V
FINANCIAL SECTOR DEVELOPMENT

In 2002, financial sector continued with different speeds for domestic loan resource involvement and lending. The main key word was **domestic-demand-oriented aggressive credit supply**. As favourable interest environment and strong competition were maintained, banks' loan and leasing portfolios sustained previous growth rates in the third quarter (see Figure 5.1). Similar to the second quarter, loan growth focused on financing housing loans and commercial real estate. To cover the growth, liquid assets were reduced and external borrowing was to offset slower deposit increase.

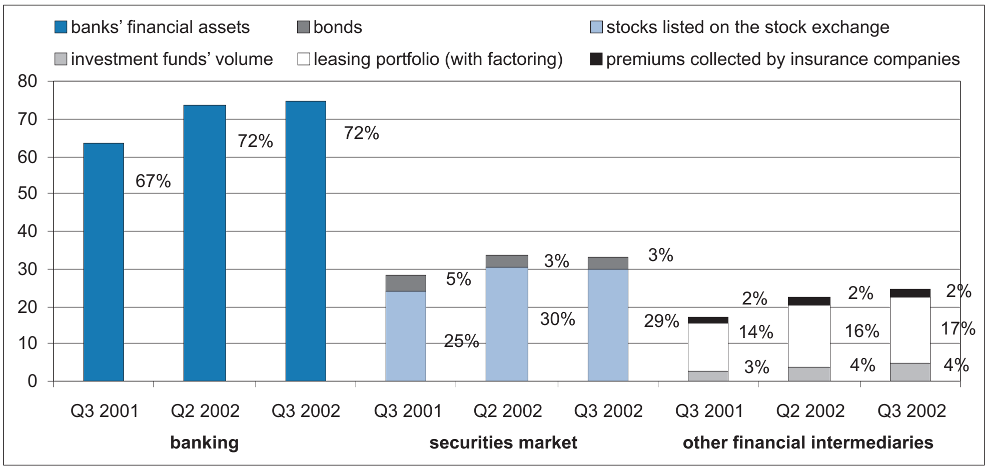

Figure 5.1. Estonian financial intermediaries (EEK billion and % of GDP)

Due to high competition, **banks' activity efficiency kept rising**, well displayed in continuously declining interest margins. Nevertheless, profitability remained high, sustained by expanding credit base and cost saving. Any potential changes in profit depend on factor price. The loan quality did not deteriorate in the third quarter. However, banks' capitalisation shrank slightly in end-quarter but remained high anyway (15.5%).

In other financial intermediaries, investment funds sustained the fastest growth revealing a change in household and corporate saving and investment behaviour. As shrinking non-resident issuing restricts the growth in the bond market, no financial deepening has been noticed in the securities market, despite a slight growth in the share price. The successful implementation of the second pillar of the pension reform has melted for the time being the investor interest in life insurance and supplemental funded pension insurance.

Banking[1]

Banks' Assets and Their Quality

In the third quarter of 2002, banks' total assets maintained the annual growth of the second quarter, reaching 17%. In the end-October, the banks' total assets amounted to

[1] The Chapter on Banking also covers the Leasing Sector.

76.5 billion kroons (see Figure 5.2). The growth of total assets slowed against the year-ago period, primarily due to liquid assets shrinking to 19.1%. The liquid assets decreased by 1.8 billion kroons at the expense of foreign deposits.

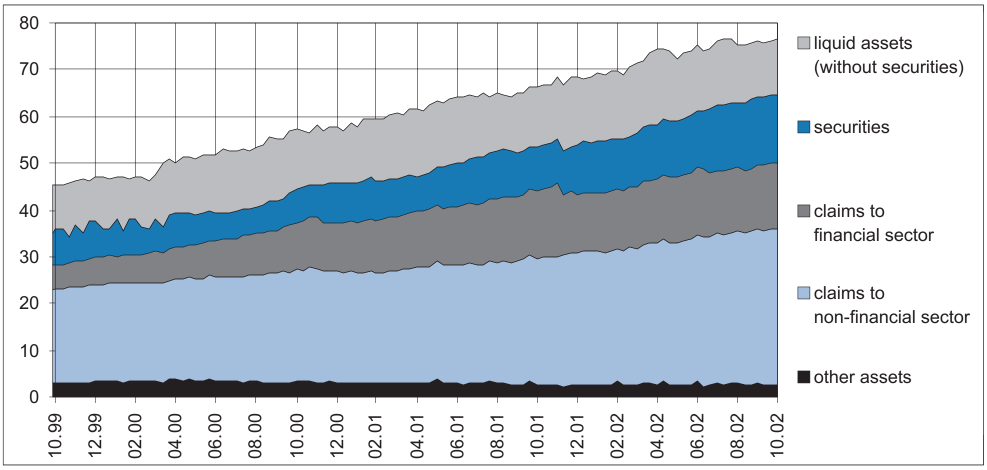

Figure 5.2. Banks' total assets (EEK billion)

The growth of assets was sustained primarily by loan demand, boosting the loan and leasing portfolio by more than three billion kroons during the third quarter (the stock being 50.9 billion kroons in end-September). The volume of housing loans gained most – 1.2 billion kroons (see Figure 5.3). However, financing of business real estate remained below last year, remaining still above half a billion kroons (was 541 million kroons). The loan stock decreased most in trade (271 million kroons) and energy sectors (141 million kroons).

