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SUMMARY

The capacity of the banks in Estonia to lend has remained good despite the Covid-19 crisis. This has been supported by the capital buffers built up in previous years and sufficient supplies of funding from rapidly growing deposits and bond issues. The outbreak of the virus affected the risk assessments of the banks and they tightened lending standards in the first half of last year in response to the sharp rise in uncertainty and the reduction in risk tolerance. The second half of the year saw standards eased though, despite the new wave of the virus.

Competition in the banking market increased in some segments in 2020, unlike in the previous couple of years, but competition in the Estonian banking market is still weaker than that in many other countries in Europe. Several foreign banks had left the Estonian banking market in the preceding years or merged their business activities. This at first reduced competition and made many clients look for a new bank, but several domestic banks have by now grown strongly and some large foreign-owned banks are again active in the lending market. This has gradually increased competition pressures, and the average interest rate has fallen a little. Competition should increase in the banking market in future, as several banks are aiming to grow further and issuing covered bonds has expanded the options for funding. It should be noted though that the small banks are not able to compete yet with the large banks in all loan segments, especially on the price of loans.

Non-bank financial intermediation has so far coped relatively well with the difficult times and has been able to fund companies and households in its own niche. Funding intermediated by non-bank financial intermediation grew more slowly in 2020, but the growth still continued and was again faster than the growth in bank loans. Like it did at the banks, the volume of funding dropped in the spring, but then it recovered relatively quickly. Demand has mostly shaped the dynamics of the growth in funding issued, but lending by savings and loan associations has probably been restrained because deposits stopped growing.

Corporate assessments of access to funding at the end of 2020 were at about the same level as in 2019. Assessments of access to funding deteriorated in the first half of the year, but then improved in the second half. The coronavirus crisis affected above all the outlook for companies to earn revenues and so their desire and capacity to borrow. Companies in different sectors have been affected quite differently. Access to funding has been made worse in the sectors affected most by Covid-19 such as accommodation and food service, and transport, as the credit capacity of companies has declined and lenders have become more cautious. There was no improvement in those sectors in the second half of the year and loan prices rose for them.

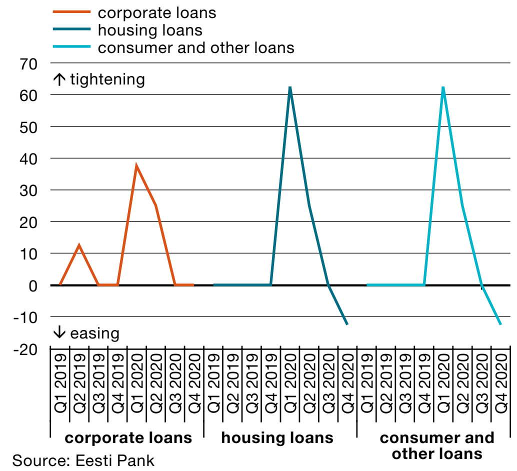
Apart from a short period in the spring, demand for housing loans remained strong in 2020. Households with a higher income than the average and better credit capacity have been hurt less by the crisis and after a short period of uncertainty their willingness to borrow recovered. Competition has gradually started to increase in the housing loan market, which was previously very concentrated, and this has probably affected interest rates, which have fallen a little. Other lending conditions at the end of 2020 were at about the same level as in 2019. Demand for consumption loans was notably smaller last year than in previous years. There are a lot of lenders in this segment of the market, and the market became even less concentrated last year. There was however no consequent fall in the price of loans.

The Estonian government, like those in other countries, supported businesses during the Covid-19 crisis with direct loans and guarantees for bank loans. The total amount given as direct loans and guarantees was around the European average. Several companies that were particularly hit by the crisis have benefited very much from this. Direct loans issued by the state dominate in Estonia though, and substantially more of them were issued than the European average. It is debatable whether it is wise to provide cheap direct loans at a point when the private lending market is functioning despite the economic crisis. The state needs to be careful, as interfering in the lending market could crowd out smaller but growing banks, and so hurt competition in the long run. The state would be better to prefer guarantees to direct loans. This would preserve the useful risk assessments of the private sector, harm competition less, and use less taxpayers money to achieve the same goals.

1. THE LOAN SUPPLY FROM THE BANKS AND COMPETITION

The sharp rise in uncertainty and the decline in risk tolerance led banks to tighten their lending standards in the first half of 2020. The second half of the year saw standards eased though. The Bank Lending Survey of banks in the euro area in 2020 showed though that banks in Estonia tightened lending standards and conditions for both companies and households in the first half of the year. The reasons given for the tightening were the general development of the economy and the outlook for it, a reduction in risk tolerance, and a reduction in borrower's creditworthiness. The health crisis started to abate in the summer though and the economy to improve, and lending standards were no longer tightened. The second wave of the Covid-19 virus did not lead to lending standards being tightened in Estonia, and they were even eased for some loan products (see Figure 1). Looking forward, the banks consider that corporate lending standards will remain the same in the first quarter of 2021, but those for households may ease even further.

Figure 1. Diffusion index of changes in credit standards



Source: Eesti Pank

The changes in the supply of credit in different segments of the loan market have been quite different. Possible changes in the supply of loans can be assessed by comparing changes in lending volumes and interest rates. There were signs of a reduction in the supply of loans in the first half of 2020 in corporate leases and car leases to households, as the average interest rate rose and lending volumes fell (see Table 1). Increased lending volumes for short-term loans to companies and a fall in the average interest rate on them indicated in contrast an increase in the supply of credit. A reduction in the supply was visible in the second half of 2020 in leases to businesses and households and in short-term corporate loans. An increase in supply was apparent though in long-term corporate loans and in the housing loan market for households.

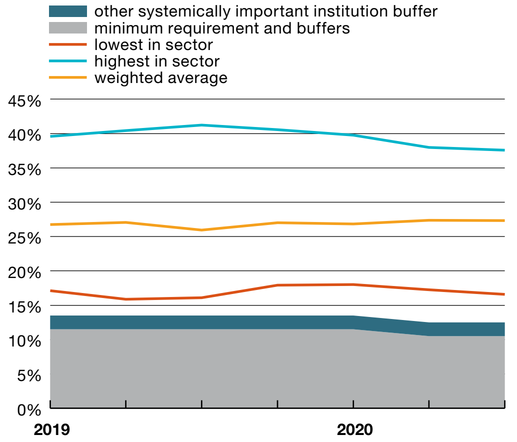
The capitalisation of the banking sector does not currently limit the supply of loans from the banks. The total own funds of the banking groups consolidated in Estonia covered 26% of their risk exposures as at the end of September 2020 (see Figure 2), which exceeds by a large margin the macroprudential capital requirements of 10.5%-12.5%. Although capitalisation varies across the banks, banks that are more highly capitalised than the median have three quarters of the loan market.

Table 1. Indicators across different loan segments for changes in the loan supply from banks

Segment of the loan market	from Q1-2 2019 to Q1-2 2020				from Q3-4 2019 to Q3-4 2020			
	loan contracts		loan turnover		loan contracts		loan turnover	
	volume	interest rate	volume	interest rate	volume	interest rate	volume	interest rate
Companies								
Short-term bank loans	⇧	⇩	⇧	⇩	⇩	⇧	⇩	⇧
Long-term bank loans	⇧	⇩	⇩	⇧	⇧	⇩	⇧	⇩
Leases	⇩	⇧	⇩	⇧	⇩	⇧	⇩	⇧
Factoring	⇩	⇩	⇩	⇩	⇩	⇩	⇩	⇩
Households								
Housing loans	⇧	⇧	⇩	⇧	⇧	⇩	⇧	⇩
Car leases	⇩	⇧	⇩	⇧	⇩	⇧	⇩	⇧
Other household loans	⇩	⇧	⇩	⇩	⇩	⇩	⇩	⇩

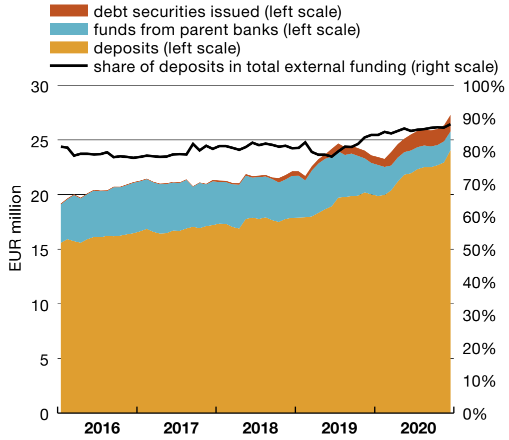
Explanations:
⇧ increase from the previous year
⇩ decrease from the previous year
possible increase in supply
possible reduction in supply

