V
FINANCIAL SECTOR DEVELOPMENT

In the second quarter of 2002, developments in the financial sector were primarily subject to continuously favourable interest rates, which sustained high loan demand in the real sector – banks' loan and leasing portfolio underwent a record growth. Contemporaneously, securities market was subject to negative sentiments prevailing in world markets (see Figure 5.1).

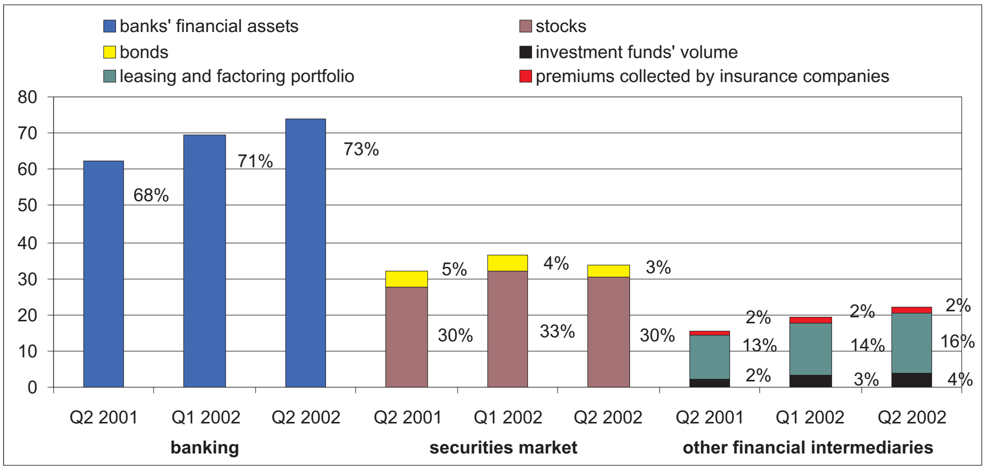

Figure 5.1. Estonian financial intermediaries (EEK billion and % of GDP)

Under constantly high competition banks' interest margins kept declining, profitability remained unchanged compared to the previous quarter. Despite the accelerated growth of overdue loans in the second quarter, their share in the loan portfolio has not increased. Banks' capitalisation remains high and regardless of shrinking liquid assets banks' liquidity buffers stay adequate.

Banking

Banks' Assets and Their Quality

During the second quarter, banks' total assets increased by 3.9 billion kroons, reaching 75.2 billion kroons by end-June at an annual 16.9% growth rate (see Figure 5.2). The growth of assets was sustained by large loan demand, boosting the loan portfolio by more than three billion kroons during the second quarter. The debt of the real sector as a ratio of GDP grew significantly and exceeded 44% at the end of June, being three percentage points above end-2001.

Loan and leasing portfolios grew mostly due to commercial undertakings as corporate financing gained over two billion kroons during the second quarter. Lending and leasing to individuals added meanwhile 1.1 billion kroons.

By sectors of economy and purpose of loan, primarily **housing** was financed in the second quarter: the stock of housing loans gained more than a billion kroons (see Figure 5.3). Also loan supply for the **acquisition of corporate real estate** added volume (by 631 million kroons).

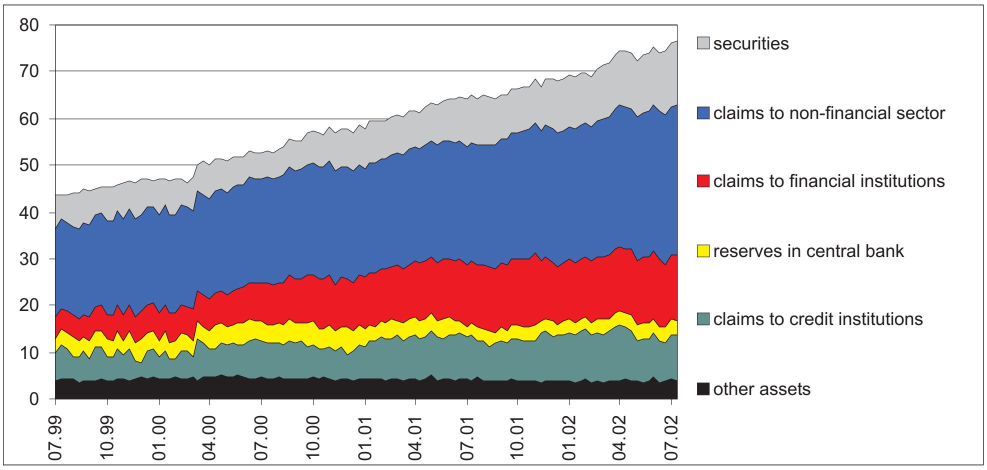

Figure 5.2. Banks' total assets (EEK billion)

