pillar will not bring about significant changes on the fund market because pension funds are likely to accrue additional 100 million kroons in the year 2002 and in the next few years 500 million kroons, on the average.

Payment System

In comparison with the first quarter of 2001, the number of payments increased over the same time period this year by 28% – up to almost seven million transactions per month. The payment turnover grew by over 21% during the same period. The most significant change was noted with incoming external payments, the turnover and quantity of which grew by 32 and 38% respectively against the fourth quarter of 2001 (see Figure 5.15).

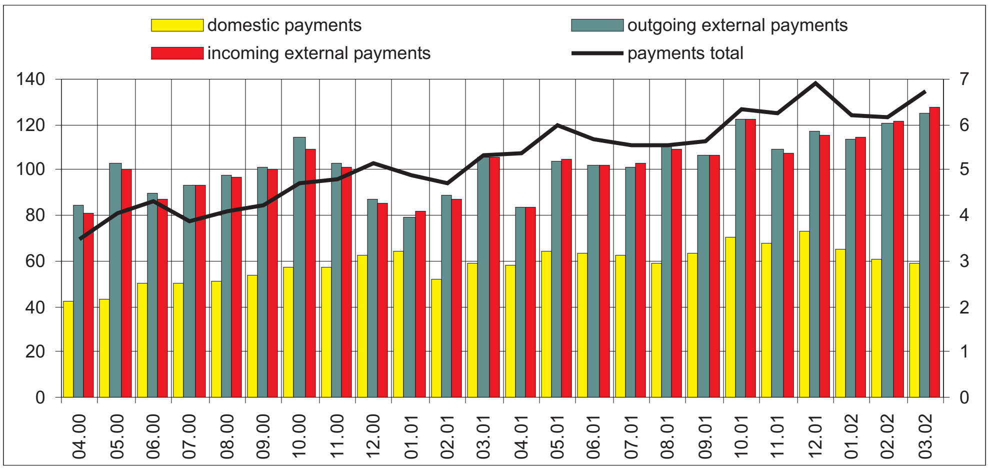

Figure 5.15. Turnover of payments by types (EEK billion, the left scale) and total number of payments (million, the right scale)

The use of paper-based payment orders and such electronic payment modes as telebanking and telephone banking has been steadily declining. More and more alternative payment options as payment by card, Internet and direct debit orders are used (see Figure 5.16).

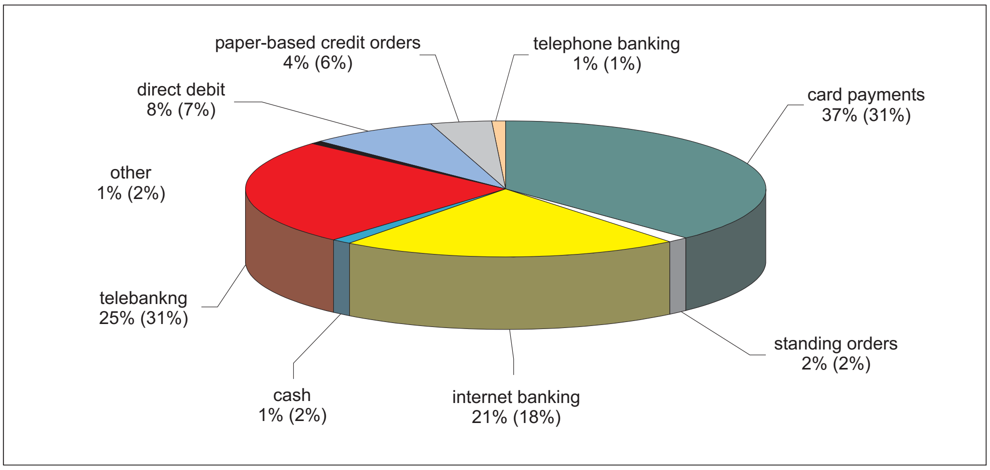

Figure 5.16. Structure of payment instruments in the 1st quarter of 2002 (in brackets 1st quarter of 2001)

By the end of the first quarter of 2002 credit institutions had issued altogether over one million bank cards, out of which 17% were passive, ie not a single payment operation was made with them. 88% of the issued bank cards were debit cards. Over 120,000 credit cards had been issued. Hand-in-hand with the increasing quantity of bank cards, their potential use has widened – by the end of the first quarter the number of ATMs had grown to 685 and POSs accepting card payments to 5,367.

Table 5.2. Number of bank cards per 1000 inhabitants

Country	Bank cards per 1000 inhabitants
Great Britain	1,979
Finland	1,653
Estonia	748
Latvia	380
Lithuania	196

Compared to other EU applicant countries, the number of bank cards per capita in Estonia is the highest, but in comparison with the EU Member States Estonia still has possibility for development. For example, Latvia had issued over 0.9 million bank cards and Lithuania over 0.7 million by the end of 2001, the penetration ratio per capita being respectively two and four times lower than in Estonia. At the same time in Finland and the UK the ratio was 1.7 and 2 bank cards per capita already at the end of 1999 (see Table 5.2).