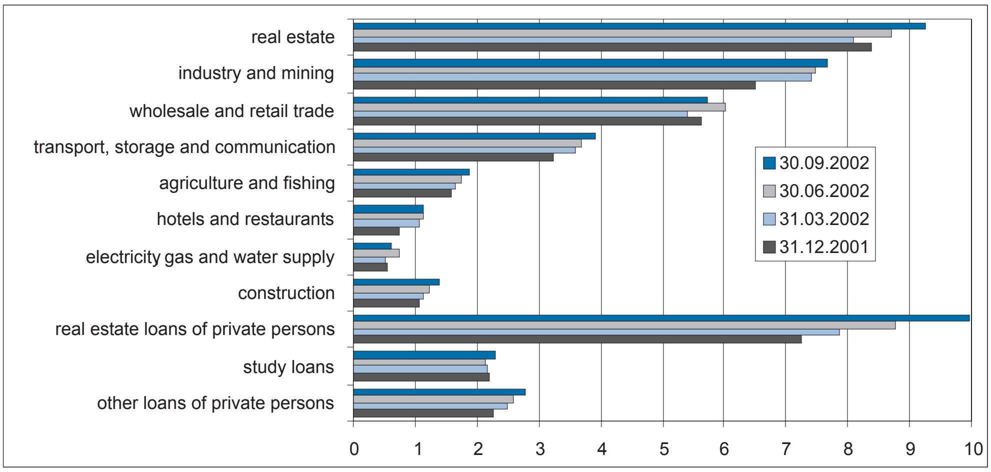

Figure 5.3. Loan and leasing portfolio by sectors of economy and purpose of loans (%)

Similar development also characterised the volume of the loan portfolio by sectors. The turnover of housing loans and commercial real estate loans in the third quarter exceeded the second quarter whereas consumption loans decreased (410 and 502 millions respectively). In October, housing loans maintained their growth rate and reached a record high turnover – 499 billion kroons. The turnover of commercial real estate in October remained at half of September (233 and 472 million kroons, respectively).

As banks have changed their pattern in financing their leasing companies, bonds have replaced lending. This led to a more than 700-million-kroon growth in banks' bond portfolio in the third quarter (see Figure 5.4).

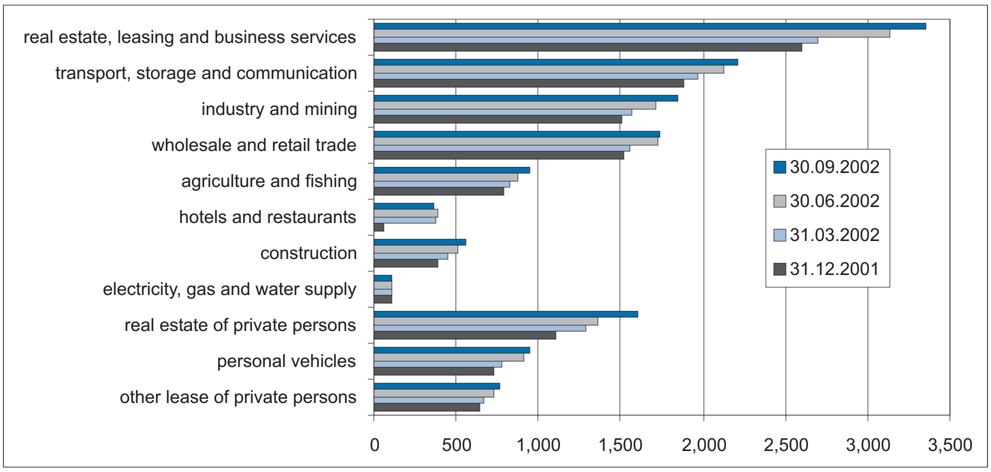

Figure 5.4. Leasing portfolio by sectors of economy (%)

By leasing objects, real estate and equipment increased most during the third quarter whereas leasing of vehicles remained about a half below late spring. Leasing of office equipment grew rapidly; its volume is small but stock of claims increased about threefold against the third quarter of 2001. Purchasing of consumer goods by leasing slightly declined.