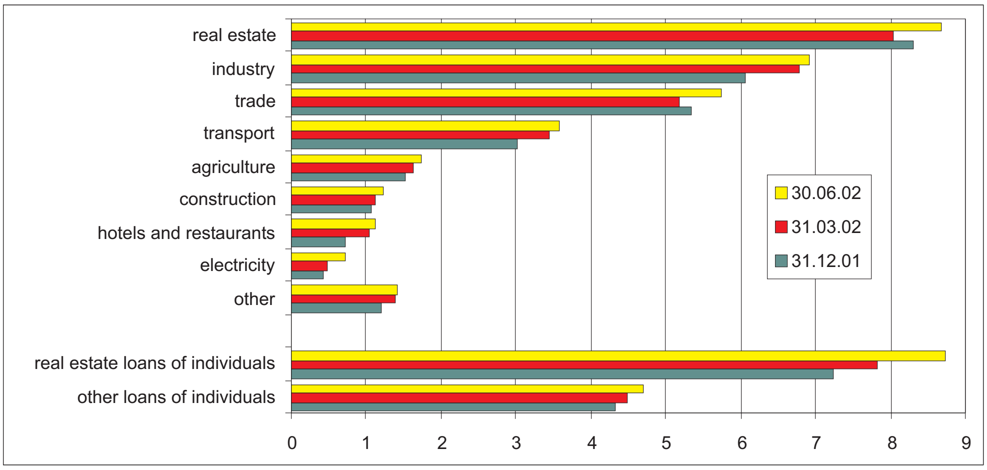

Figure 5.3. Loan and leasing portfolio by sectors of economy and purpose of loans (%)

Public sector financing remained significantly lower. In the first quarter, the industrial sector received more than 700 million kroons of loans, while in the second quarter the growth was merely 115 million kroons.

By leasing objects, leasing of **vehicles** increased most during the quarter whereas the growth in real estate leasing remained about a half below the first quarter (see Figure 5.4). Unlike the banks' loan portfolio, among individuals **consumption leasing** grew rapidly whereas housing leasing was considerably more modest.

In the second quarter, the annual growth of **overdue loans** accelerated and exceeded manifold the growth in the volume of **corporate** borrowing (see Figure 5.5). The volume of loans overdue more than 60 days remained relatively low, reaching 2.2% in the real sector's loan portfolio at the end of June (see Figure 5.6). By sectors of economy, worsening of the loan quality was visible in the most-financed **real estate sector**, in which overdue loans exceeded 600 million kroons in end-June (including 232 million kroons of housing loans).

Banks' **liquidity buffers** did not change much in the second quarter. As a result of aggressive lending, the share of liquid assets in total assets shrank by 2.6 percentage points against end-March – to 21.9%. **The banks' securities portfolio** increased by over 800 million kroons over the quarter, including 180 million kroons of investment to increase the share capital of Latvian Hansabanka.

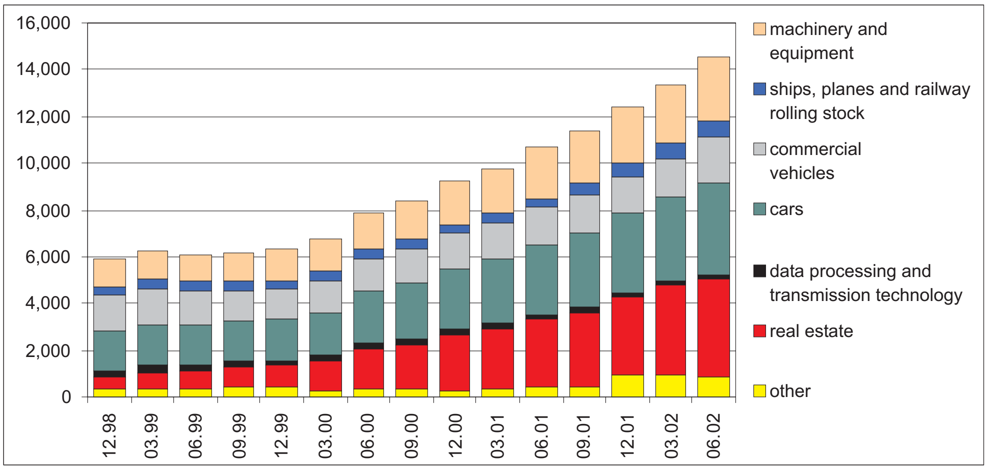

Figure 5.4. Volume of leasing companies' portfolios and structure by leasing objects (EEK m)

