III BANKING SECTOR STABILITY AND RISKS

STRATEGIC DEVELOPMENT OF THE BANKING SECTOR

Competition on the Estonian banking market tightened further in the fourth quarter of 2005 and first quarter of 2006. The last half-year saw the addition of new branches of foreign credit institutions that commenced operations in Estonia as well as credit institutions expressing their desire to provide cross-border services from their country of origin. **As at 31 March 2006, seven companies licensed as credit institutions in Estonia and branches of seven credit institutions licensed in another European Union Member State were operating in Estonia.** Five foreign credit institutions had representative offices in Estonia and 97 foreign credit institutions had submitted an application for providing cross-border services.

Within the past 12 months, the aggregate volume of assets of the banks licensed in Estonia and the branches of foreign banks operating in Estonia grew 33% on a solo basis, exceeding 200 billion kroons at the end of the first quarter of 2006 (see Figure 3.1). At the end of the first quarter of 2006, 99% of the banking sector assets belonged to the branches of foreign credit institutions or credit institutions controlled by non-resident financial groups. Despite new market participants, the distribution of the local loan market did not change considerably within the past half-year: at the end of the first quarter, over 97% of the total outstanding loans and leasing financing granted in Estonia divided between four major market participants. The same credit institutions also hold over 96% of the deposits deposited in Estonia (see Figure 3.2).

Besides residents' deposits, during the past half-year the rapid growth of financing portfolios was also financed by funds received from parent banks. At the end of the first quarter of 2006, the share of institutional foreign borrowing in banking sector liabilities rose again to 43%, which reflects the close dependence of banks operating in Estonia on non-resident parent banks. Meanwhile, local banks also continue operating on and channel funds to the markets of other, mainly neighbouring countries. The majority of financial groups licensed in Estonia are still operating in the Baltic States, but continue expanding their activities also in the Russian Federation.

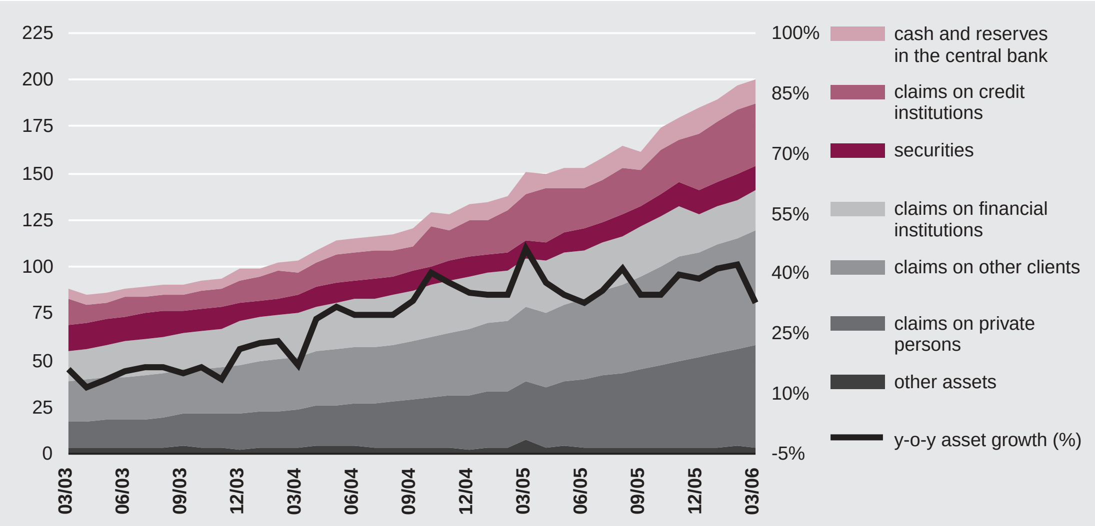

Figure 3.1. Banking sector assets (EEK bn)

