Eesti Pank
Bank of Estonia

Flash report

LOAN LOSSES OF BANKS AND ASSESSMENTS OF CAPITAL ADEQUACY IN THE ECONOMIC DECLINE STAGE

Flash report, 22 July 2009

The banks operating in Estonia have used their earlier years' profits to form strong capital buffers, which are sufficient also during the current economic slump. The Estonian banking sector will meet the capital adequacy requirement in 2009.

As anticipated, the share of loans overdue by more than 60 days in the loan portfolio of banks reached its recent years' highest level by mid-2009. Banks have suffered losses due to increased loan write-downs this year.

Although current economic outlooks expect the share of overdue loans and the volume of loan losses to augment, banks have prepared themselves for even more negative scenarios and they have enough capital buffers. Close integration with strong Nordic financial groups provides additional security to the Estonian banking sector.

The capital buffer of the banks operating in Estonia supports them in the changed economic situation.

The banks operating in Estonia have used their earlier years' profits to form strong capital buffers, which are sufficient also during the current economic contraction. Taking into account the existing capital buffer[1] of the Estonian banks, the banking sector could write off a total of 9 billion kroons (6% of the portfolio) and still meet the 10% minimum capital adequacy ratio.[2] The total capital volume of the entire sector amounts to 26 billion kroons, which constitutes 16% of the loan portfolio.[3]

In spring 2009 Eesti Pank conducted a stress test using the assumptions and results of the central bank's spring macroeconomic forecast. In addition, some presumptions were added in respect of the further development of the banking sector.

- Since the situation of both the domestic and the external economy has deteriorated, we have downgraded the estimation of banks' profitability in the **baseline scenario of the stress test** compared to earlier years. The banking sector as a whole will earn a pre-loss profit of 3 billion kroons in 2009, which is half of the profit earned in 2008. Loan losses are calculated using a 45% LGD (loss given default) ratio.

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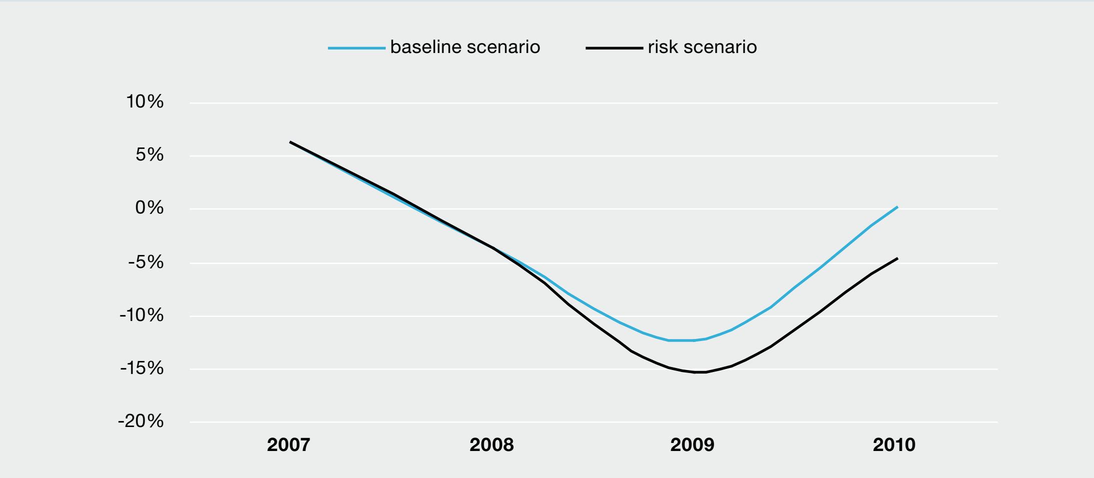
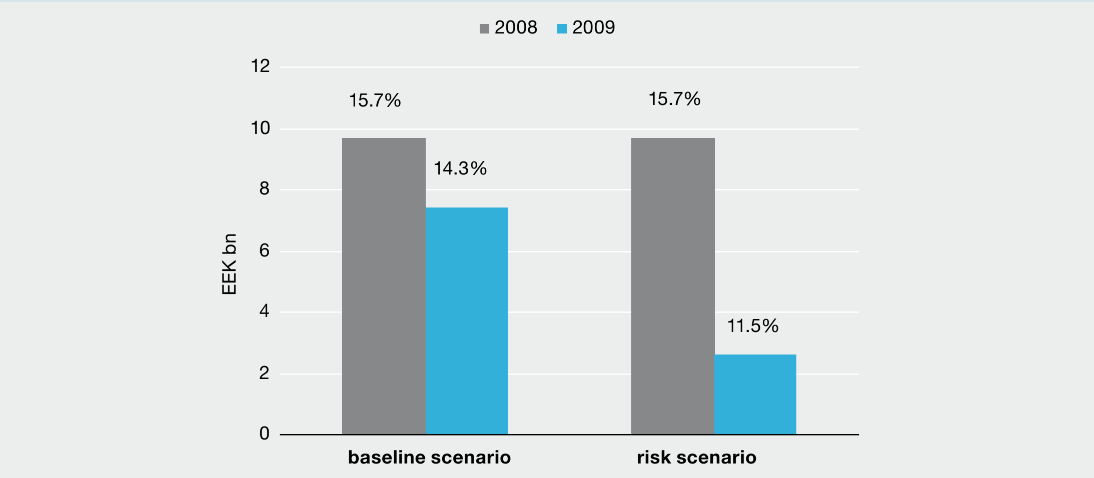
[1] The capital buffer is the part of a bank's capital that exceeds the 10% minimum capital adequacy ratio.
[2] Swedbank's capital for covering risks in all the Baltic states has been reduced here to comply with the risks taken in Estonia only.
[3] The capital adequacy requirement must be met by the subsidiaries of foreign banks operating in Estonia (that make up 74% of the Estonian banking market) and by local banks (1% of the Estonian banking market). The branches of foreign banks operating here (holding 25% of the Estonian banking market) are not obliged to comply with the capital adequacy requirement