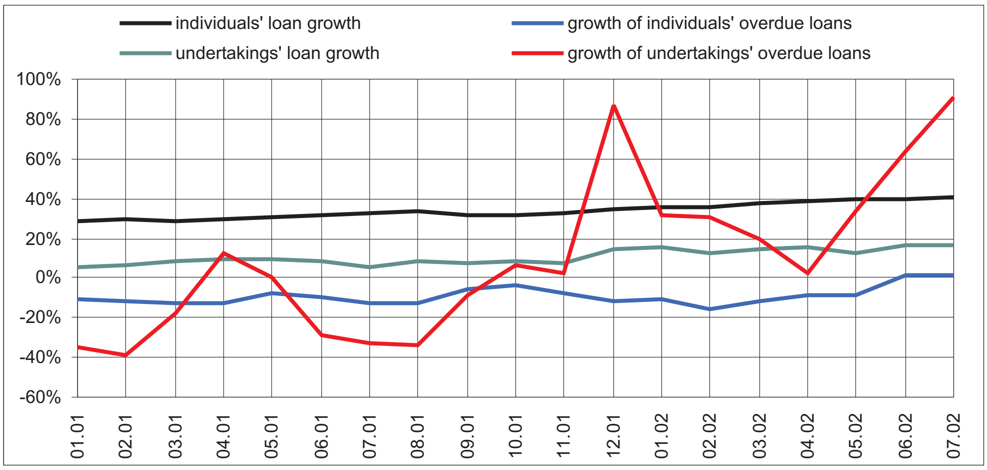

Figure 5.5. Growth of loans granted to undertakings and individuals and growth of their overdue loans

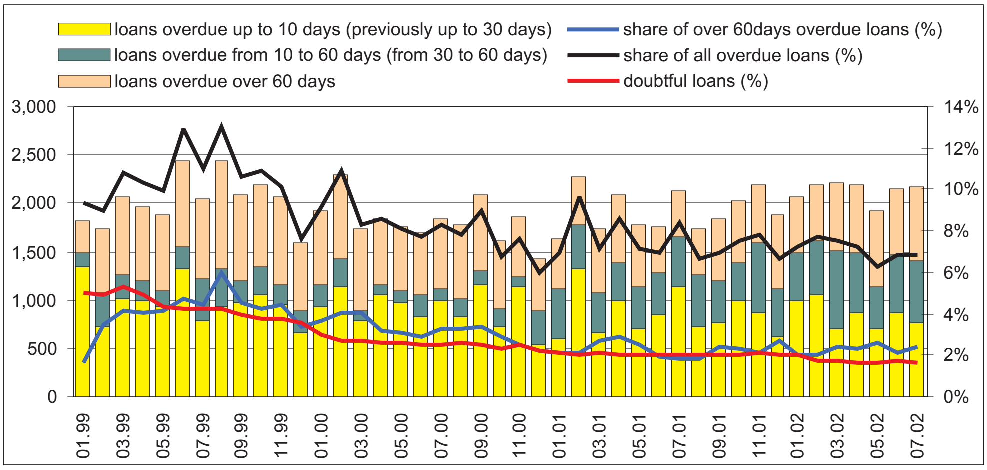

Figure 5.6. Volume of overdue loans (EEK m, the left scale) and their share (the right scale) in public and real sector loan portfolio*

* 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.

Liabilities and Equity Capital

The volume of increment in domestic deposits (2.5 billion kroons) in the second quarter was comparable to the year-ago period (see Figure 5.7). A year ago, the real sector was responsible for about a quarter of the growth, while this year the government's strong fiscal position became significant.

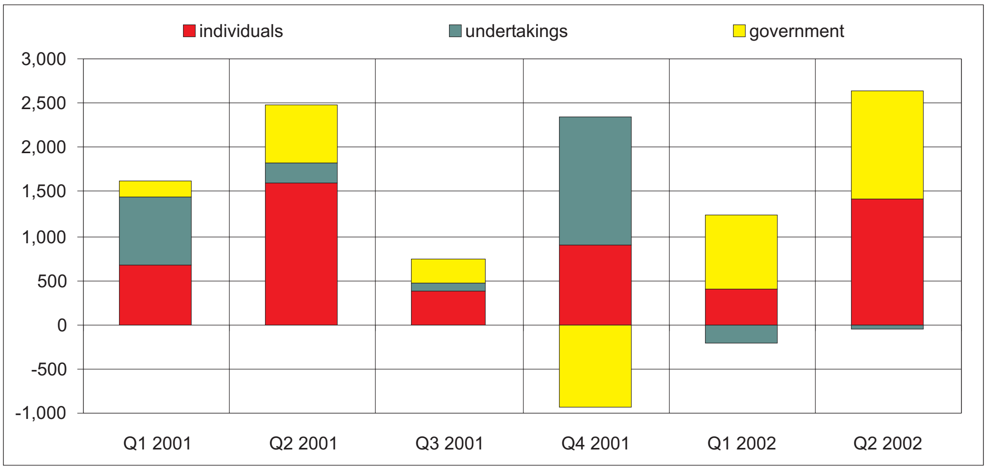

Figure 5.7. Growth of deposits in quarter (EEK m)

Apart from domestic deposits also relatively active **external borrowing has bolstered** loan supply. The share of institutional external borrowing in liabilities has remained stable between 20–22% (see Figure 5.8). Similar to the previous quarter, external liabilities increased mostly through involving foreign deposits, banks issued bonds for about 590 million kroons. The maturity structure of external liabilities has displayed continuous growth in the share of loans with maturity over two years.