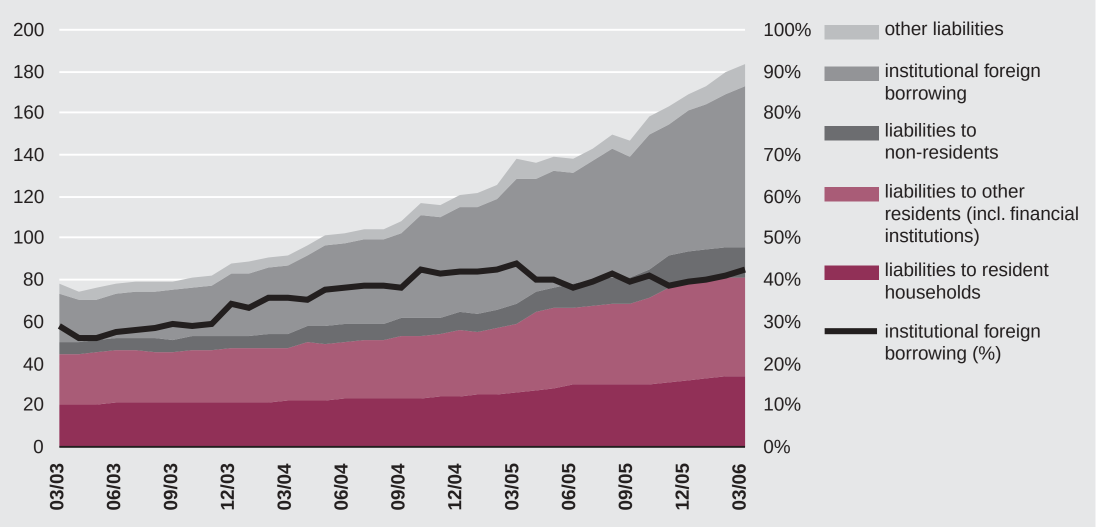

Figure 3.2. Liabilities of credit institutions (EEK bn)

QUALITY OF ASSETS

Owing to the strong loan demand the year-on-year growth of banks' and leasing companies' aggregate portfolio picked up even further during the last two quarters. Thus, the total volume of bank loans and leasing granted in Estonia exceeded 146 billion kroons in March 2006 and the year-on-year growth of financing portfolios accelerated more than up to 50% by the end of March. The volume of financing portfolios grew by 26 billion kroons during the past six months. The increase in the housing loans and consumer credit contributed 47% to growth. During the past six months, the share of housing loans in the financing portfolio grew by nearly 2 percentage points, approaching 32% at the end of March. The share of crediting of the second largest sector – commercial real estate development and/or management companies – in the financing portfolio of banks and leasing companies accounted for more than 15% at the end of the first quarter of 2006 (see Figure 3.3).

Domestic bank loans are ever more collateralised by mortgages or pledges of building (76% of the total loan volume; see Figure 3.4). The share of loans without collateral has decreased to 6.2% (40% of that accounts for loans issued to households, 37% to companies and 23% to the government). On the one hand, this may be regarded as more careful risk hedging by banks, but it is important that the actual market value of the collateral would exceed the outstanding loan amount also in case there would be a need to sell the collateral on less favourable market conditions than the present ones. Therefore, it is crucial that despite the current tight competition banks would not neglect the importance of assessing the clients' loan servicing ability and would retain the appropriate down payment requirement.

The quality of banks' loan portfolios has remained good in the favourable economic environment and the accelerating growth of loan portfolios, despite the fact that the majority of loans and leasing are granted with a floating rate and the raising of key interest rates since the second half of 2005 has thus increased the loan servicing costs for customers.

By the end of the first quarter, the share of **loans overdue for more than 60 days** among loans issued to the non-financial sector decreased below

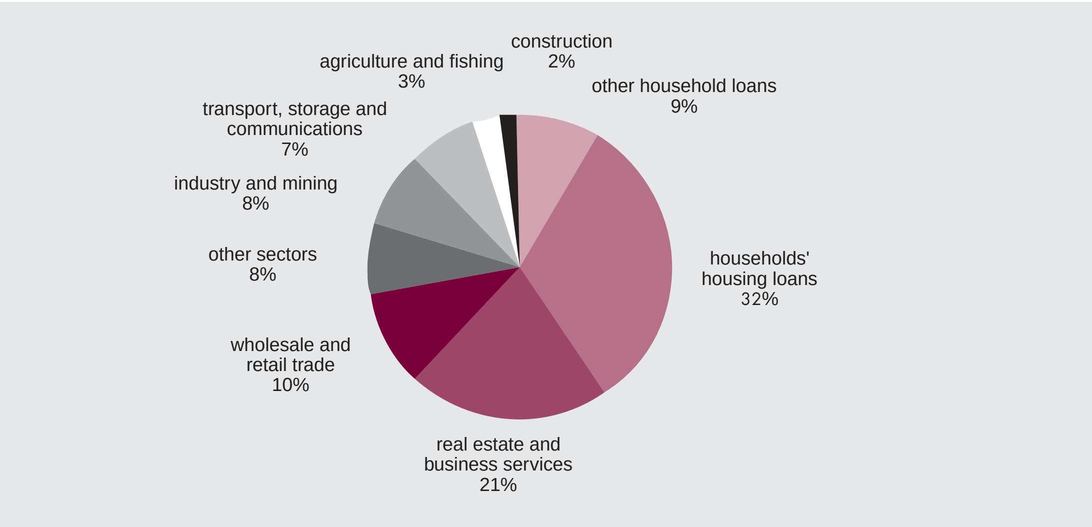

Figure 3.3. Financing by banks and leasing companies (as at 31 March 2006)