Figure 2. Capital requirements and buffers of the banks



* Figure does not contain microprudential buffers
Source: Eesti Pank

Figure 3. Structure of the debt liabilities of the banks

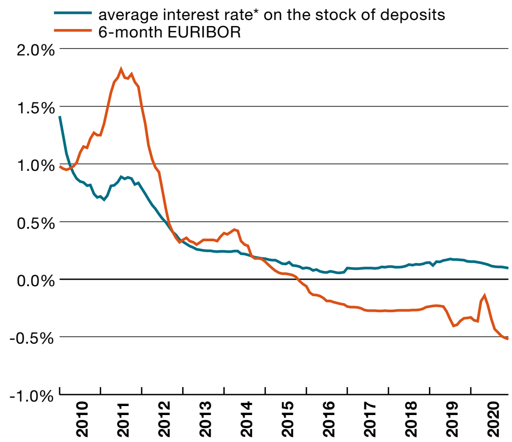


Source: Eesti Pank

The supply of loans from the banks is supported by funding based on rapidly growing retail deposits. Retail deposits have long played an important role in the Estonian banking sector as one of the most stable sources of funding. The deposits of the non-financial sector were around three quarters of all deposits at the end of 2020, and deposits covered 88% of the debt liabilities of the banks (see Figure 3). The relatively rapid growth in deposits meant the deposits exceeded the loan portfolio by 3 billion euros at the end of 2020, and the loan-to-deposit ratio fell to 86% for Estonia as a whole at the end of the year. The share of deposits in funding varies between banks and the banks with the smallest share of deposits have also issued securities to fund their activities.

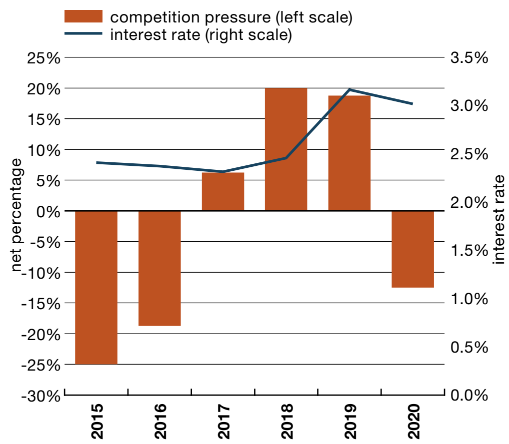
Low interest rates and cheap funding have encouraged the supply of credit from the banks. The interest rate on deposits had already been very low for a long time (see Figure 4), and in 2020 it fell further. Interest rates in the inter-bank money market also continued to fall, and the six-month Euribor had reached record low levels by the end of December 2020. The supply of credit from the banks in Estonia is also supported by the additional liquidity offered on favourable terms to commercial banks by the Eurosystem through its monetary policy operations. The increasing uncertainty that the Covid-19 pandemic caused led conditions to be eased even further on long-term refinancing operations in March and April 2020.

Figure 4. Cost of funding



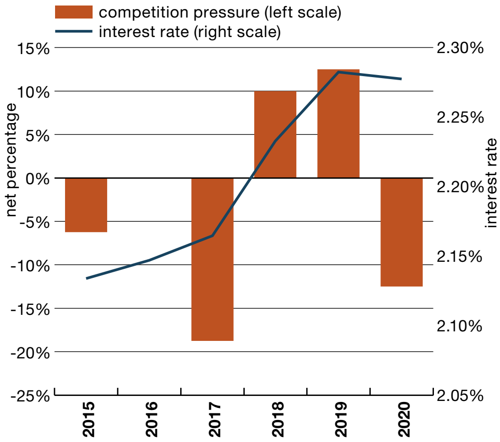
* Deposits, funding from parent banks, bonds issued
Sources: ECB, Eesti Pank

Figure 5. Competition pressure on the margins of corporate loans and the interest rate



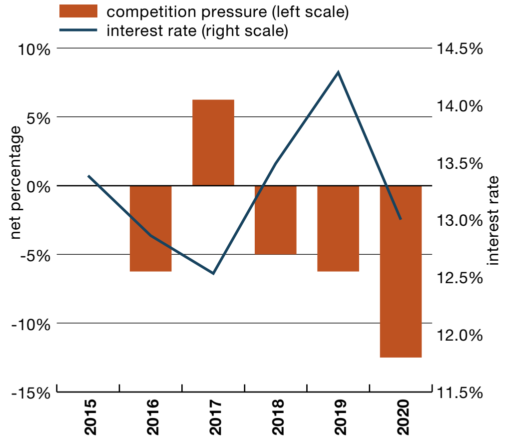
Sources: European Central Bank, Eesti Pank calculations

Figure 6. Competition pressure on the margins of housing loans to households and the interest rate



Sources: European Central Bank, Eesti Pank calculations

Figure 7. Competition pressure on the margins of consumer loans to households and the average turnover interest rate



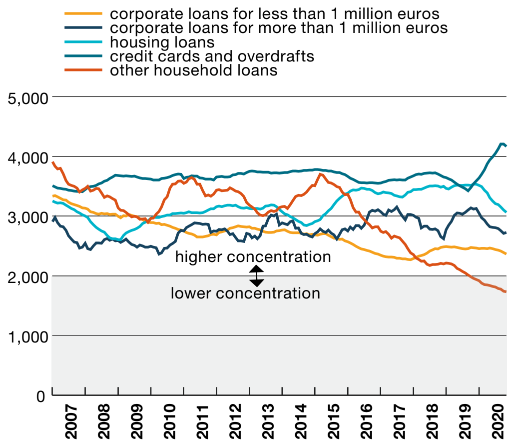
Sources: European Central Bank, Eesti Pank calculations

The supply of credit in the second half of 2020 was also affected by some increase in competition pressures. The Bank Lending Survey identified that some banks found that competition pressure on loan margins increased in the second half of 2020. Interest rates on new corporate long-term loans and housing loans were lower in 2020 than a year earlier (see Figures 5-7). The average interest rate only rose on new short-term loans to companies in 2020.

Increased competition pressure was also reflected in reduced concentration in the banking sector. The Herfindahl–Hirschman index showed that concentration declined in almost all segments of the loan market in 2020 (see Figure 8)[1]. The concentration index for other household loans shows that market concentration was relatively low there by the end of 2020.

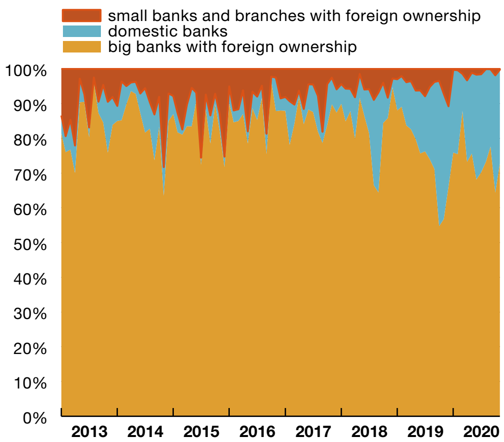
The development trends of the past couple of years continued in 2020 and the market share of domestic banks increased (see Figures 9 and 10). The growth in the market share of domestic banks stopped in the first half of the year for some time, but then returned in the second half of the year as the domestic banks started again to make determined efforts to increase their market share. The growth of domestic banks has been fastest in consumer loans to households and small loans of below 250,000 euros to businesses, as it is easier for smaller banks to compete in these segments. Claiming market share for large corporate loans and housing loans is a slower process. Competition in housing loans was increased in 2020 not only by the

Figure 8. Herfindahl–Hirschman index across different loan segments



Last observation 28.03.2019
Source: Eesti Pank

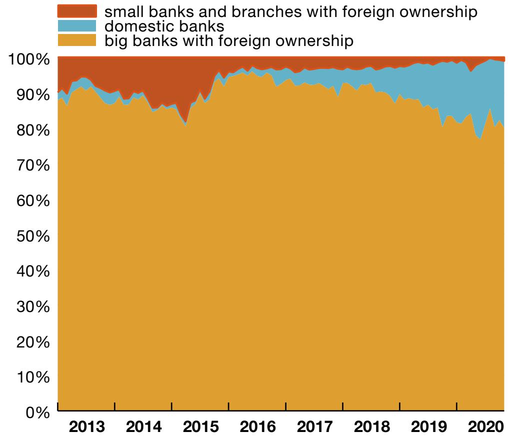
Figure 9. Long-term corporate loan market share across different bank groups



Source: Eesti Pank

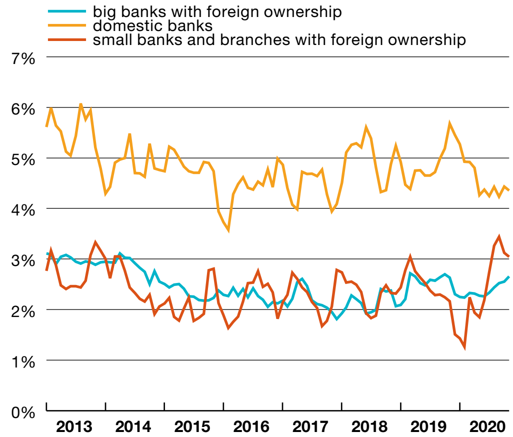
1 The rise in the concentration index for the credit card and overdraft market came from the reclassification of some loans.