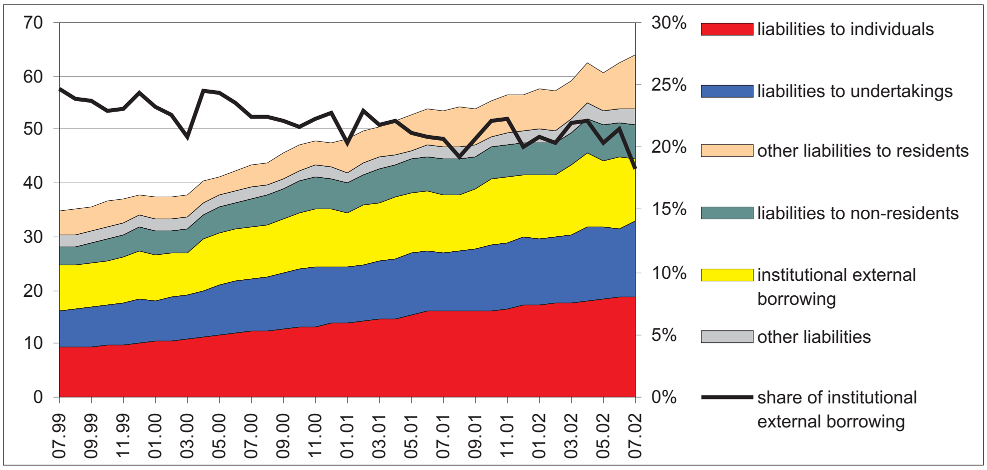

Figure 5.8. Banks' external liabilities (EEK billion, the left scale) and share of institutional external borrowing (the right scale)

The rapidly growing loan portfolio led to a 1.2 percentage point decline in the **banks' capital adequacy** at the end of the second quarter compared to the end of the first quarter. In July the adequacy reached 16.7%. By banks the indicator varied from 11 to 32%. In July a rapid change took place in capital adequacy as net own funds accounting was changed in two credit institutions, sending the volume of net own funds up by 1.4 billion kroons.

Profitability

In the second quarter the banks' **net profit** was close to the first quarter result – 258 million kroons. The net profit of the first half-year was 520 million kroons, 18 million kroons less than a year ago.

Return on equity in the banking sector remained slightly below the first quarter but relatively high anyway (see Table 5.1). Interest margins continued declining also in the second quarter (see Figure 5.9) whereas **for the first time annualised spread remained below 4%**.

Table 5.1. Banks' profitability indicators

	Q2 2000	Q3 2000	Q4 2000	Q1 2001	Q2 2001	Q3 2001	Q4 2001	Q1 2002	Q2 2002
Equity multiplier	7.01	7.34	7.72	7.85	7.91	7.92	7.71	7.53	7.95
Return on equity	2.55%	2.45%	0.09%	4.08%	2.92%	3.78%	9.64%	2.84%	2.79%
Return on assets	0.36%	0.33%	0.01%	0.52%	0.37%	0.48%	1.25%	0.38%	0.35%
Profit margin	0.14	0.12	0.00	0.18	0.14	0.20	0.37	0.16	0.15
Assets utilisation	2.67%	2.71%	2.99%	2.94%	2.62%	2.42%	3.39%	2.30%	2.39%
Net interest margin	1.16%	1.15%	1.16%	1.05%	1.06%	1.02%	1.01%	0.95%	0.95%
Price difference	1.22%	1.20%	1.20%	1.06%	1.08%	1.02%	1.00%	0.93%	0.94%
Net profit (EEK m)	186	179	7	307	231	308	838	262	258