The overall quality of the loan portfolio did not deteriorate: the share of loans overdue more than 60 days was on the average 2.3% in the third quarter, only 0.3 percentage points above the year ago period in 2001 (see Figure 5.5). **By sectors of economy, the quality of lending to agriculture and commercial real estate sector worsened** (see Figure 5.6). The overdue loans in the commercial real estate sector were responsible for about 30% of all overdue loans. Housing loans represent the largest share – about a quarter – of the loan portfolio, overdue housing loans reached 23.6% of the total.

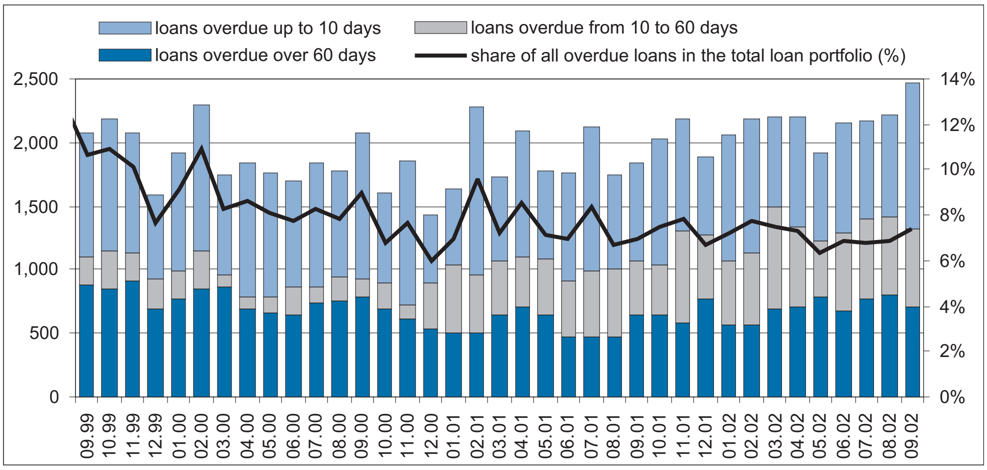

Figure 5.5. Volume of overdue loans (EEK m, the left scale) and their share in public and real sector loan portfolio (the right scale)

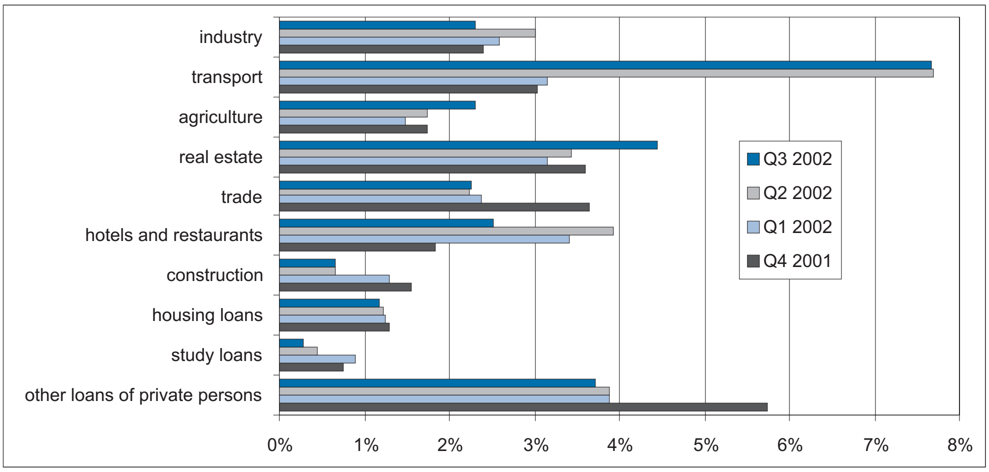

Figure 5.6. Share of over 60days overdue loans in the total loan portfolio (%)

Mortgage is becoming increasingly important as collateral. It gains volume as the share of real estate loans is increasing and registration process is coming to an end. Mortgage together with pledged structures is responsible for two thirds of all collaterals. **Potential fluctuation in real estate prices is going to be an increasingly significant factor, which affects the value of bank-owned collaterals.**

Liabilities

Due to single factors, the deposit growth of resident undertakings accelerated temporarily in the beginning of the third quarter (see Figure 5.7). Later, demand for external borrowing increased and the share of external liabilities to total liabilities recovered 21% by end-quarter, ie the level of the end of the second quarter.

Rapidly growing loan portfolio extended the net position of loans with maturity over five years throughout the nine months of 2002, reaching about half of the total balance by end-September.