- The **stress test risk scenario** projects that banks will be able to cover only running costs out of their profit and will thus not earn pre-loss profit. Here, we use a 60% LGD ratio.



Real GDP growth under different forecast scenarios

Proceeding from the economic forecast and the assumptions of the stress test, the Estonian banking sector will be able to meet the capital adequacy ratio in 2009 according to both the baseline and the risk scenario of the stress test. Although the baseline scenario projects the banks' loan losses to amount to up to 4% and the risk scenario to up to 5% of the loan portfolio, banks will be able to manage with their growing loan losses owing to the capital buffers accumulated in good times. In July 2009, the capital adequacy of the banking sector was 22%, exceeding the 10% minimum requirement by more than twice.



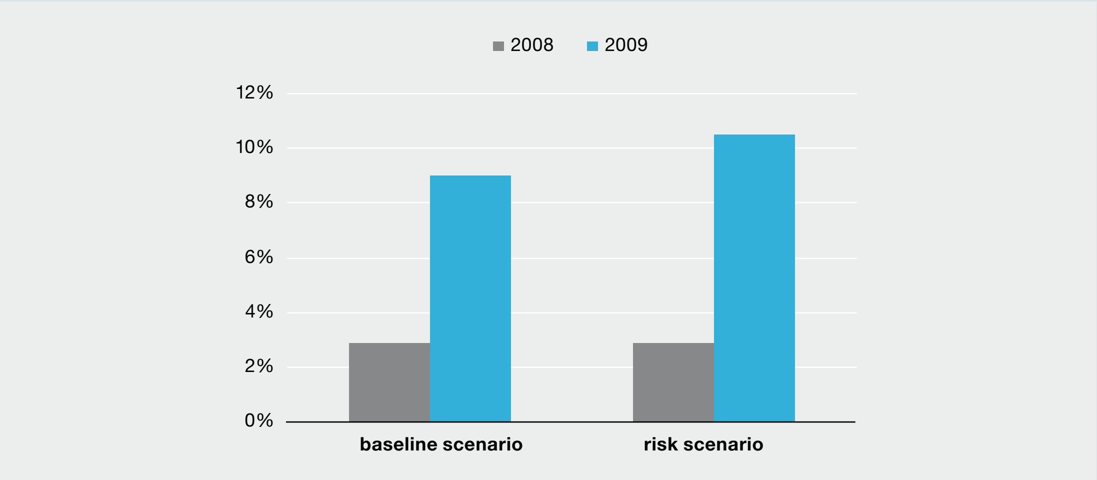
Banking sector's capital buffer (EEK bn) and capital adequacy ratio (%) under different stress-test scenarios

Changes in the share of overdue loans in light of the 2009 global financial crisis

In the economic decline stage, the banks' capital buffer is mostly affected by changes in the loan portfolio quality. This is, in turn, characterised by an increase in the share of overdue loans. Overdue loans enable the assessment of future financial standing of the banks and the volume of loan losses. The ultimate size of loan losses depends, among other things, on the existence and value of collaterals. In other words, it is important to ascertain the percentage of a loan the bank would lose (considering also the value of the collateral) should the customer become insolvent.

By May 2009, the share of loans overdue by more than 60 days grew to 5.5%, which could be anticipated in the current economic situation. The respective indicator stood at 1.1% a year ago. From the point of riskiness, the share of overdue loans was the largest in households' consumer credit, as expected, followed by corporate loans and households' housing loans. As a result of the current economic environment, the construction sector has the most overdue loans, and it is followed by the real estate sector.