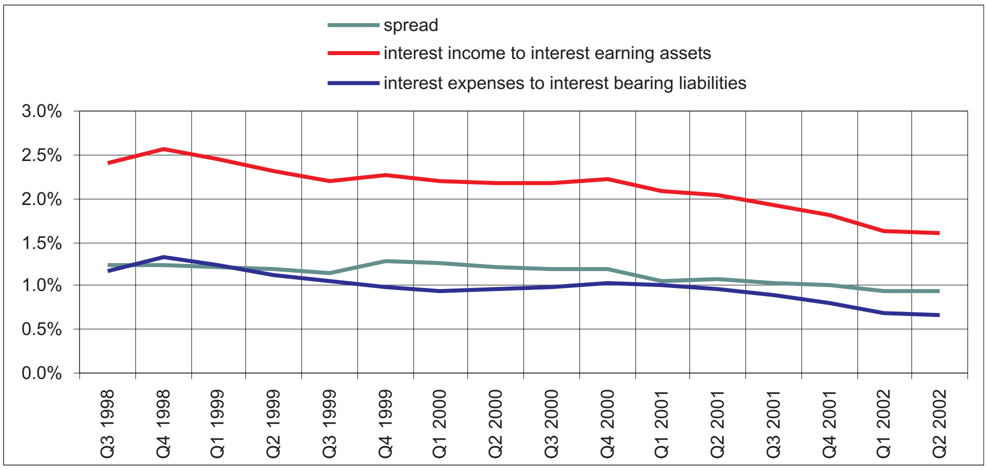

Figure 5.9. Spread between banks' assets and liabilities

Securities Market

In the second quarter, the volume of Estonian securities market shrank by more than 2 billion kroons as a result of stock price decline – down to 35.9 billion kroons (see Figure 5.10). Besides a contraction in the volume of the stock exchange, also the volume of bonds shrank. Whereas the volume of fund units went up, reflecting increasing registration of units with the Estonian Central Securities Depository. Beginning from the end of 2001, the volume of subscription rights has significantly increased and reached 700 million kroons in the second quarter.

The aggregated turnover of the securities market remained high for the second quarter in succession, in nearly all market segments. The turnover of stocks was on the usual level in the second quarter, while the share of OTC stock transactions in the volume remained really high. The bond market underwent the largest growth, its turnover being 600 million kroons in the second quarter.

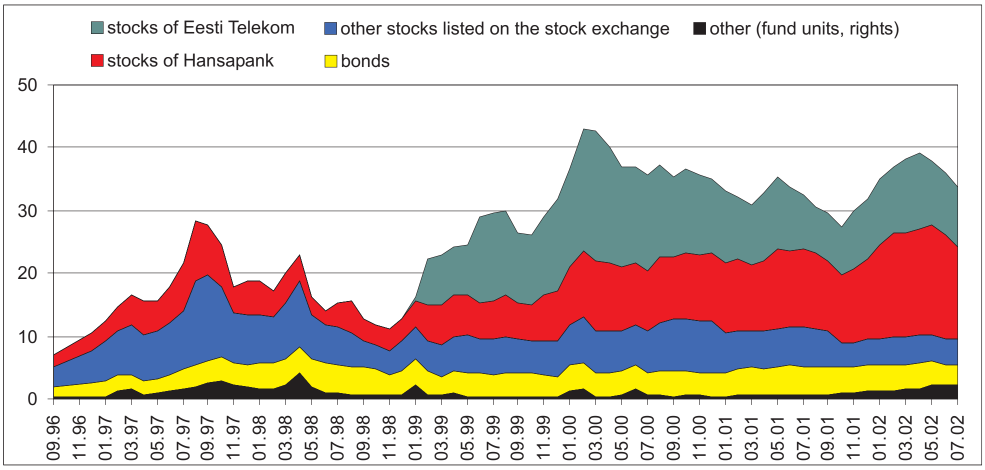

Figure 5.10. Securities market capitalisation (EEK billion)

Bond Market

The volume of the bond market remained low in the second quarter. The volume of end-July, 3.7 billion kroons, is comparable to end-1998. The decline is primarily due to the reduction of non-resident issues in the first half of the year. While in 2001 the share of non-resident issues reached 60%, in the first half of this year only to 20% of total bonds issued. The increase in the volume of resident corporate issues offset the decrease in the volume of non-resident issues (see Figure 5.11). The favourable interest rate level and increased demand have bolstered growth of volume in domestic corporate issue.

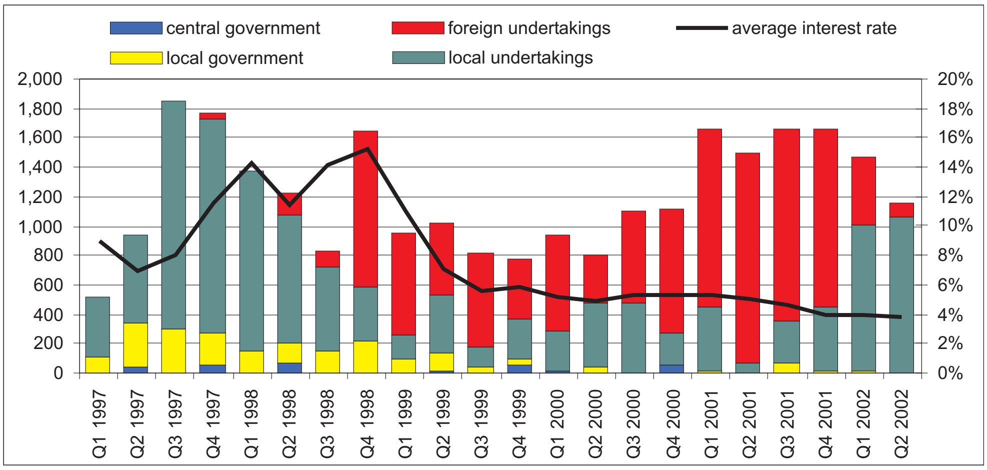

Figure 5.11. Volume of bonds issued in a quarter by issuers (EEK m, the left scale) and average interest rate of kroon bonds (the right scale)

However, bond maturities are still mostly below a year. Due to the high stake of domestic issuers the average interest rate of bonds was 3.74%.