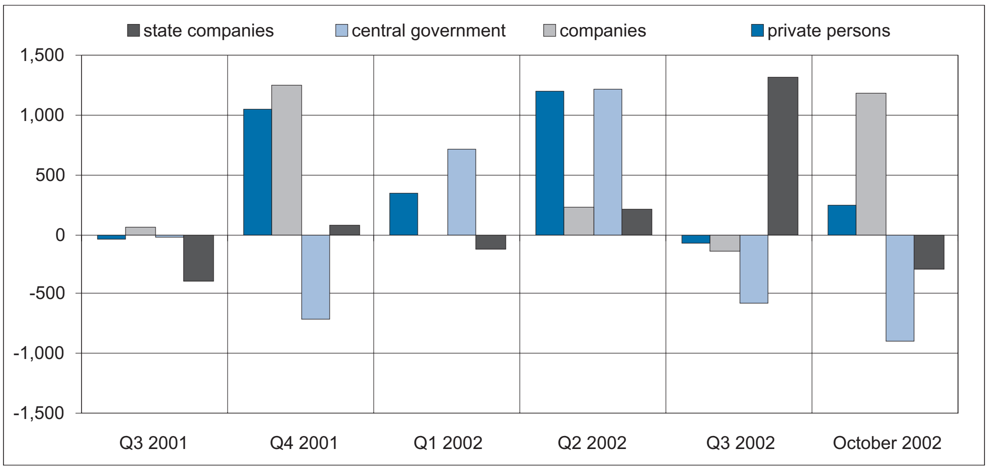

Figure 5.7. Growth of deposits in a quarter (EEK m)

Changes arising from new calculation guidelines[2], which entered into force in July 2002, were prevailing in capital adequacy in the third quarter. The new calculation base increased technically capital adequacy indicators at the beginning of the quarter. Due to growing risk assets, capital adequacy shrank by end-quarter to the average of the second quarter (15.5%).

Return on Equity

In the third quarter, the banks' net profit (346 million kroons) exceeded the previous two quarters by a third (see Table 5.1). The profit of large banks increased and of three small banks decreased. The cumulative profit of three quarters (866.5 million kroons) remained on the year-ago level.

Table 5.1. Banks' profitability indicators

	Q3 2000	Q4 2000	Q1 2001	Q2 2001	Q3 2001	Q4 2001	Q1 2002	Q2 2002	Q3 2002
Equity multiplier	6.75	7.08	7.48	7.71	7.85	7.84	7.76	7.77	7.78
Return on equity	11.25%	8.32%	9.19%	9.61%	11.01%	20.87%	19.30%	18.86%	18.56%
Return on assets	1.67%	1.18%	1.23%	1.25%	1.40%	2.66%	2.49%	2.43%	2.39%
Profit margin	0.15	0.11	0.11	0.11	0.13	0.23	0.23	0.23	0.24
Assets utilisation	11.08%	11.14%	11.34%	11.25%	10.92%	11.38%	10.72%	10.47%	10.14%
Net interest margin	4.77%	4.69%	4.51%	4.41%	4.28%	4.14%	4.03%	3.92%	3.88%

The annual return on equity remained slightly below the second quarter, however, 18.6% is still a high indicator. Expanding credit base and shrinking liquid assets as well as increased cost efficiency boosted return. In the third quarter, the cost-benefit ratio[3] dropped below 60% for the first time.

The price spread continued to shrink also in the third quarter. This time it shrank by 13 basis points against the third quarter in 2001. Further shrinkage is inhibited, as sustained depreciation of external resources is unlikely, domestic saving shows only modest growth and following recommendations by Eesti Pank the government reduced its deposits in commercial banks. To sustain lending, banks have to rely more on expensive external resources. In order to remain competitive, they have to focus increasingly on internal saving and efficient operation.

Securities Market

Stock Market

On Estonian stock market, a price decline in the second quarter and early third quarter was replaced by a rise at the beginning of August. By mid-November the index Talse recovered the early-second-quarter level, 190 points. Throughout the quarter, primarily

[2] Main changes in Guidelines: 1) discounts from gross own funds are possible, based on the risk level of investments in undertakings belonging to the banking group; 2) trading book instruments were excluded from category I risk assets (now also trading book risks are calculated by different risk groups); 3) claims to Latvian and Lithuanian credit institutions were moved from category III to category II.
[3] Ie ratio between administrative costs and net business outcome.

share prices in industrial and construction sectors remained above the stock index level, appreciating by 5% over three months. The Hansapank stocks suffered a sharp fall in July-August, however, in October the record level of the year was recovered (see Figure 5.8). Share prices in the services sector rose in October as well, although due to the recession at the beginning of the year their level has not changed considerably against other shares.