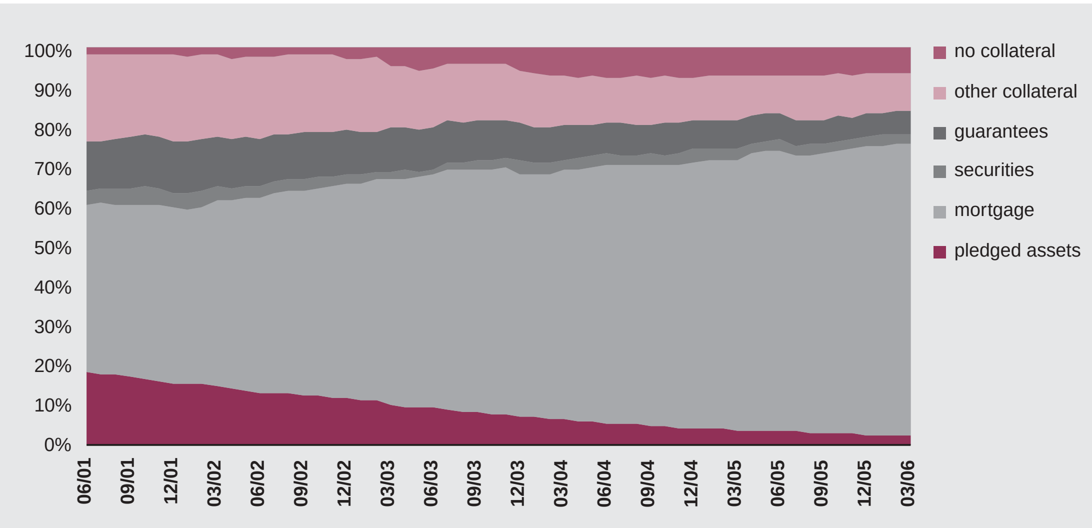

Figure 3.4. Loan collaterals by type

0.3% on an aggregate basis (see Figure 3.5). The ratio of the stock of provisions for loan losses decreased to 0.5%, but provisions still exceeded the amount of loans overdue for more than 60 days by nearly 1.7 times. Though lately the share of loans overdue among consumer credit has slightly increased, the amount of loans overdue for a longer period has so far remained modest (see Figure 3.6).

Due to the continuing strong loan demand also in other neighbouring countries (mainly the Baltic States where banks operating in Estonia have subsidiaries), the annual growth of **banking groups**' aggregate loan and leasing portfolio picked up to 58% by the end of the first quarter. By the end of the first quarter, the aggregate volume of the loan portfolios of banking groups licensed in Estonia thus exceeded 222 billion kroons. The share of loans issued to Estonian residents has been decreasing steadily in this aggregate portfolio. Consequently, at the end of the first quarter, claims to Estonian residents in the aggregate portfolio of banking groups reached 52%, i.e. barely over a half of total claims (52%). Claims to Lithuanian and Latvian residents held the next largest shares (18% and 17%, respectively). The share of financing the operations of Russian Federation residents in the banking groups' aggregate portfolio remained below 4% at the end of the first quarter of 2006.

In light of rapid growth, the quality indicators of loan portfolios have remained on an aggregate basis good also in case of **banking groups**. By the end of the first quarter, the ratio of the stock of provisions for loan losses decreased to 0.7% of the loan portfolio, whereas the share of loans overdue for more than 60 days declined as well (to 0.4%). Consequently, at the end of the first quarter the aggregate stock of provisions made by banking groups exceeded the volume of loans overdue for more than 60 days by more than 1.7 times.

Although indicators vary across banks as well as banking groups, the provisioning practices of Estonian banks may generally be considered rather conservative in comparison with the rest of Europe. According to the European Central Bank, the EU-25 average of non-performing and doubtful assets comprised 2.7% of banks' loans an advances in 2004[1], while the average ratio of the stock of provisions amounted only to 2.0%[2].

Thus, the quality indicators of the Estonian banking sector's loan portfolios may be considered relatively good, but the interpretation of current indicators also calls for considering the present favourable economic environment. Though in view of the rapid loan portfolio growth, the ratio of problem loans has recently remained quite low, it is essential that banks retain sufficient conservatism in assessing and hedging risks in order to maintain sustainability.