Stock Market

While in the second quarter the capitalisation of Tallinn Stock Exchange shrank by 2.1 billion kroons against the first quarter, in July alone the volume of the stock market dropped about as much again. This was due to the infusion of negative attitudes from external markets: the liquidation of foreign investors' positions gathering momentum at the end of June was followed by resident-investor-side sales pressure of stocks.

The index TALSE decreased to 163.49 points by end-July, swinging the stock exchange back to the level of January (see Figure 5.12). However, more than half of the index growth initiated in the second quarter of 2001 was maintained. In the second quarter, shares in the services sector led by Estonian Telecom (-15%) shredded most in the value. The price of the Hansapank stocks stated to fall only in June and lost 14% of its value in two months. Stocks of industrial and construction companies have managed to maintain their previous level throughout the recession.

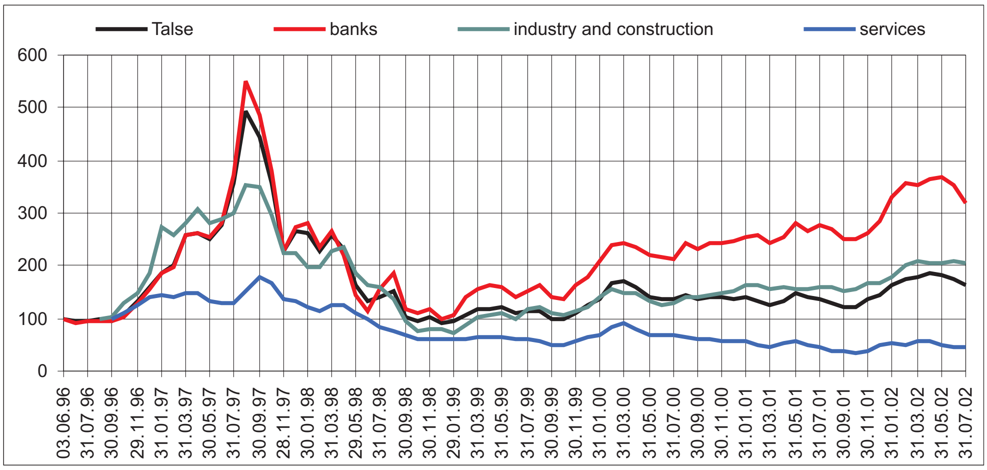

Figure 5.12. Talse and indices of stocks traded on the Tallinn Stock Exchange by sectors of economy (points, 3 June 1996 = 100)

Other Financial Intermediaries

Investment Funds

The volume of investment funds continued growing in the second quarter, although at a reduced pace. This indicates a price decline at securities markets. In July the volume of funds increased by 350 million kroons, primarily due to rapidly growing money market funds (see Figure 5.13). The share of bonds grew significantly in fund assets, reflecting partly the entry of new interest rate funds to the market as well as the growth of bond funds this year.

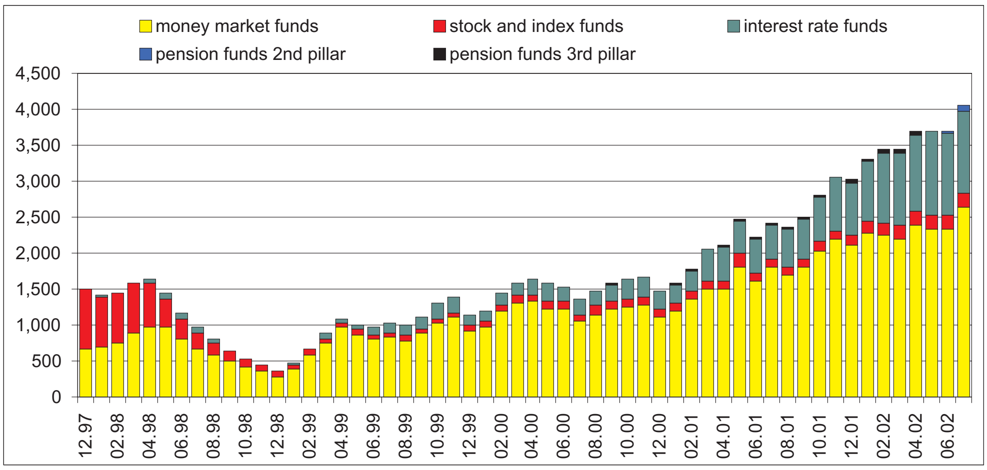

Figure 5.13. Volume of investment funds (EEK m)

A slight downward trend characterised the yield of all types of funds in the second quarter. Money market funds suffered the sharpest fall, the productivity decreasing by 0.5 percentage points – down to 3.2%. The recession of securities markets has not yet significantly curbed yield of stock funds.