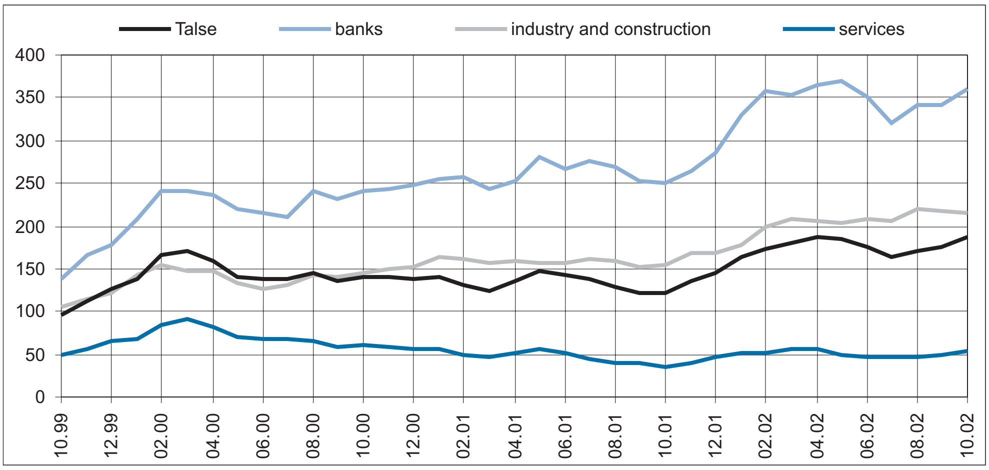

Figure 5.8. Talse and indices of stocks traded on the Tallinn Stock Exchange by sectors of economy (points, 3 June 1996 = 100)

Price increase raised the capitalisation of Tallinn Stock Exchange from 28.5 billion kroons in end-July to 32.0 billion kroons in end-October (see Figure 5.9). Despite the price increase, both the turnover of the stock exchange and OTC sales have shrunk. Foreign brokers, who have become members after Helsinki Exchange Group (HEX) acquired the stock exchange, have not been very active. Their transaction mediation was merely 1.3% of the gross turnover between March and October. The ongoing enlargement of HEX towards Central and Eastern Europe was a positive message: in spring 2002 a controlling interest was acquired at Riga Stock Exchange and, according to unofficial sources, also Warsaw Stock Exchange will be acquired.

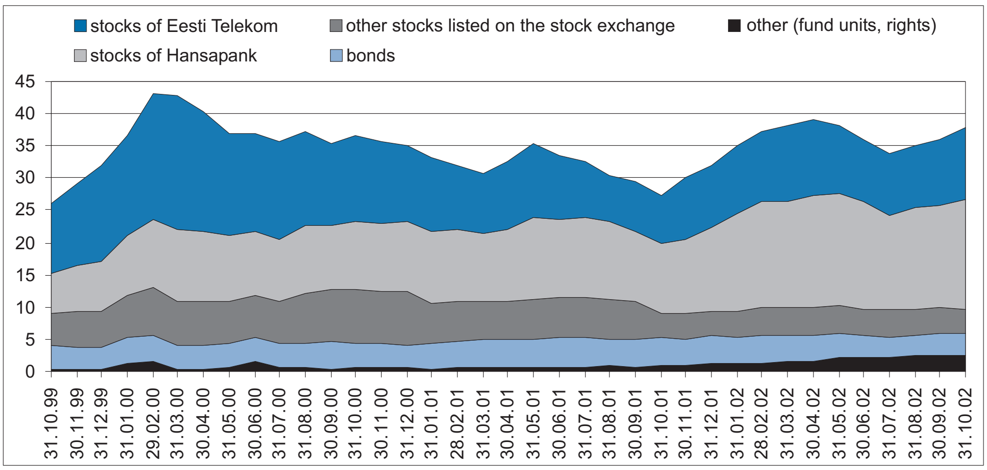

Figure 5.9. Securities market capitalisation (EEK billion)

Bond Market

The volume of the bond market sustained the level of the previous period in the third quarter, reaching 3.3 billion kroons. While in 2001 non-resident financial institutions used Estonian bond market to cover equity risks of their local subsidiaries, in 2002 these volumes have shrunk. This probably shows that according to foreign banks, such risks have declined. The volume of non-resident bond issues did not recover in the third quarter either.

Partially, local undertakings' (including banks and other financial institutions) bond issues have offset the shrinking non-resident bond issue whereas their volume has grown fourfold against 2001. In the third quarter, the volume of new issues totalled 800 million kroons, remaining, however, below the level of the first half-year (see Figure 5.10) and shrinking the turnover of the secondary bond market, as it trades primarily with debt instruments of non-resident banks and resident banks and leasing companies.