Figure 10. Home loan market share across different bank groups



Source: Eesti Pank

Figure 11. Three-month moving average interest rate on long-term corporate loans

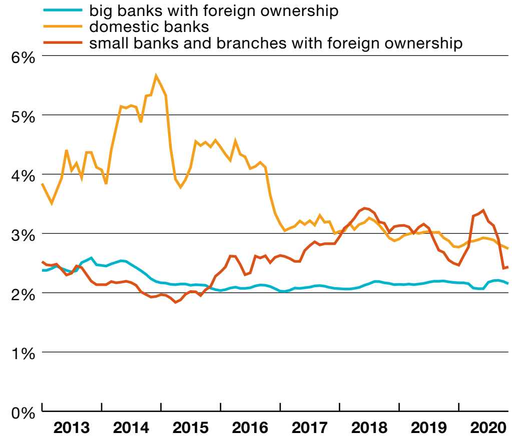


Source: Eesti Pank

growth of domestic banks, but also by increased activity by one large foreign bank. The ambition of several banks to grow and the extension of funding options at the banks should increase competition in banking in the future, as it will no longer be possible to grow by filling the gap left in the market by the departure of one bank a few years ago.

The big foreign-owned banks are able to lend at lower interest rates. The interest rates on long-term corporate loans and on housing loans issued by domestic banks have been higher (see Figures 11 and 12). The higher interest rates on loans issued by domestic banks have raised the average interest rates for the loan market as a whole, as their market share has increased at the same time. There are several reasons why the interest rates are lower at the large foreign-owned banks. The first is that they have a large client base, which means that they can benefit from scale effects. They can also access funding from their parent banks, which makes their loan capital cheaper. The large banking groups

Figure 12. Three-month moving average interest rate on housing loans across different bank groups



Source: Eesti Pank

are generally more stable, which means they can access capital more cheaply. They also gain some advantage from the synergy of the banking group, which means that different functions can be distributed across different countries, and they can be more cost efficient and can share skills and knowledge better[2].

2 For more see the section *The big foreign-owned banks are able to lend at lower interest rates than the domestic banks* in Financing of the Economy 2020.

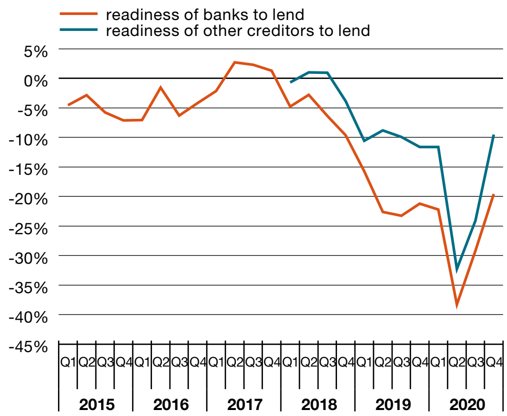
2. ACCESS OF COMPANIES TO FUNDS

The main factors affecting the access of companies to funding and the prices of loans in 2020 were the economic difficulties caused by the coronavirus crisis and the aggressive growth of some domestic banks. The coronavirus crisis affected above all the outlook for companies to earn revenues and so their capacity to borrow. The strength of the banks has meant that the impact of the crisis on the banking sector, including the supply and conditions of credit, has generally been modest[3]. Companies in different sectors have been affected quite differently. Access to funding has been made worse in the sectors hurt most by Covid-19 as the credit capacity of companies has declined and borrowers have become more cautious. The opposite change has been seen in access to funding for households, which has been supported by the aggressive growth of banks and by increased competition in the banking market. Non-bank sources of funding have also coped relatively well with the crisis and have equally managed to fund companies[4].

Assessments by businesses of access to funding deteriorated in first half of the year, but then improved in the second half (see Figure 13). This probably reflects the high level of general uncertainty among companies in the first half of the year, and the reduction in that level in the second half of the year. It also matches the assessment of the banks that loan conditions were tightened in the first half of the year and loosened in the second half. Although the assessment by companies of the credit environment at the end of the year was quite similar to what it was in 2019, the average for the year had deteriorated. Assessments deteriorated in most countries in the European Union, and on average by more than in Estonia (see Figure 14). Among companies in Estonia, 9% said that access to funding was the largest problem for them, while 10% of companies on average said the same in the European Union.

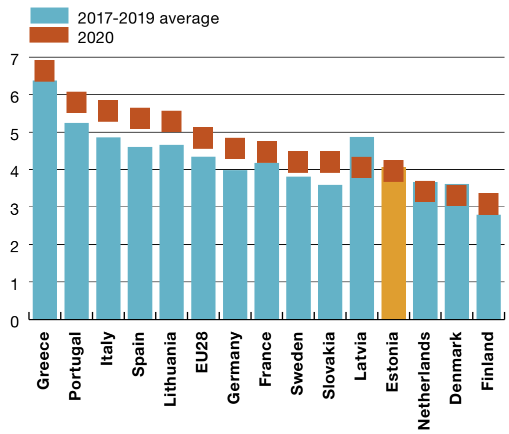
The biggest deterioration in assessments of the credit environment was found in the sectors that were hurt most by Covid-19. The most obvious example of this was businesses in accommodation and tourism, but the same was true for businesses in transport and retail (see Figure 15). The assessments of accommodation

Figure 13. Assessment by businesses of the lending environment



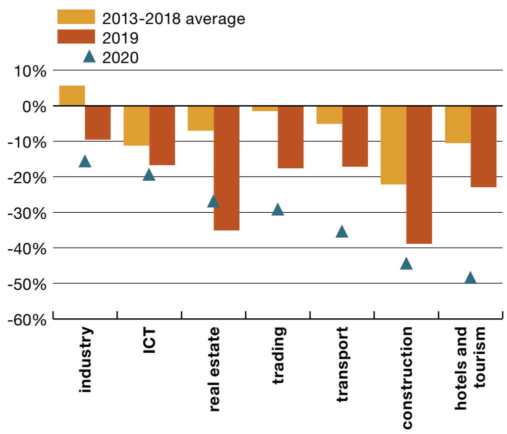
The percentage shows the difference between the shares of respondents giving favourable and unfavourable assessments
Figure does not contain microprudential buffers
Source: Estonian Institute of Economic Research

Figure 14. Assessment by SMEs of access to external sources of funds*



* 1 - does not affect business activities at all, 10 - affects business activities a great deal
Sources: European Central Bank, SAFE

Figure 15. Assessment by businesses of the readiness of banks to lend

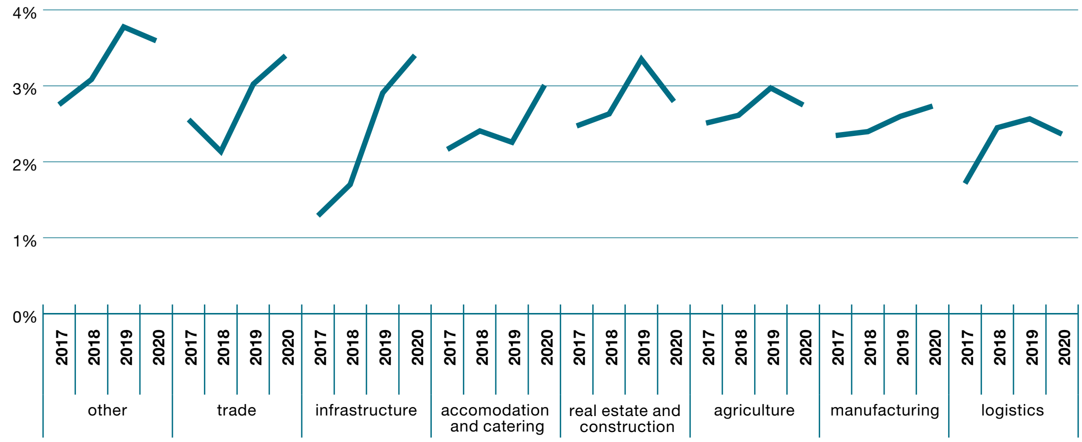


The percentage shows the difference between the shares of respondents giving favourable and unfavourable assessments
Source: Estonian Institute of Economic Research