In June and July people were relatively active in joining the funded pension scheme. While by the end of Phase One (1 June) 37,000 people had joined the funded pension scheme, by 8 August another 45%, ie as many as 54,000 had joined[1]. 65% of them had chosen funds of the most aggressive strategy and the law obliged about 15% of them to join.

Insurance

In the second quarter non-life insurance companies gathered premiums for 445 million kroons, about 30% more than a year ago (see Figure 5.14). Most of the growth comes from insurance of legal persons' property and voluntary motor vehicle insurance. Considering the rapid growth of housing loans and leasing, the insurance of individuals' property has not significantly increased.

Life insurance companies collected premiums of about 100 million kroons, 20% above the year-ago period. Most of the growth comes from supplemental funded pension insurance contracts.

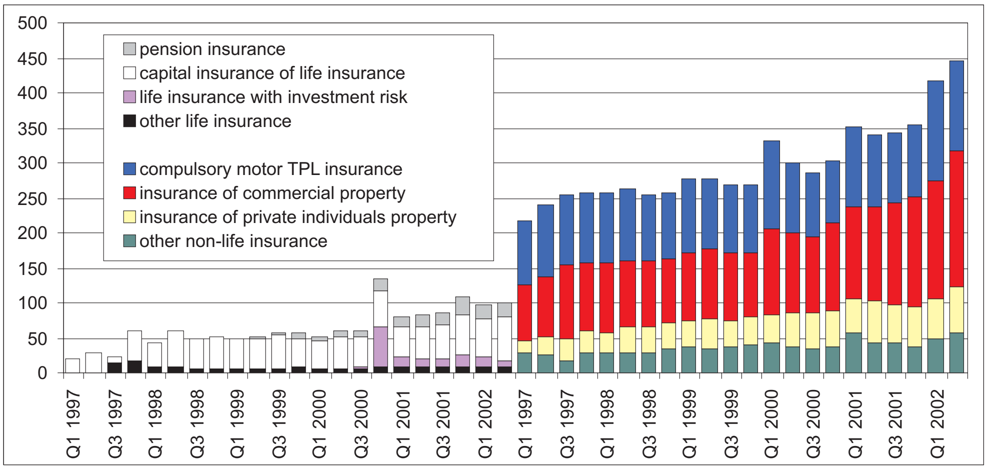

Figure 5.14. Gross premiums collected by insurance companies (EEK m)

Payment System

Compared to the second quarter of 2001 the number of payments has increased by 28% over the same period this year – reaching an average of 7.3 million transactions a month. The turnover of transactions increased, meanwhile, by about 17%. The amount and volume of external payments grew most (see Figure 5.15).

[1] By end-June 39,458 third-pillar insurance contracts had been concluded under supplementally funded pension scheme. Thus, 7% of the employed workforce had contracts (source: BNS, Estonian Association of Insurance Companies).

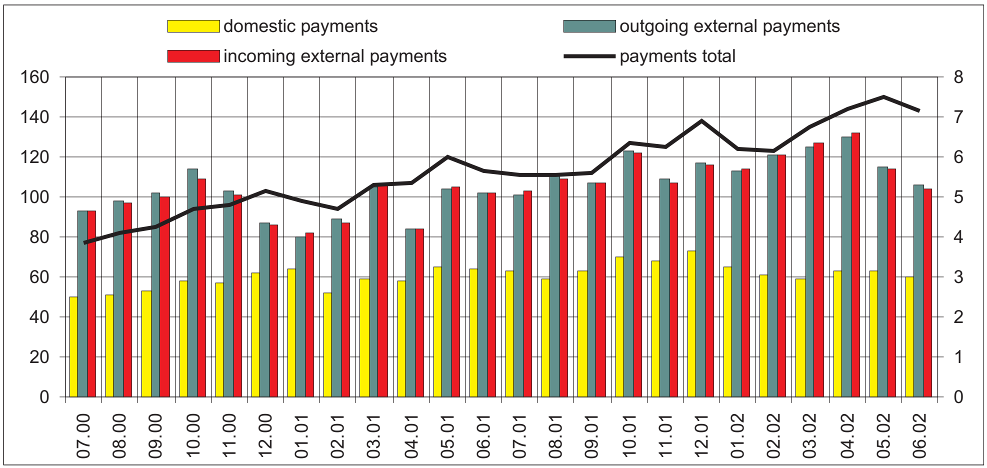

Figure 5.15. Turnover of payments by types (EEK billion, the left scale) and total number of payments (million, the right scale)

As bankcards, direct debits and Internet banking kept growing, the share of telebanking, paper-based payment orders and cash has been diminishing. The amount of standing orders has remained on the year-ago level of the second quarter (see Figure 5.16).