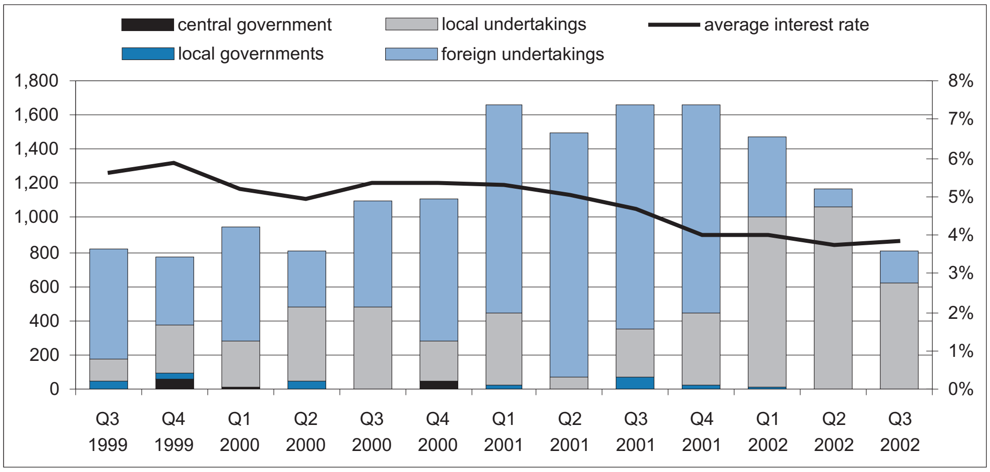

Figure 5.10. Volume of bonds issued in a quarter by issuers (EEK m, the left scale) and average interest rate of kroon bonds (the right scale)

A shift in bond maturity from 3month maturity to 3–6months maturity was sustained. Interest rates of bonds decreased similar to money market interest rates.

Other Financial Intermediaries

Investment Funds

Rapid growth of investment funds continued also in the third quarter. The record high growth – 850 million kroons – sent gross volume to 4.6 billion kroons (see Figure 5.11). The growth was attributable mostly to interest rate and money market funds whereas the money market funds grew less than the interest rate funds, as the latter had higher return. **The growth derives primarily from corporate interest to invest free assets elsewhere instead of depositing, as the deposit interest level remains low. Also households' share in investment funds has gone up.** They prefer mostly interest rate and stock funds, suitable for medium and long-term saving.

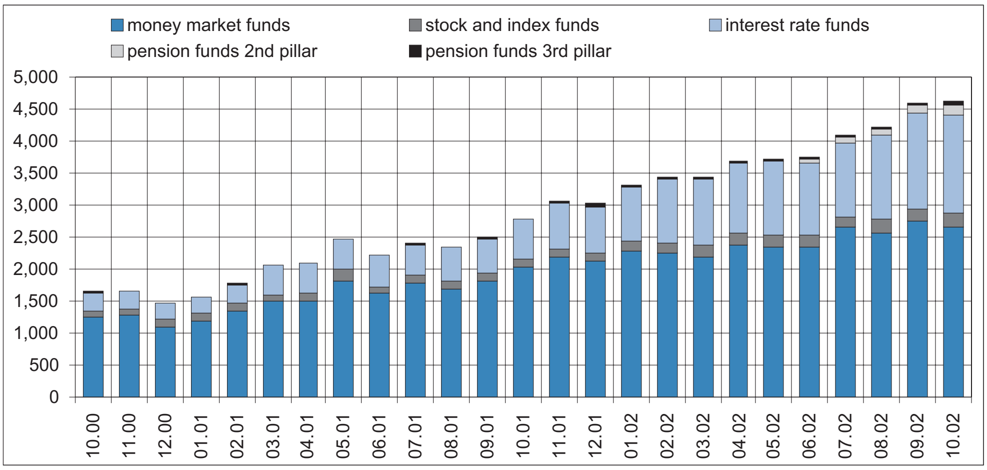

Figure 5.11. Volume of investment funds (EEK m)

Investment portfolios of investment funds have a more-or-less equal share of domestic and foreign assets. However, the share of foreign assets has increased due to rapidly growing funds and a limited choice of domestic financial assets. By instruments, the share of foreign assets in debt instruments is close to 70%, in stocks slightly over 40% and in deposits a third.

The assumed growth in pension funds is exercising an increasing impact on funds' development. About 35% of the employed (207 200 persons) had joined the second pillar of the pension reform by end-October. The volume of mandatory pension funds reached 182 million kroons by end-October whereas problems in making contributions have inhibited further growth. Besides contributions and yield the mandatory share of pension management companies in the fund is responsible for about half of the volume. The mandatory pension fund index (EPI) has remained positive, but bond funds have had the highest yields due to insecure outlooks at the stock markets.

Pension fund assets in the third pillar have displayed slower growth and reached 43 million kroons by end-October. Most likely it owes the slower growth to keener attention on the second pillar of the pension reform.

Insurance

Restructuring continued at the life insurance market. A special regime was imposed on Nordika Elukindlustus in May in order to protect the insured in the situation in which company's equity did not comply with the law. The special regime was terminated on 1 July with the transfer of the portfolio to ERGO Elukindlustus. Now there are five life insurance companies at the market, three of them owned by banks.