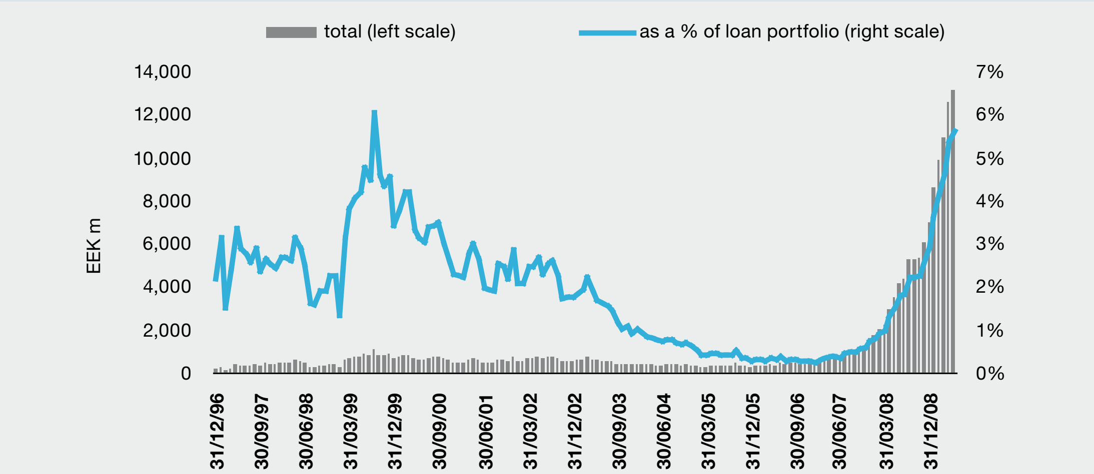
Based on the assumptions of Eesti Pank's spring forecast, the share of loans overdue by more than 60 days may amount to some 9% of the portfolio by end-2009 in the case of the stress test baseline scenario and to 10.5% in the case of the risk scenario. Since the repayment behaviour of borrowers varies across sectors, the consumer credit portfolio is expected to suffer the largest share of overdue loans. Both experience and international comparison allow assuming that the quality of housing loans in the banks' loan portfolio will remain relatively better also in the economic downturn stage. The quality of corporate loans will deteriorate faster than that of households, but the former is expected to recover more rapidly as well.



Forecast for loans overdue

Overdue loans of the banks operating in Estonia in historical perspective

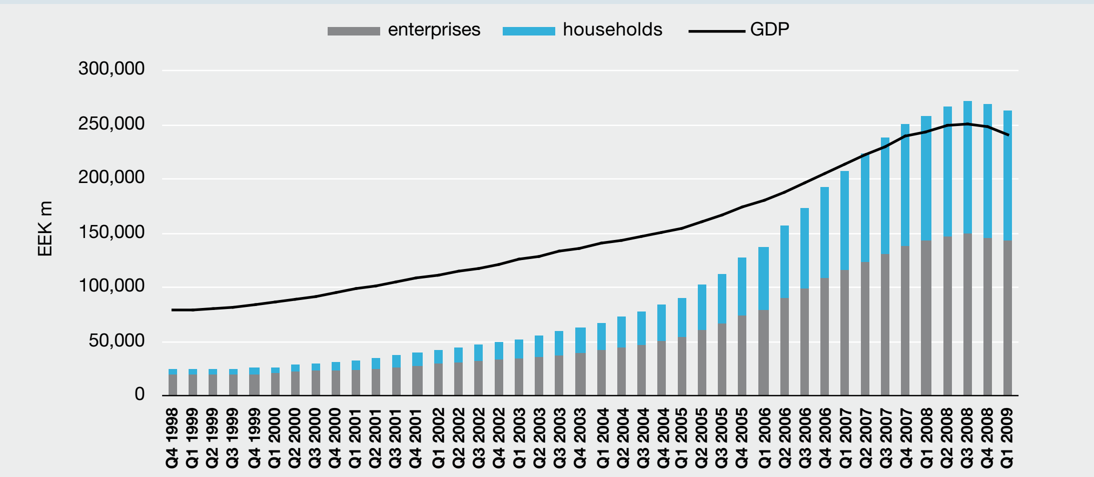
In an economic growth period, when the income of borrowers is sufficient to repay loans and the value of collaterals remains high, the loan losses of banks are marginal. The years 2005 and 2006, when overdue loans amounted to just 0.3% of the portfolio, were very good in this respect. But declining economic volume is accompanied by strong pressures on the budget of companies and households, causing the amount of problematic loans to increase. Possible corrections of the value of collaterals increase the potential loan losses of banks even more.