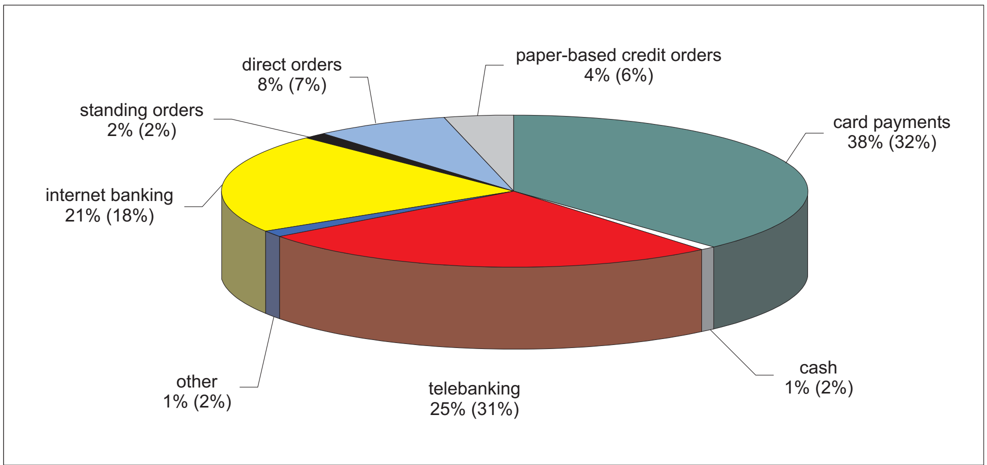

Figure 5.16. Structure of payment instruments in the 2nd quarter of 2002 (in brackets 2nd quarter of 2001)

By the end of the second quarter of 2002 credit institutions had issued over 923,000 debit cards and about 132,000 credit cards, of which 15% and 26%, respectively, were passive (ie cards not used for transactions). Simultaneously with the growth of bankcards, the **number of ATMs** went up to 710 and that of **points of sale accepting card payments** to 5,767 (see Figure 5.17).

In order to provide better and faster services, credit institutions have been upgrading and supplementing the range of services – since end-June **prompt domestic payment** has been available and as of this autumn **payment via mobile phone**. Prompt domestic payment is a SWIFT-based payment mode prepared by Eesti Pank and commercial banks both for retail and corporate customers, accessible in bank offices, via Internet and telephone banking. The new payment mode allows inter-bank transactions within Estonia in just a few minutes. M-payment

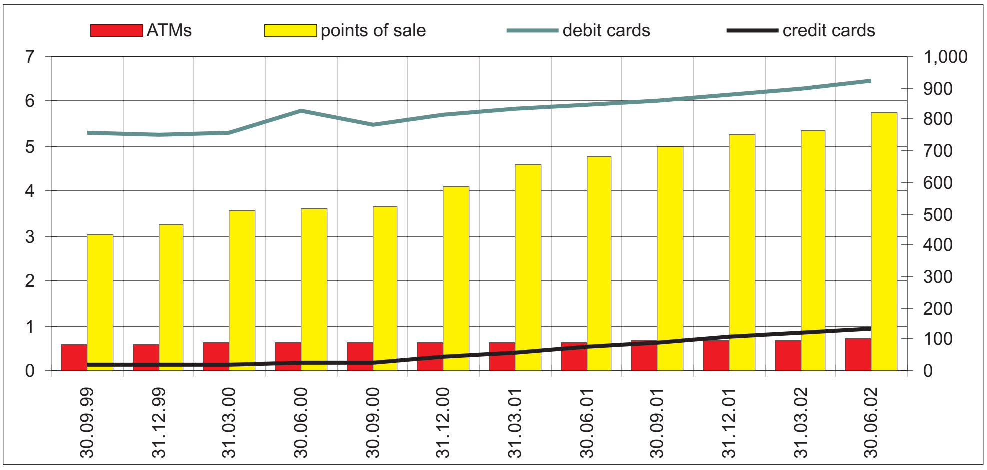

Figure 5.17. Number of ATMs, points of sale (EEK thousand, the left scale) and number of bankcards (EEK thousand, the right scale)

is an alternative mode to card payments accessible to mobile phone holders to pay for goods and services. In June, Estonian large banks launched an m-payment pilot project with about 1,000 test users.