In the third quarter, life insurance companies collected premiums for 101 million kroons, about 20% more than a year ago (see Figure 5.12). Similar to pension funds, the growth of the supplemental funded pension scheme (third pillar) has slowed down as well due to the implementation of the second pillar. Endowment assurance is undergoing accelerated growth. Together with life insurance with investment risk the two include a pension insurance component. Reconstruction at the life insurance market has facilitated growth in profitability.

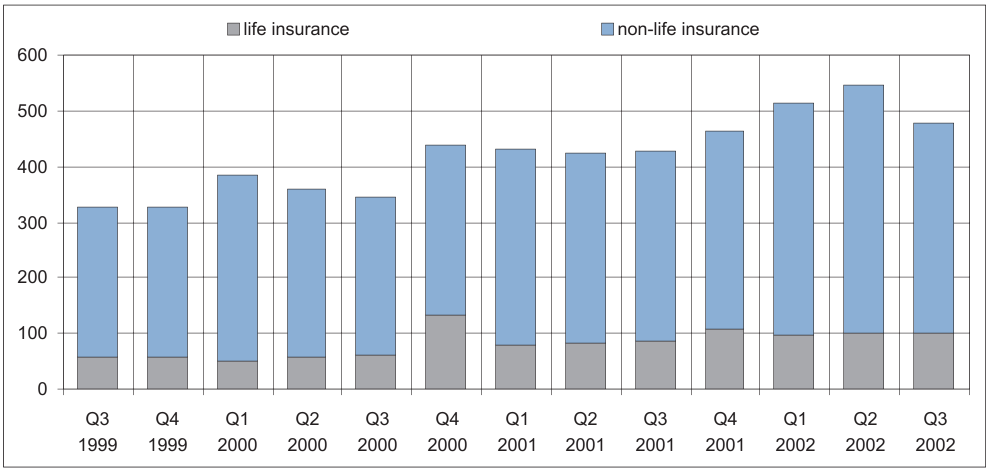

Figure 5.12. Gross premiums collected by insurance companies (EEK m)

While over the last year, non-life insurance market has been growing rapidly, signs of slowdown appeared in the third quarter. In previous periods, acquisition of real estate, sale of vehicles and a rise in compulsory motor TPL insurance tariffs had sustained growth. In the third quarter non-life insurance companies gathered 376 million kroons of insurance premiums. The growth of volume has slowed down in all main types of insurance, except in voluntary corporate motor vehicle insurance and compulsory motor TPL insurance.

Payment System

In nine months of 2002, the number of payments was 28% above the year-ago period (see Figure 5.13), on the average 6.9 and 5.4 million transactions were made a month, respectively. The turnover of external payments grew most – incoming payments by 14% and outgoing payments by 13%.

Bankcards and credit orders continued to be leading payment instruments, being responsible for more than 90% of payments made via credit institutions during nine

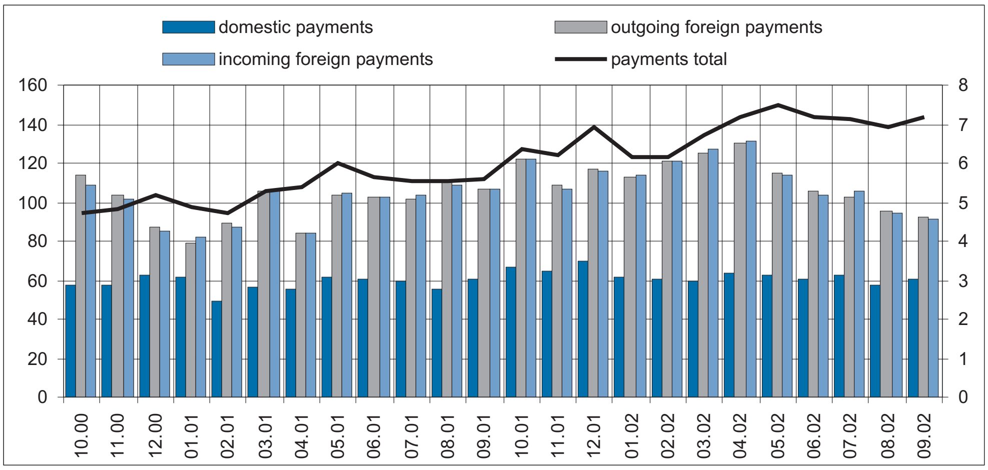

Figure 5.13. Structure of payments by turnover (EEK billion, the left scale) and total number of payments (million, the right scale)

months of 2002 (see Figure 5.14). Expanding use of electronic payment channels increased the share of electronic credit orders to 93% of total credit orders during the first three quarters of 2002 (against 91% a year ago).