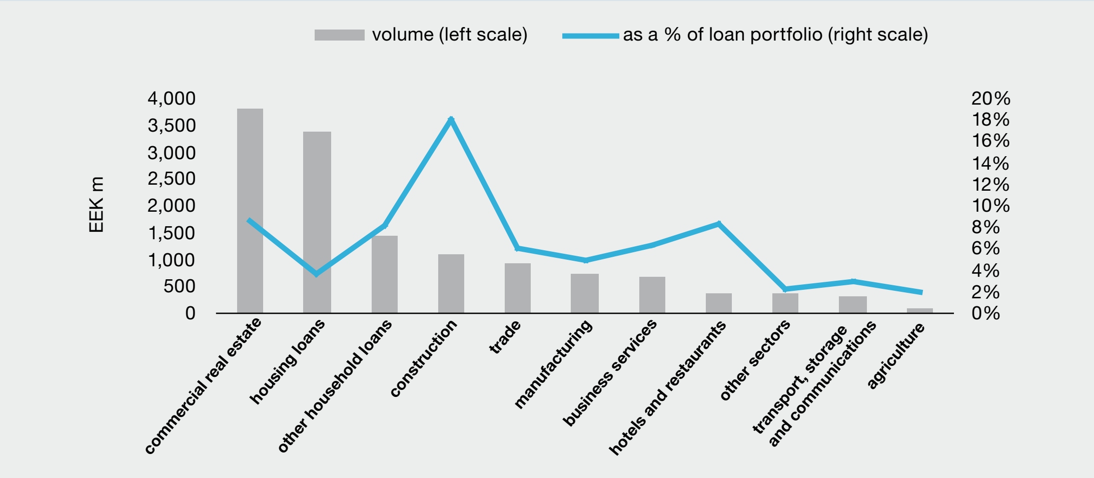
Loans overdue by more than 60 days

The last time overdue loans grew as rapidly as now was during the so-called Russian crisis, when the share of loans overdue by more than 60 days sporadically shot up to 6%. The Russian crisis caused banks' loan losses to rise to 1.3 billion kroons (i.e., to 6.5% of the loan portfolio) in 1998-2000. Loan losses were in the same magnitude in the Nordic countries during the financial crisis at the start of the 1990s. The current economic downturn, which in Estonia started in the second half of 2008, is more profound than the Russian crisis, and its duration and effect on the behaviour of the economy and the credit market more protracted. The current and future development of overdue loans and loan losses should be assessed in this context.

The marked growth of the indebtedness of the non-financial sector is a substantial difference between the situation now and ten years ago. Whereas the total indebtedness of Estonia's enterprises and households made up 32% of GDP at the end of 1990s, it now amounts to 106%. A larger debt burden makes the non-financial sector more vulnerable to the recession. In addition, the ranking of the sectors that have taken out loans has changed. In the course of the Russian crisis the loan portfolio mainly comprised loans to the manufacturing and trading sector, whereas now most of the loans have been issued to fields of activity related to real estate. The consequences of the recent property boom manifest themselves in the loan portfolios of both enterprises and households.



Non-financial sector loans and GDP



Volume and share of overdue loans by sectors

Summary

Losses arising from lending activity decrease the capital of banks. Against the backdrop of increasing loan losses, banks try to protect their capital by changing their credit conditions in the course of an economic cycle. Credit conditions are more lenient in the upward phase and it is easy to get a loan, and the conditions are normally tightened when the cycle turns downward. In order to maintain the capital position, banks restrict the amount of new borrowers and issue loans to only very solvent customers.

The banking sector can guard itself against more adverse circumstances by accumulating reserves in good times. In Estonia, the creation of capital buffers during the rapid growth stage was also favoured by tightened capital regulations by which Eesti Pank demanded larger-than-usual capital stock from commercial banks in the case of housing loans. In the current economic situation it is natural that capital buffers decrease, but when the cycle turns, the capital stock will have to be restored.

Additional information: The framework of Eesti Pank's stress test

Stress tests are one of the possibilities to observe economic developments and assess banks' resilience. These tests enable one to analyse what might happen to a bank's portfolio if certain macroeconomic scenarios materialise. Stress tests do not definitely render exact answers, but they do help assess the need for taking measures.

Stress tests ascertain whether banks will be able to meet the regulatory minimum capital adequacy requirements in a new economic environment. At this point it is also important to look at the speed at which capital buffers are decreasing and possible development trends in the years ahead.

The stress tests conducted by Eesti Pank are based on the central bank's macroeconomic forecasts and the banking sector's stress test model. The analysis of the strength of the banking sector relies on the baseline and risk scenario of the economic forecast. The analysis makes it possible to assess the development of overdue loans and loan losses by both banks and loan types.