3 See The loan supply from the banks and competition.

4 See The development of non-bank financial intermediation during the Covid-19 crisis.

Figure 16. Average interest rates on long-term corporate loans



Source: Eesti Pank

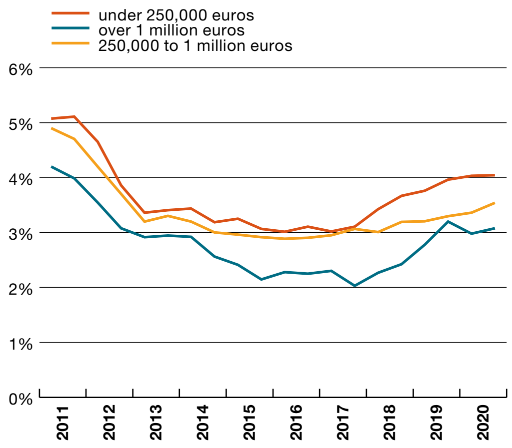
and tourism companies, unlike those of companies in other sectors, did not improve in the second half of the year. The opinion of companies in real estate, which had been very negative in the past couple of years, was that the credit environment had improved. In general the assessments were similar for bank loans and loans from other lenders.

Interest rates across sectors were on average in 2020 around the same as a year earlier, but those on loans to businesses in accommodation, food service and retail rose (see Figure 16). This is probably because the risk level of such companies increased. The average interest rate on loans to companies in energy, water, and information and communication also rose, which is probably not a consequence of the Covid-19 crisis. Interest rates fell though for real estate and agriculture, which did relatively well last year.

The loan market for large companies was affected least by the coronavirus. Large enterprises with more than 100 employees found that the loan market deteriorated less last year than other companies did, and that it started to improve in the second half of the year. Interest rates on loans for more than a million euros did not rise, indicating that the interest rates for large enterprises were not higher (see Figure 17).

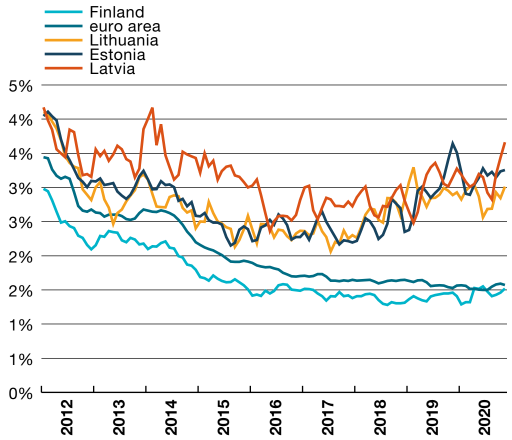
Interest rates are higher in Estonia than elsewhere in the euro area for both large and small loans. The average interest rates on loans to businesses in Estonia are about the same as those in Latvia and Lithuania (see Figure 18).

Figure 17. Average interest rates on long-term corporate loans by size of loan



Source: Eesti Pank

Figure 18. Average annual interest rate on new corporate loans



Source: European Central Bank

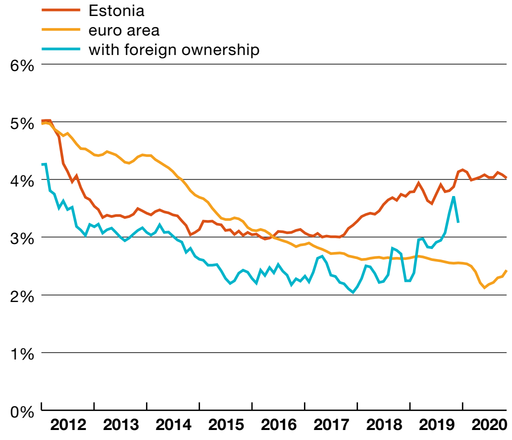
Interest rates are also higher than the European average for different sizes of loan, so the higher interest rates cannot be entirely put down to the size of companies. There have been times in the past decade though when the interest rates on small loans in Estonia have been below the euro area average (see Figure 19).

Part of the reason why interest rates rose rapidly in Estonia in 2018-2019 is that several foreign banks exited the market, reducing competition in it while their market share was partially taken over by domestic banks that were not yet able to issue loans at the same low price. **Estonia may expect competition to increase to some degree in the future, and the price of loans to fall.** The funding options of several banks have improved and they are showing a desire to grow powerfully. Smaller banks have so far been able to do this by taking the market share of the banks that exited the market, but this will no longer be possible and so competition pressure will increase[5]. Other parts of the financial sector will gradually become more able to compete with banks as well.

The price of lending by banks, or the interest rate, can be evaluated in various ways.

- One way is to look at how sustainable the level of interest margins is, meaning how much interest margins affect the profit of banks and their ability to cope with loan losses, and so the sustainability of their capacity to provide loans. Several international organisations and central banks have been highlighting for some years now that interest margins in Europe do not take sufficient account of the risks and that the profitability of the banks is too low. That the higher interest rate in Estonia helps the banks is shown by their ability to continue providing loans even during economically difficult times. Access to funding is probably more important for the sustainable development of the economy than loans having the lowest possible price.

Figure 19. Interest rate on new long-term corporate loans for under 250,000 euros



Source: Eesti Pank

- Another approach is to look at how well the current interest rate suits the current position of the economy. The Covid-19 crisis caused the economy to shrink in size in 2020 while prices fell, meaning that real interest rates rose rapidly. Low interest rates may in consequence actually be better in the short term. A recovery in the economy and in inflation is expected in the coming years, and the recovery is expected to be faster than the average in the euro area[6]. This suggests that in future the average interest rate in the euro area may actually be too low for the position of the Estonian economic cycle. Real interest rates, which indirectly take account of the position of the economy, will probably become more equal in Estonia and the euro area in the years ahead.
- There may be more of a problem for the competitiveness of exporting companies however, as Estonian companies have to compete in foreign markets with companies that have some advantage in the cost of financing.

5 See also The loan supply from the banks and competition.

6 See the macroeconomic forecast of the Eurosystem of December 2020. https://www.ecb.europa.eu/pub/projections/html/index.en.html.

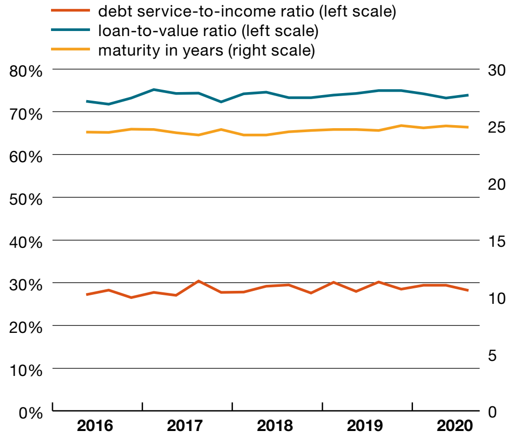
3. ACCESS OF HOUSEHOLDS TO FUNDING

The crisis in 2020 affected the need and ability of households to borrow in different ways. The negative impact on households as a whole so far appears to have been quite limited. A survey by Turu-uuringute AS in early autumn of the financial behaviour of households found that it was residents with lower incomes who saw their financial position had deteriorated. People on higher incomes, who were anyway better able to cope and who often have better access to credit, even noted that their financial position had improved, and they had not lost as much confidence about their incomes. The majority of the population found that their net income had not changed over the year[7]. People on lower incomes forecast at the end of 2020 that their savings would shrink over the next year, while people on higher incomes believed that they would be able in future to build up even more savings than before[8]. As a result, there is great variation in how ready households are to take a loan or otherwise use credit. Probably for similar reasons, the Covid-19 crisis has affected demand for housing loans and consumption loans quite differently.

Demand for housing loans decreased sharply as the situation around the virus worsened in the spring of 2020 and after the emergency situation was declared. There were half as many transactions for apartments in Estonia in each of April and May 2020 as in the same months of 2019. Demand for housing loans was slowed by uncertainty about the outlook for the economy and by restrictions on movement, which prevented on-site visits to real estate properties. It is notable though that the number of transactions with new apartments fell by only 1%, while the number of transactions in the secondary market fell by 38%. This left the share of transactions that were for new apartments at an estimated 25% in the second quarter, having been 17% in the second quarter of 2019. The share of transactions in Tallinn that were for new apartments rose to 36% from around 24% a year earlier. It is probable that it was mainly households with the highest credit capacity who were able to complete loan transactions for housing at this time.