CAPITAL ADEQUACY

As of 1 March 2006, based on the analyses[3] and forecasts of Eesti Pank, the central bank decided to increase the risk weight used for housing loans issued to Estonian residents in calculating the own funds requirement (capital adequacy) for banks and banking groups licensed in Estonia from 50% to 100%. In other words, while until now banks were required to finance only 5% of housing loans issued to Estonian residents from their own funds (95% could be external funds), by the amended regulation banks are required to provide 10% of the loan value from own funds.

Although Eesti Pank has repeatedly drawn attention to the potential increase in risks and also notified market participants of the planned regulation amendment, the year-on-year growth of banks' financing portfolios and consequently also risk assets picked up even further in the fourth quarter

[1] As the definitions of non-performing and doubtful assets differ between countries, these data should be interpreted with caution.
[2] "EU Banking sector stability", November 2005.
[3] See also "Financial Stability Review", November 2005.

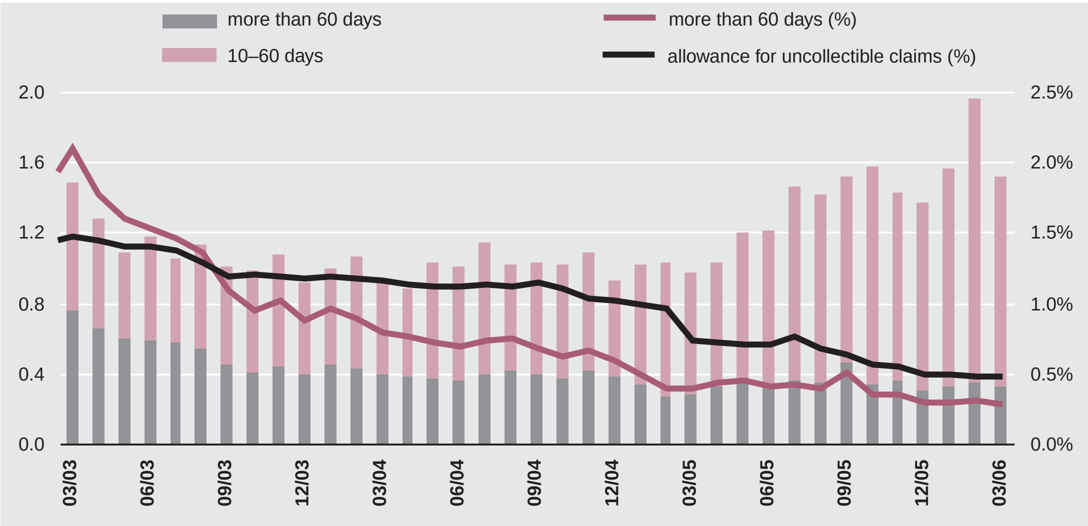

Figure 3.5. Volume of overdue loans (EEK bn; left scale) and share of overdue loans and allowance for uncollectible claims in banks' loan portfolio (right scale)

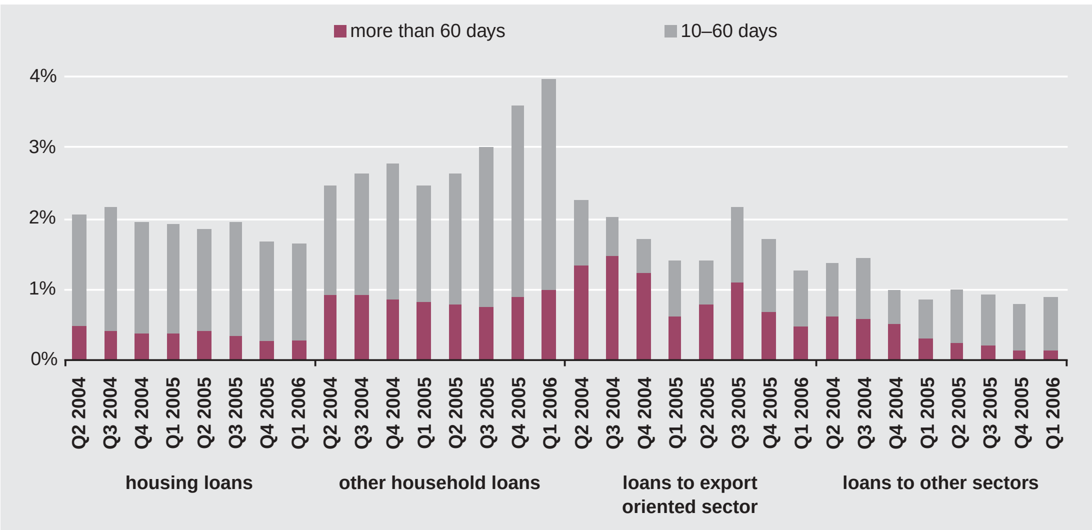

Figure 3.6. Overdue loans by economic sectors

* 3 months average

of 2005 and first quarter of 2006, reaching 37% in January-February (i.e. before the enforcement of the regulation amendment). By the end of March, banks' aggregate risk assets had increased by 22 billion kroons compared to the end of February (monthly growth 17%), of which approximately 17 billion stemmed from the regulation amendment's entry into force on 1 March.