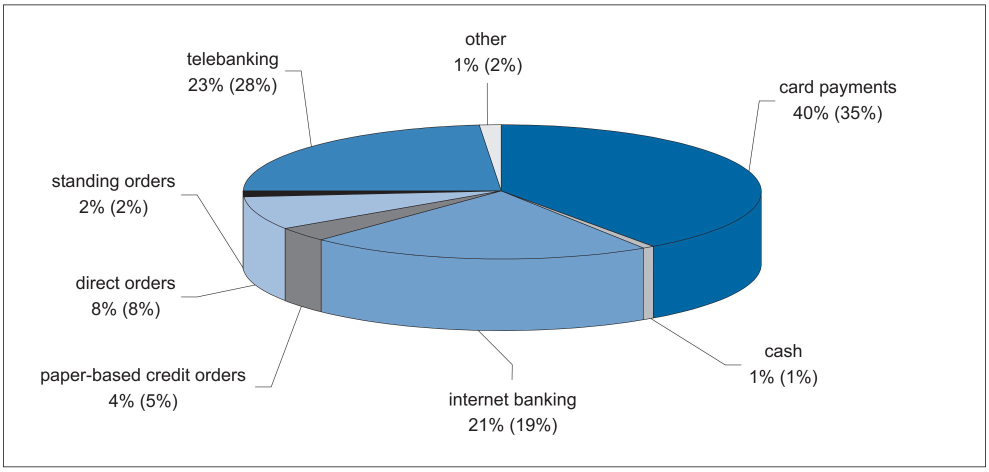

Figure 5.14. Structure of payment instruments in the 3rd quarter of 2002 (in brackets 3rd quarter of 2001)

Ever more bankcards, Internet banking and telebanking as well as standing and direct orders are being used as an alternative to cash and paper-based payment orders. Out of more popular payment instruments, the use of card payments, Internet banking and direct payments increased most during nine months of 2002 against the year-ago period, 50; 44 and 35%, respectively. The main advantage of direct orders for the retail segment lies in comfort and financial benefit for the user (free of charge for the customer), while the corporate segment saves in cost and risk associated with cash payments and cash flow management improves, as payments occur on fixed dates.

Besides above payment instruments, customers of Hansapank and Ühispank who are simultaneously also customers of Estonian mobile phone companies or have a calling

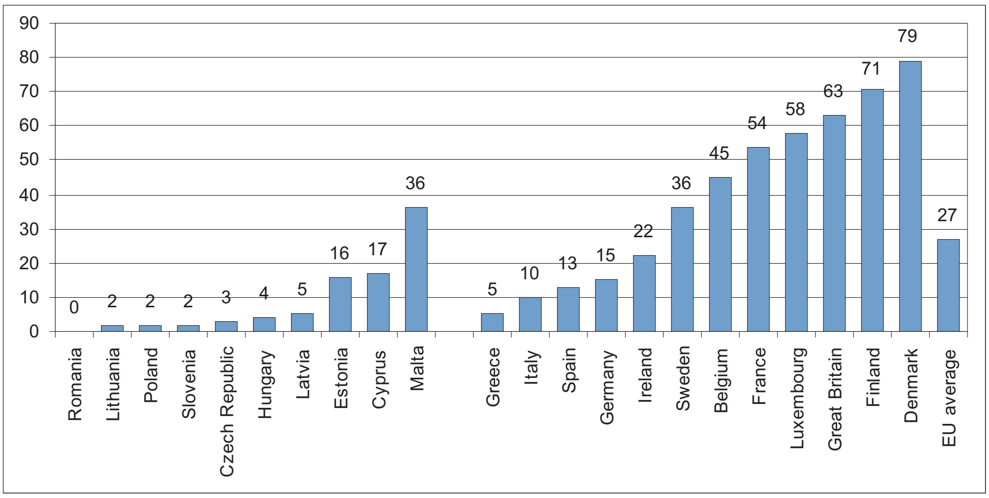

Figure 5.15. Annual number of card payments per inhabitants (EU accession countries – data for 2001; EU member countries – data for 2000)

card can **pay for goods by mobile phone** beginning from November. In end-November about a hundred companies offered m-payment. Banks intend to increase the number to a thousand during a year.

By the end of the third quarter of 2002, Estonian credit institutions had issued about 1.1 million bankcards, 17% of which were passive, ie cards not used for transactions. The share of passive credit cards dropped from 31% to 27% over six months, displaying growing consumption and short-term crediting of daily purchases.

Access by card has expanded – between April and October of 2002 the number of ATMs increased by 25 and that of points of sale accepting card payments by 1227.

The number of bankcard transactions per capita in Estonia exceeds the indicator in most other EU accession countries; for example, *ca* 16 transactions were made per capita in 2001. At the same time, this figure remains about two-thirds below the weighted EU average (see Figure 5.15). Estonia is on the same level with Germany and Cyprus, but more than four times below Finland and Denmark.