Demand for housing loans recovered in the second half of 2020. The total amounts of transactions for housing reached record levels from September to the end of 2020. The growth in the stock of housing loans returned to its level from before the crisis and stood above 6% for the year as a whole, which was only a little less than in the previous year. Confidence started to return to households on average incomes over the summer, while the economic forecasts of the banks in the summer were a little more optimistic than those made in the spring.

Figure 20. Weighted average values of indicators of housing loans



Source: Eesti Pank

Conditions on housing loans were tightened in the first half of the year, but were then later eased. This dynamic is reflected in the results of the Bank Lending Survey, the developments of interest rates, and changes in market concentration[9]. The average maturity, loan-to-collateral ratio, and debt service-to-income ratio on housing loans that were issued did not change substantially throughout the year (see Figure 20). Surveys of households and banks showed that the share of housing loan applications that were accepted increased (see Figure 21).

The average interest rate on new housing loans has fallen a little since the middle of summer 2020. The rise in the average interest rate in previous years has probably been a consequence of weak competition and strong demand for loans. Several banks that previously had a small share of the market grew strongly during 2020. This caused competition pressures and probably also affected the price of loans.

7 Survey of the financial behaviour of households by Turu-uuringute AS.

8 Estonian Institute of Economic Research.

9 See The loan supply from the banks and competition.

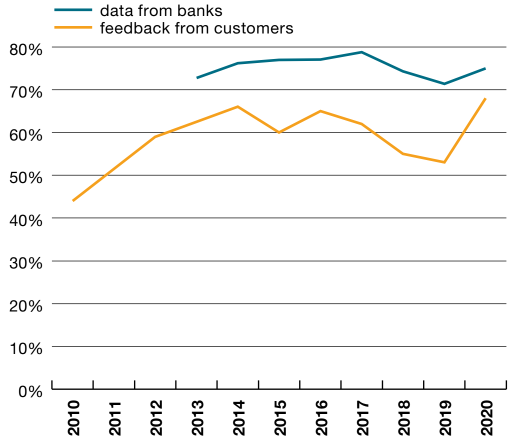
The months ahead will show whether this was a temporary phenomenon or whether the average interest rate will settle at a lower rate in the next couple of years. The very low base interest rate means the average interest rate today is generally low next to the rates of the past 15 years that the large foreign banks have been operating in Estonia.

The average interest rate on new housing loans in Estonia is higher than the average for the euro area. The average interest rate on new housing loans rose in the spring in most countries of the euro area, but the long-term trend of the average interest rate in the euro area keeping on falling has generally continued (see Figure 22).

The volume of new consumption loans also fell sharply in the spring, but unlike housing loans, they did not climb back in the second half of 2020 to their level of 2019. Vehicle leases saw a deeper fall in turnover of more than 50% over the year in the spring. The amount issued by the banks as leases in the second half of 2020 was notably less than in the same months of 2019. Leases issued by other lenders did not surpass their level of 2019 either. The turnover of overdrafts and credit cards has also fallen a long way. Demand for consumption loans has been affected by uncertainty and by restrictions on movement. It should be noted for comparison that the turnover of instalment loans issued by non-bank creditors recovered in the second half of 2020.

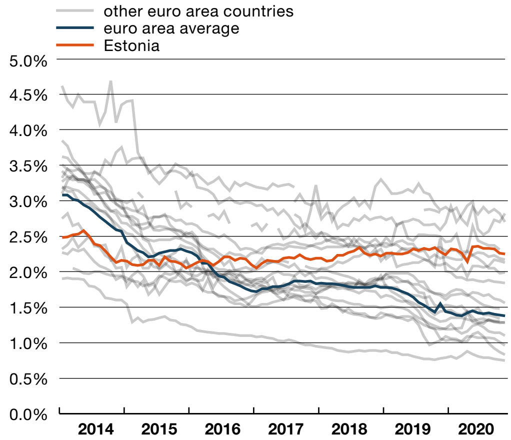
Fewer people than before told the survey by Turu-uuringute AS that they managed to borrow the amount they wanted. At the same time there were also fewer people who said the bank had refused to lend to them. A much larger share of people found that the lending conditions were too strict. In 2020, 70% of applicants for consumption loans received the amount they applied for, and 4% received a loan for a smaller amount. Although the number of respondents was very small, it is still illustrative that 49% of respondents who did not receive a consumption loan said that the transaction fell through because the lending conditions were too tight. The APR and the average cost of consumption loans rose a little from where it started the year, and has since fallen back (see Figure 23).

Figure 21. Applications granted for housing loans as a share of households that applied



Source: Eesti Pank

Figure 22. Average annual interest rate on new housing loans



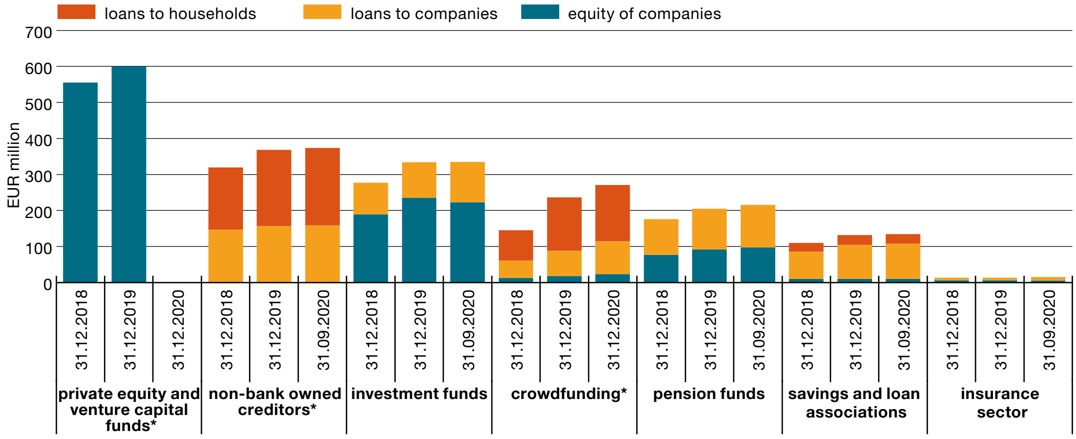
Source: European Central Bank

Figure 23. Interest rate on new car leases and consumer loans

* three-month moving average
Source: Eesti Pank

4. THE DEVELOPMENT OF NON-BANK FINANCIAL INTERMEDIATION DURING THE COVID-19 CRISIS

Figure 24. Funding for non-financial companies and households from non-banking financial intermediation



*estimate
Source: Eesti Pank, EstVCA

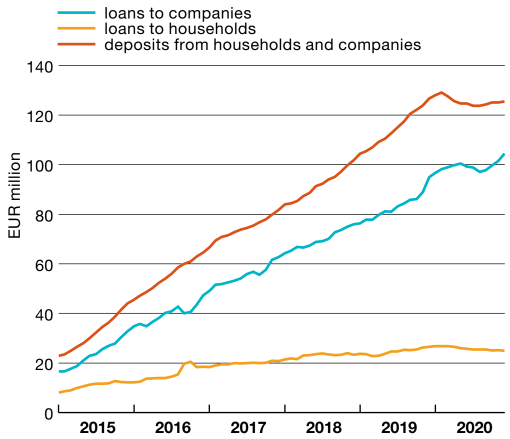
The growth in funding supplied to the non-financial sector by non-bank financial intermediation slowed in 2020, though it still continued (see Figure 24). The growth still remains faster than the growth in the assets of banks. Like it did at the banks, the volume of funding dropped in the spring, but then it recovered relatively quickly. Demand and the absence of major supply-side restrictions have mostly shaped the dynamics of the growth in funding issued, but lending by savings and loan associations has probably been restrained because deposits stopped growing.

SAVINGS AND LOAN ASSOCIATIONS

The rapid growth in the stock of loans issued by savings and loan associations to companies slowed sharply in 2020. It was halted even in the summer, but it bounced back in the second half of the year and yearly growth in it had reached 5% by the end of the year. The rapid growth in the stock of loans issued by savings and loan associations to households turned into a small fall in 2020 (see Figure 25).