As to the structure of risk assets, in case of the Estonian banking sector credit risk weighted balance-sheet assets account for a vast majority of total risk weighted items. Within the past two quarters their share rose to more than 90%. The share of credit risk weighted off-balance-sheet items, however, decreased to 6%. The share of risk adjusted trading book and foreign exchange positions has decreased in the past two quarters close to 2% of total risk weighted items (see Figure 3.7).

At the end of the first quarter, banks' net own funds reached 18.8 billion kroons on an aggregate basis, which is 5 billion kroons more than at the end of September. Own funds were significantly boosted also by the inclusion of additional subordinated liabilities (+3.3 billion kroons compared to the end of the third quarter of 2005), which is reflected in changes in the structure of own funds (the share of Tier II capital has increased). Hence, by the end of March the aggregate capital adequacy ratio of banks grew to 12.4%, despite the rapid growth of assets and the increase in risk weighted items as a result of the measures taken. The lowest capital adequacy ratio of banks stood at 10.4% at the end of March (see Figure 3.8).

As the volume of the banking sector's financing portfolios continued to grow rapidly during the past two quarters also in the neighbouring countries where banking groups licensed in Estonia are operating, the **risk weighted items of banking groups** licensed in Estonia increased 48% in 2005. At the end of the first quarter of 2006, the aggregate volume of banking groups' risk weighted items thus reached already 242 billion kroons (the implementation of the 100% risk weighting instead of the former 50% for housing loans to Estonian residents is also reflected here). As regards banking groups, the structure of risk weighted items did not change significantly either – over 97% of the risk weighted items stem from credit risk weighted on- and off-balance-sheet items.

At the end of March, the **own funds of banking groups** exceeded 27 billion kroons, which is over 6.7 billion kroons more than at the end of September. Similarly to banks, also the growth of the own funds of banking groups was mostly achieved by the inclusion of audited profits and the increase in subordinated liabilities. At the end of March, the aggregate capital adequacy ratio of banking groups stood at 11.3%, remaining close to the respective past year's figure (11.4%). The lowest capital adequacy ratio of banking groups at the end of the first quarter was 10.7% (see Figure 3.8).

Thus, banks have not reacted to the regulation amendment by slowing down the growth of housing loan portfolios but have preferred to increase own funds instead, which has, to the most part, been achieved by the inclusion of audited profits and by attracting additional subordinated liabilities from parent banks.

As regards future developments, it is important whether banks are ready to accept a decrease in the profitability of own funds. Should retaining the earlier levels of profitability remain a goal also in the circumstances of the amended regulation, it is important which methods will be chosen for achieving that goal.

LIQUIDITY

Funding of banks

Since last year's November, customer deposits have increased faster than loan and leasing financing. Thus, also the share of **institutional foreign borrowing** in total liabilities has remained around 40% during the last 12 months, despite the fact that banks have also been active in raising foreign funds (see Figure 3.9). In March 2006, the

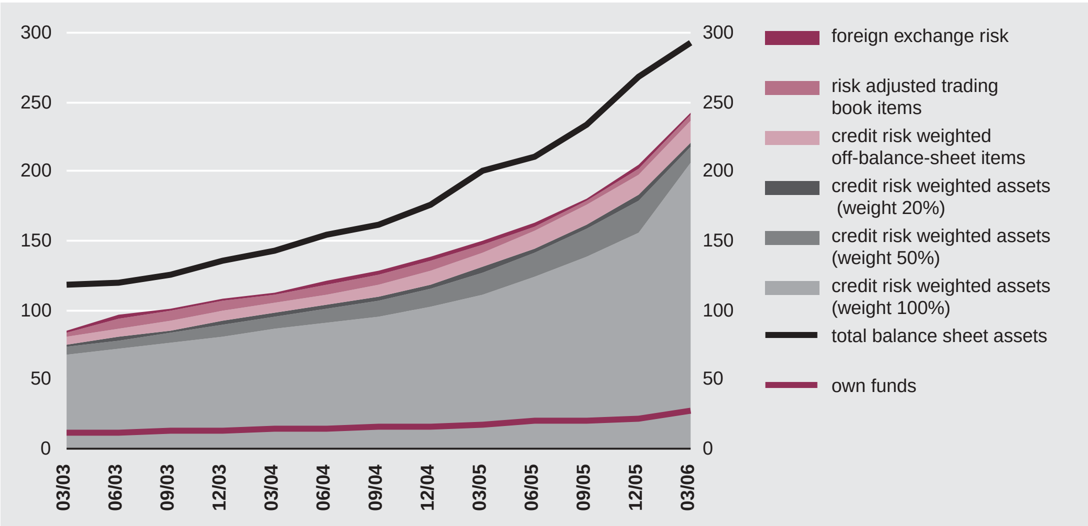

Figure 3.7. Structure of banking groups' aggregate risk weighted items and own funds

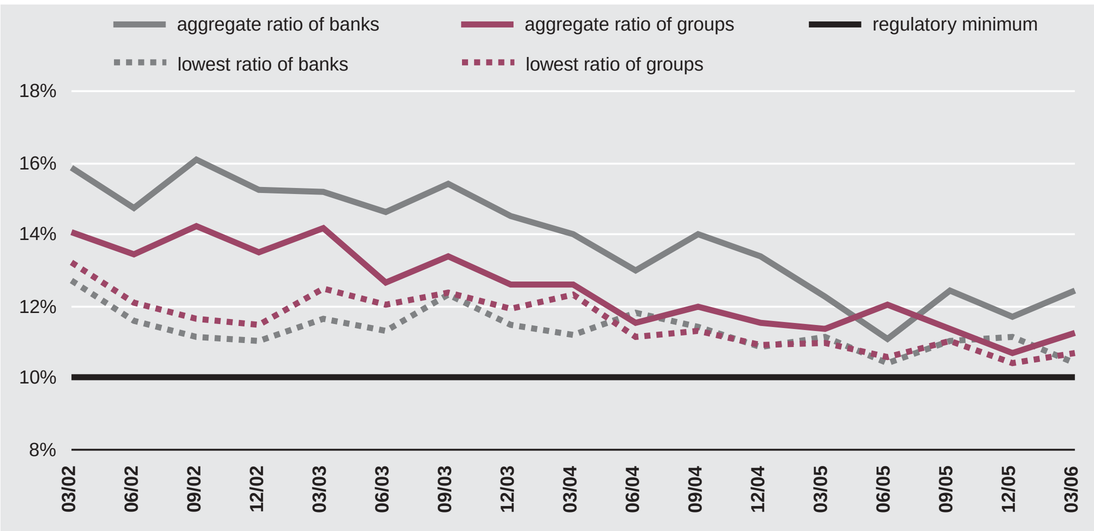

Figure 3.8. Capital adequacy of banks and banking groups

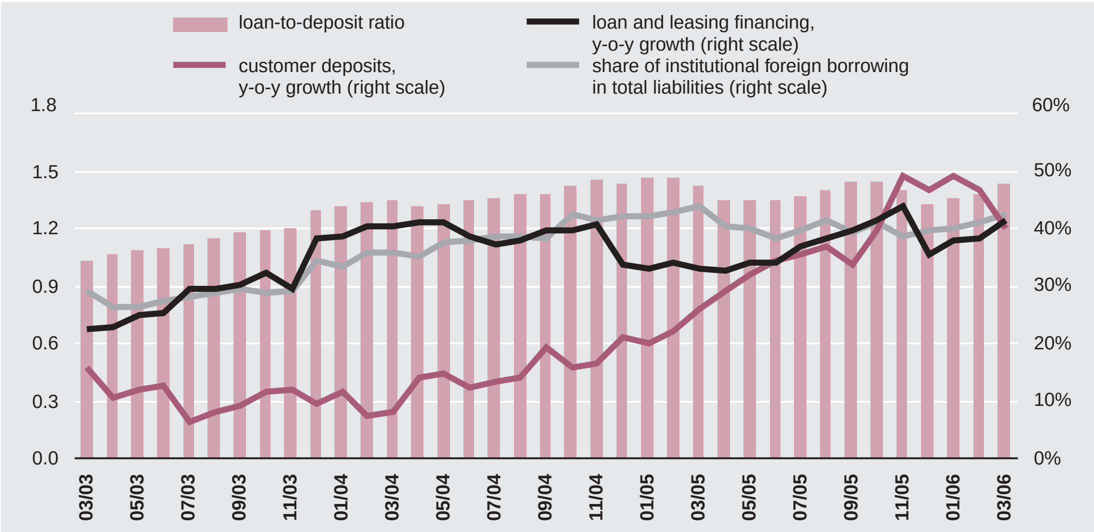

Figure 3.9. Loan-to-deposit ratio and share of institutional foreign borrowing in total liabilities (right scale)

loan-to-deposit ratio increased to 1.43 again, because of the interaction of the deceleration of deposit growth caused by the base effect and an increase in foreign borrowing.