Unlike that at banks, the flow of deposits to savings and loan associations did not increase but decreased. By the end of 2020 the volume of deposits held at savings and loan associations was around 1% smaller than it was a year earlier. A probable reason for this was the increased fear of risk caused by the Covid-19 crisis, which came on top of an investigation into one savings and loan association. This suggests that not only demand for loans, but also the dynamics of issuing them led to a reduction in the capacity of savings and loan associations to provide credit. The slower growth in deposits meant that the liquidity of savings and loan associations also dropped substantially.

Figure 25. Loans and deposits at savings and loan associations



Source: Eesti Pank

CROWDFUNDING

The amount of funding intermediated through crowdfunding platforms grew more slowly in 2020 than in previous years (see Figure 26). The amount of funding intermediated to businesses still grew relatively quickly, given the year of crisis, at around 30%. Both the turnover and the stock of funding to businesses increased. The volume of new loans issued to households fell quite substantially, though the stock still grew by around 5%.

Despite the crisis and the increase in non-performing loans, the number of investors and account holders rose on several platforms. It appears to be the larger platforms that have been more successful. It is apparent that investors became more cautious even so, as in several portals the financing periods for projects have been prolonged. The share of funding issued in Estonia has declined constantly as the portals expand abroad. Some 60% of the funding goes to Estonia on average, and 40% goes elsewhere.

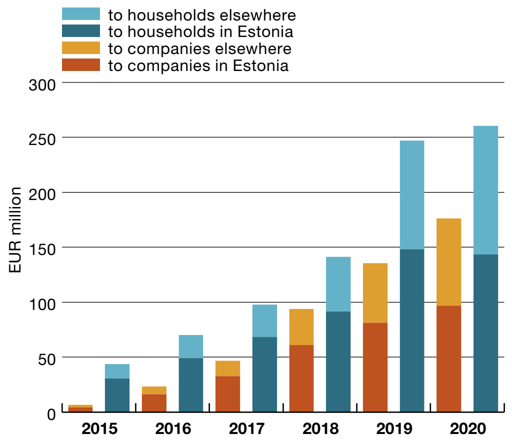
CREDITORS INDEPENDENT OF BANKS

The volume of new funding intermediated to households by creditors dropped sharply when the coronavirus crisis erupted, and it was some 40% smaller in the second quarter than a year earlier. There was a rapid recovery in the third quarter of 2020, but the volume of loans issued was still smaller than before the crisis. The stock of loans issued grew more slowly in 2020 as a consequence, but at the end of the third quarter it was 5% larger than at the end of 2019 even so. The growth in the stock was slowed not only by the reduction in the volume of new loans, but also to a small extent by increased write-offs. The stock of loans issued by creditors to the non-financial sector was about the same as a year earlier by the end of the third quarter of 2020.

FUNDS

Private equity and venture capital funds saw some growth in 2020, but less than in previous years. Market participants are relatively optimistic about the outlook for events in 2021[10]. The possible impact of the pension reform is seen as the largest challenge to the sector, since local pension funds are large institutional investors in both private and venture capital funds. Pension funds invest directly in private equity and venture

Figure 26. Stock of funding intermediated by crowdfunding platforms*



*estimate
Source: Eesti Pank

capital funds, and encourage foreign investors to enter the market. Another challenge is migration policy, and the possible changes in regulations that are foreseen.

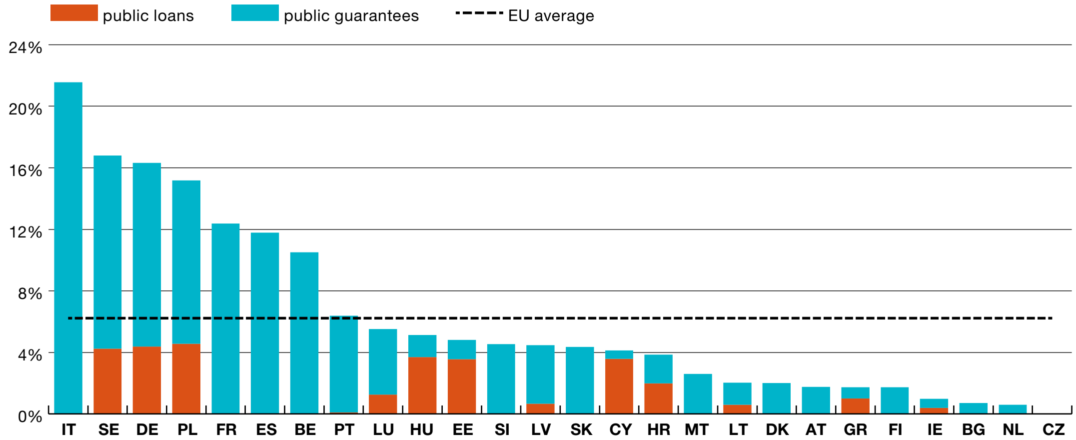
Despite the announcement that the second pension pillar will be made voluntary, the direct investments made by the pension funds in non-financial companies in Estonia were maintained. These investments remain very small as a share of the total volume of pension funds though, at a little over 4%. However, the pension funds affect the Estonian economy most through their funding of the private equity and venture capital sector.

Investments by investment funds in the non-financial companies in Estonia were around the same in 2020 as in the previous year. Some two thirds of these investments were investments by real estate funds. Payments into investment funds were a little more than withdrawals last year despite the crisis.

10 The Market Pulse survey of the Estonian Private Equity and Venture Capital Association (EstVCA).

5. THE IMPACT OF STATE SUPPORT MEASURES ON THE LOAN MARKET

Figure 27. Government support measures as a percentage of the GDP of 2019

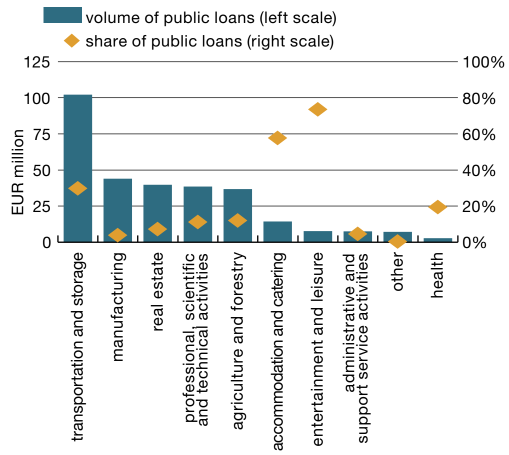


Sources: European Systemic Risk Board, Eesti Pank

The needs of companies and households for financing may be very different during the crisis from what they normally are. The crisis may cause additional temporary liquidity problems or lasting payment difficulties for some, while other parts of the non-financial sector may find new opportunities for investment in the complications caused by the crisis. The general uncertainty may equally make it harder for the financial sector to assess the risk level of companies and projects, and the risk appetite of the banks may be lower. The banking sector may also face difficulties and supply-side limits during the crisis, preventing the banks from issuing sufficient loans. It may be very important for the government to keep some companies functioning in the same way, at least in the short term, and maintaining employment and easing social problems is a priority for the government, more so than for the banks. **These are the main reasons why national governments are intervening more in the loan market during the crisis than they normally would.**

The Estonian government passed an assistance package of 2.3 billion euros in spring 2020 to support companies struggling with temporary problems and to help the economy recover. The government wanted to provide most of the assistance through loans and guarantees, which together made up some 57% of the package[11]. The loans and guarantees in Estonia were worth 5% of the GDP of 2019, which is close to the European Union average of 6% (see Figure 27).

Figure 28. Share of direct public loans in new bank loans



Sources: KredEx, Rural Development Foundation, Eesti Pank

The budget of direct state loans was larger in Estonia than the average for other member states, and the programme of guarantees was smaller than the average.

Direct loans issued by the state dominate in Estonia though, and substantially more of them were issued than the European average. In the last three quarters of 2020 from April to December, 300 million euros of loans were issued in Estonia, or around 1.1% of the GDP of 2019. The government wanted to support companies primarily through working capital loans, but by the end of 2020 the vast majority of 85% of direct loans were issued as investment loans[12]. The distribution of the loan amounts across branches

11 The funds in the assistance package were also used for direct support, tax measures, public sector support and creating reserves.