As the ownership structure of Hansapank changed, the share of **non-resident parent banks' resources** in funding the Estonian banking sector increased as expected, comprising approximately three-quarters of institutional foreign borrowing. In addition, while until now funds from parent banks were primarily received as deposits, in the past half-year loans have prevailed in this respect. As loan and leasing financing has been growing fast and the capital adequacy regulation amendment necessitated an increase in own funds, some banks have also included subordinated liabilities from parent banks.

The **price of funds** raised by banks continued to increase across the funding structure (see Figure 3.10). As a result of the interest rate rise on the European money market, banks raised the interest rates on customer deposits, which is why also the average cost of deposits increased. Furthermore, the cost of funds received from banks also grew, partly because the maturity structure of funds changed.

Liquid assets

The share of liquid assets in total assets increased to 24.6% by the end of March, exceeding the average of the past 12 months by 1.5 percentage points (see Figure 3.11). Actually, however, liquidity has not increased because the increase in **liquid assets** was brought about by transactions related to intra-group liquidity management. Without taking this into account, the level of the banking sector's liquid assets would have been slightly less than 20%, which is several percentage points lower than the 12-month average.

For the same reason, liquid assets increased robustly in ratio to current liabilities in December 2005, finally decreasing to 45% in March 2006. Without considering transactions related to intra-group liquidity management, the indicator of March would have remained close to that of November 2005 (36%). As the high liquid asset ratios of the banking sector at the end of 2004 and at the beginning of 2005 resulted from raising large amounts of market-based funds, the decrease in