12 A large part of the investment loans were issued to what were called nationally important projects.

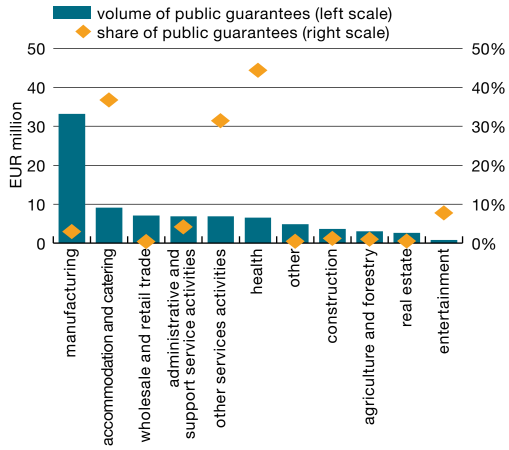
of the economy was affected by some individual large loans in transport and storage, professional, scientific and technical activities, and real estate (see Figure 20). As manufacturing is a large part of the economy and the restrictions caused problems in supply chains and elsewhere, it is logical that manufacturing companies received some 40 million euros in loans in total. Meanwhile though, loans of almost the same amount were issued to the much smaller agriculture and forestry sector.

Around 84 million euros in guarantees were issued in those nine months, or 0.3% of GDP, which is well below the European average. Some 40% of the guarantees that were used were issued to manufacturing (see Figure 29). Accommodation and food service, which was affected the most by the restrictions, was also more enthusiastic than other sectors in using the guarantees. Guarantees are used to ease the repayment schedules of existing bank loans and also for new financing that was used to ease temporary liquidity problems, carry out renovation and repairs, or reorganise earlier business models. Wholesale and retail, administrative and support service activities, and other service activities each took a similar amount of guarantees. These service sectors were also affected very much by the Covid-19 crisis and the restrictions on movement. Several such sectors equally found it difficult to provide sufficient collateral for loans, and the state guarantees helped with this.

Direct loans and guarantees issued by the state over the nine months were a small part of the total amount issued as new bank loans, but they filled a significant role for some sectors that have been hit most by the crisis. Direct loans offered by KredEx and the Rural Development Foundation were equal to 5.6% of new bank loans. Loans issued by state institutions made up 1% of short-term financing from the banks and a more substantial share of around 19% of long-term bank loans. The share of direct loans was largest in entertainment and recreation at 74% and in accommodation and food service at 58%. The total volume of state guarantees that were used was equal to 1.6% of new loans, and they were similarly taken in the branches of the economy that had suffered most in the crisis.

Direct loans from the state were relatively cheap. The average interest rate on long-term direct loans from the state was 2.5%, which was

Figure 29. Share of new bank loans with public guarantees



Sources: KredEx, Rural Development Foundation, Eesti Pank

lower than the average rate of 3.3% on investment loans issued by banks. By contrast, the average interest rate on working capital loans issued by the state was higher at 4.1% than the average rate of 2.9% on short-term financing issued by the banks. The rates on both short and long-term direct loans from the state were lower though than those from the domestic banks that are looking to grow. The state needs to be careful, as interfering in the lending market could crowd out smaller but growing banks, and so hurt competition.

The state would do better to prefer guarantees to direct loans. Guarantees go less against the principles of the market economy, as the decision to lend is taken by the private sector. Banks also have an advantage in assessing the capacity of their clients to repay loans, as they know their clients and their financial position better. The danger of the state harming competition in the loan market is also smaller with guarantees. Furthermore, giving guarantees allows the state to achieve the same results while spending less money, meaning less pressure is put on the public purse.

The lower take-up of the state measures than was expected does not mean that conditions need to be eased or that the goal should be set of issuing more loans. The state loans and guarantees that were used in 2020 together with the direct support given in Estonia came to some 1.4% of the GDP of 2019, which is close to the European average of 1.6%. Demand for the package of measures was smaller than expected, as the commercial banks did not have any difficulty in supplying credit. They continued lending despite the crisis and the economy grew faster than expected[13]. The banks considered the initial ceiling on credit losses set by KredEx to be too low, and so they did not consider it reasonable to use the guarantees. Readjusting the conditions of the loan guarantees took time though, and the need for the measures became less urgent in the meantime. It should in any case not be the goal of the state to provide loans at the cheapest possible rate, as the support measures should be the last resort of companies that are not able to get funding in any other way.

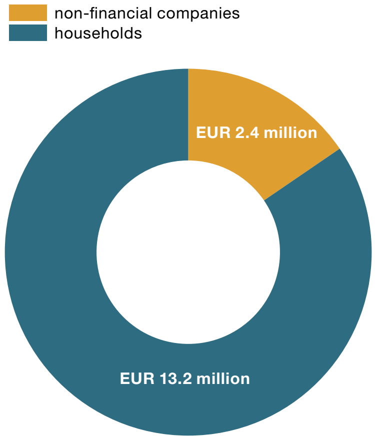
13 See The loan supply from the banks and competition.

6. USE OF ENVIRONMENTALLY-FRIENDLY LOAN PRODUCTS BY BANKS IN ESTONIA

Since the Paris agreement on limiting climate change was signed in 2015, coping with climate risks and managing them have come to the fore in the financial sector too. Pan-European steps to meet ambitious targets and the desire to reduce the risks from climate change have persuaded banks in Estonia to develop financial instruments that would encourage clients to prefer the greenest solutions possible. The demand from clients themselves for green products has also increased, pushing lenders to try ever harder to meet the expectations of their clients. This area is also becoming increasingly important in marketing terms. The banks are not only providing environmentally-friendly and sustainable products, they are also considering ways of making their own loan portfolios greener in the future by limiting the share of environmentally polluting sectors or outright refusing to finance projects or companies that are in direct contradiction of environmental goals.

The Estonian financial sector has created several green products in recent years. Several banks offer lease deals for environmentally-friendly cars[14] for example, where the interest margin and insurance conditions are more attractive than those of an ordinary car lease. The banks are also encouraging clients to choose energy-efficient homes. Residential property that is in energy class A attracts lower interest rates for developers and home-buyers, and rates are also lower for private individuals and apartment associations that renovate their homes to make them more energy-efficient. Borrowing is also cheaper for clients who use the credit to install solar panels for example. Efforts are also being made to persuade businesses to reduce their environmental footprint, by offering better loan margins on investments that are more environmentally sustainable or that improve the environment. The state has also helped to popularise green banking products through various KredEx support measures.

Figure 30. Amount issued in green bank loans in 2020



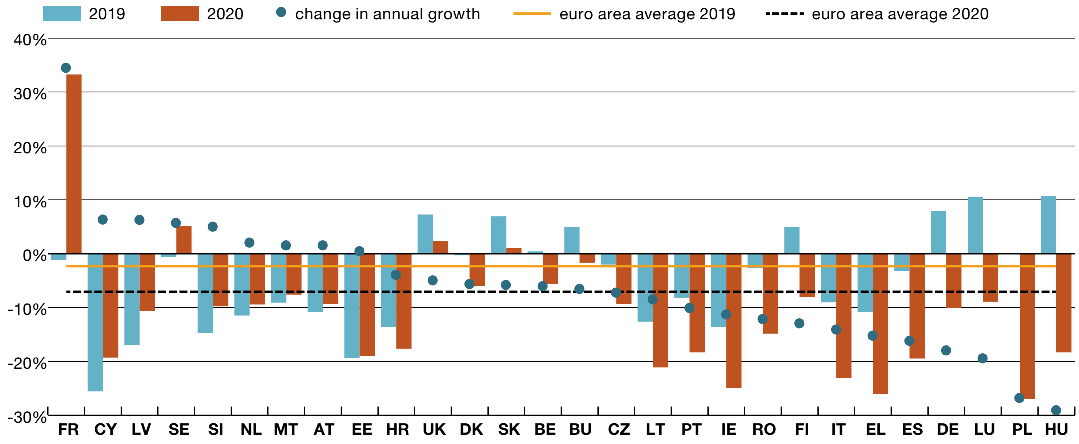
Source: Eesti Pank

These green loan products were only a small part of the new bank loans issued in 2020, but their share may be expected to increase in the coming years (see Figure 30). Such green home and consumption loans made up 0.6% of new loans to households, while strictly defined green loans to businesses were an even smaller share of new loans at around 0.03%. This estimate covers only those loan products where the bank has laid out specific environmental-impact conditions in the loan agreement. It does not cover ordinary loan products that have been issued to finance a green project such as a solar energy park. Alongside the environmentally-friendly loans, the banks are increasingly offering environmentally sustainable pension funds and other investment opportunities.

14 A car qualifies as environmentally-friendly if its CO_2 emissions are below a given level.

7. GROWTH IN THE LOAN PORTFOLIO OF THE BANKS IN EUROPEAN UNION COUNTRIES DURING THE COVID-19 CRISIS

Figure 31. Annual growth in the portfolio of short-term corporate loans at banks



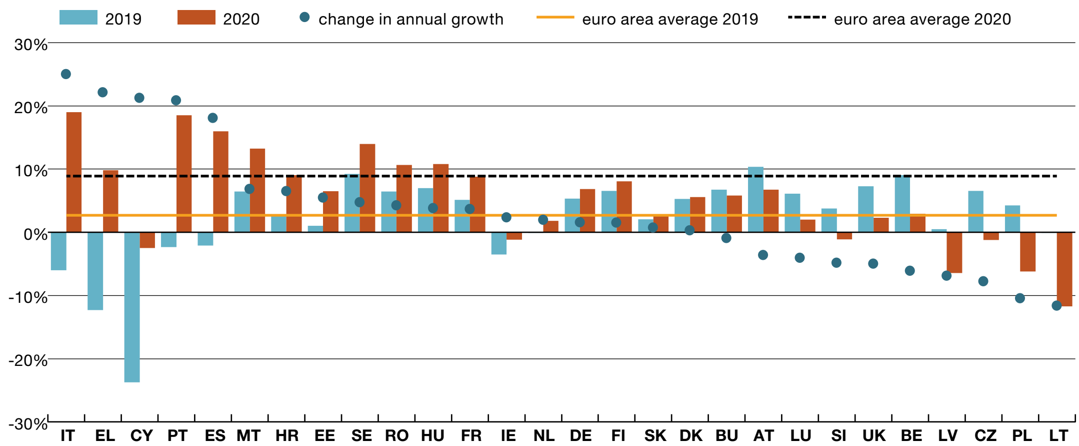
Source: European Central Bank

The eruption of the Covid-19 crisis in spring last year caused a rare degree of uncertainty throughout Europe. Measures introduced in a hurry to stop the spread of the coronavirus caused several economic activities essentially to come to a stop. Many businesses with small financial buffers were at risk of falling into liquidity difficulties relatively rapidly. For companies to survive this it was important that they had good access to short-term liquidity loans. France stands out particularly among the countries of the European Union for short-term loans, which were issued many times more than usual at the start of the coronavirus crisis, so that the portfolio of short-term loans of the banks increased by 31% in 2020 (see Figure 31).

Lending by banks increased sharply at the outbreak of the crisis in several other countries in southern Europe. The portfolios of long-term loans in Italy, Greece, Spain and Portugal declined in 2019, but in 2020 they instead grew rapidly (see Figure 32). Loans issued with maturities of 1-5 years saw particular growth in Spain and Greece, while the portfolios of loans with maturities longer than five years grew substantially in Italy and Portugal. State support measures boosted the lending markets in several countries, with wide-ranging loan guarantee programmes announced in Italy, France, Spain and Portugal of 6-22% of GDP. State support was also announced in many other countries, but demand for loan guarantees was largest in southern Europe.

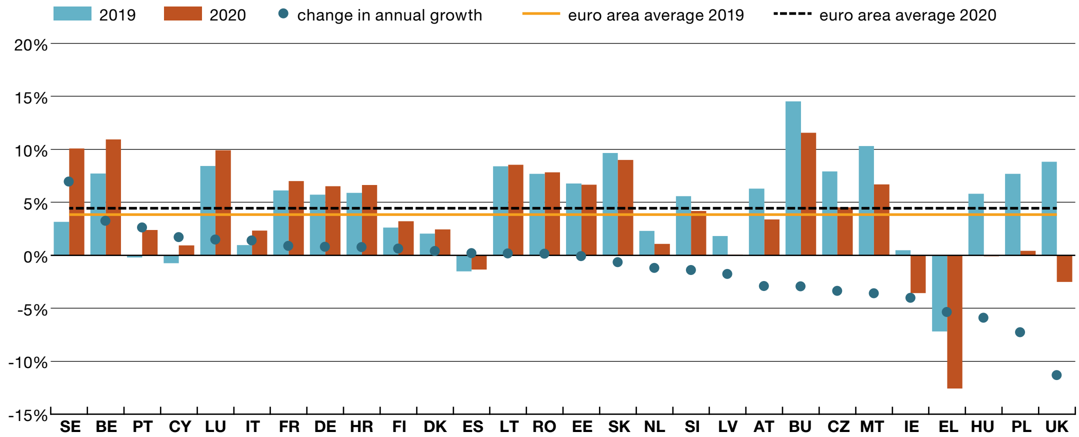
While growth in the portfolio of long-term corporate loans in the euro area as a whole picked up from 3% to 8%, the portfolios of corporate loans in Estonia and in several other countries reacted

Figure 32. Annual growth in the portfolio of long-term corporate loans at banks



Source: European Central Bank

Figure 33. Annual growth in the portfolio of housing loans at banks

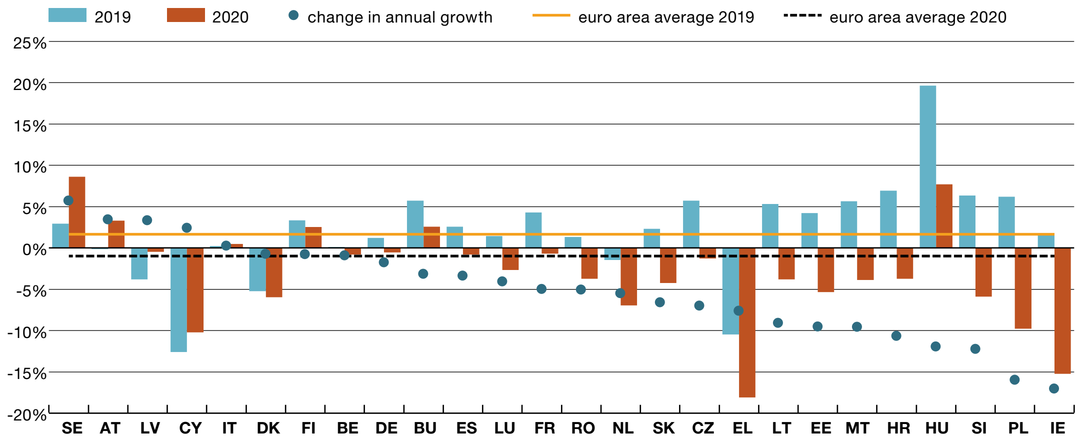


Source: European Central Bank

little to the crisis[15]. This may indicate that the initial shock of the coronavirus was less severe in Estonia, and companies did not consider it so important to increase their buffers. Banks in Estonia also granted businesses payment holidays to overcome temporary difficulties. At their peak, payment holidays covered around a fifth of the corporate loan portfolio. State guarantees for bank loans were used relatively little in Estonia, while direct loans from the state were used relatively a lot[16].

In comparison to the movements in the corporate loan markets in some countries, changes in lending to households were not so drastic in any European Union country. Activity dropped sharply in the housing loan markets of several countries when the restrictions were tightest in the spring, but real estate markets revived in the second half of the year. As much as 8% more was issued in new housing loans in the euro area from August to November than in the same months of 2019. This meant that growth in the housing loan portfolio was faster than in the previous year despite the crisis. The European Union countries with the most notable acceleration were Sweden and Belgium. Housing loans have continued to be issued with some alacrity in Estonia, and the rate of growth in the portfolio has remained at around 6-7%. There are however some countries, such as Poland, Hungary or Czechia, where

Figure 34. Annual growth in the portfolio of consumption and other loans at banks



Source: European Central Bank

15 The growth in the loan portfolio in Estonia was affected by Danske bank moving its portfolio of Estonian corporate loans abroad in 2019, and the return of this portfolio to LHV Pank in Estonia in 2020. Without this, the portfolio of long-term corporate loans in Estonia grew by around 4% in 2019 and 5% in 2020.

16 For more see The impact of state support measures on the loan market.

the fast growth in the loan portfolio seen before the crisis cooled a little. Meanwhile, the housing loan portfolio in the United Kingdom, which has by now left the European Union, shrank (see Figure 33). In consequence, housing markets in most European Union countries have remained strong and the banks stand ready to fund purchases of residential property.

The markets for consumption loans and other loans to households were affected more by the Covid-19 crisis than the housing loan market. Issuance of consumption loans fell by more than a fifth in the euro area in the spring. The market grew again somewhat in the second half of the year, but issuance of loans remained below the level of 2019. The only countries to see substantial growth in the loan portfolio last year were Sweden and Austria, while the growth in the portfolio was replaced by decline in the majority of countries. The sharpest changes of direction came in Ireland, Poland, Slovenia, Croatia, Malta and Luxembourg, and also in Estonia (see Figure 34). This was partly because consumption was hindered by the restrictions introduced because of the Covid-19 crisis, and partly because people felt much more uncertain about the future, and so postponed consumption decisions.