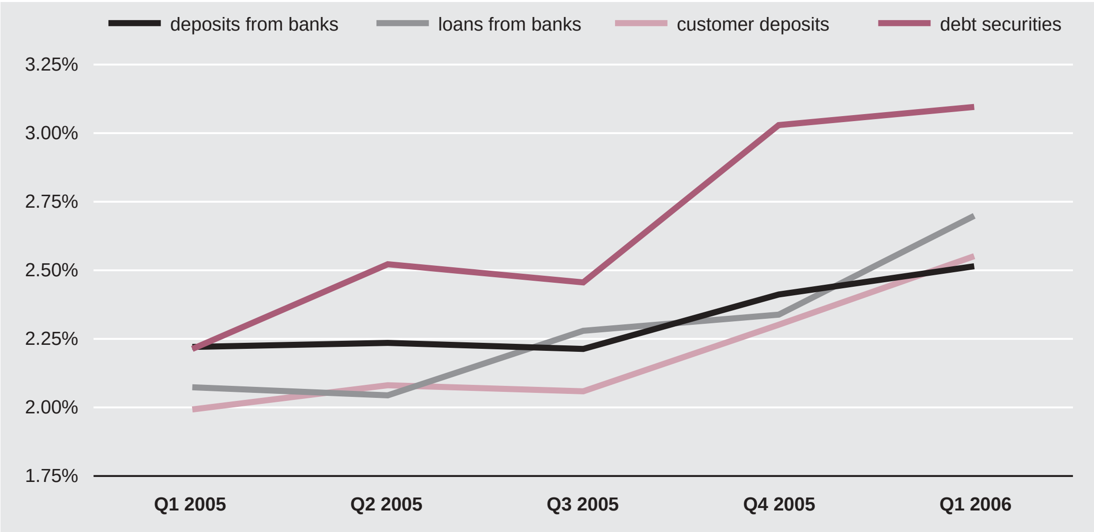

Figure 3.10. Weighted average interest rate on funds raised

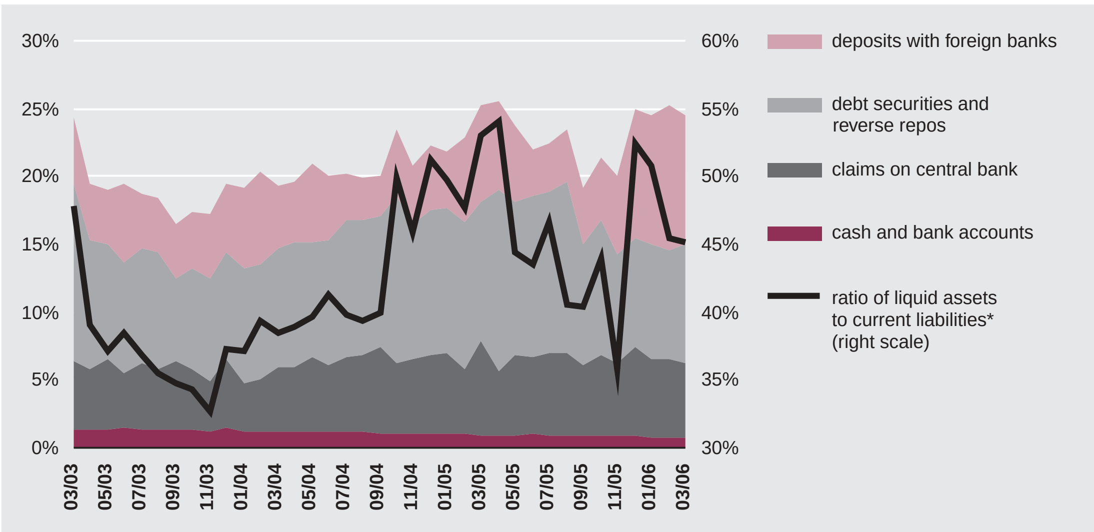

Figure 3.11. Structure of liquid assets and their share in current liabilities (% of total assets)

* current liabilites – remaining maturity of up to one month

the share of liquid assets in the balance sheet of banks with a more flexible access to parent bank funds was to be expected.

EFFICIENCY AND PROFITABILITY

The banking sector's **profit margin**[4] increased slightly in the first quarter of 2006 compared to September 2005, though the asset utilisation[5] and return on assets[6] continued to decrease (see Table 3.1). An increase in the net interest income as well as the net fee and commission income contributed greatly to the growth of the profit margin (see Figure 3.12). The net profit of four consecutive quarters was to some extent enhanced also by changes in the accounting principles resulting from the implementation of the International Financial Reporting Standards (IFRS/IAS) last year, which caused a decrease in provisioning and an increase in profit from the value adjustments of assets. Also, had the income from financial investment remained at the same level, the profit margin might have increased more. However, the return on equity[7] still dropped by 1 percentage point to 21.3% compared to September 2005, as the profit margin rose relatively little.

In the upward phase of the interest rate cycle, these Estonian banks that have a large share of loans with floating interest rates and demand deposits are in a favourable position, since the interest rate rise boosts interest income over expenses. The **average interest income on interest-earning assets** turned upwards in the first quarter of 2006. On the other hand, the growth of the **average interest expenses of interest-bearing liabilities** also accelerated, which is why the spread and net interest margin continued declining, although at a slower pace. As the volume of interest income exceeds that of the interest expenses, the net interest income has increased considerably despite the increase in average interest expenses.

Owing to the strong growth of net interest income, the share of **net fee and commission income** in the net interest income has stabilised at the September 2005 level, i.e. 52%.

Controlling expenses in the context of ever expanding operations, the banking sector has reached a certain critical level, as the share of administrative costs in income has increased to 24% again, i.e. to the same level as a year ago. Thus, the **cost-income ratio** has also remained at the level of September 2005, i.e. 45.0%. The ratio might even have grown, had it not been supported by a decrease in the loss from value adjustments of real estate investment, tangible and intangible assets, which were largely brought about by the changes in the accounting principles after the implementation of IFRS/IAS.

Similarly to the banking sector's solo indicators, the figures on the return on assets and asset utilisation of **banking groups**[8] also continued decreasing. Meanwhile, the consolidated profit margin of banking groups has decreased slightly during the past half-year, unlike the solo indicator of the banking sector (see Table 3.2). This resulted from the smaller share of net fee and commission income and net interest income in total income and the higher expenses of writing down claims. The profit margin was underpinned by a further drop in the cost-income ratio. As the profit margin decreased, so did the return on equity by 0.4 percentage points to 23.5% compared to September 2005.

As it becomes increasingly difficult to achieve higher cost-effectiveness of the banking sector on a solo basis and the impact of changed accounting

[4] Profit margin is calculated by dividing net profit by total income.
[5] Asset utilisation is calculated by dividing total income by total assets.
[6] Return on assets is calculated by dividing net profit by total assets.
[7] Return on equity is calculated by dividing net profit by equity.
[8] The consolidated ratios of banking groups have been retroactively adjusted.

principles resulting from the implementation of the International Financial Reporting Standards (IFRS/IAS) on profit is waning, profitability may be increased further mainly through a rise in net interest income and net fee and commission income. Due to the structure of banks' assets and liabilities, the increase in interest income in the upward interest cycle will probably exceed the increase in interest expenses, therefore causing a rise in the net interest margin and spread. However, presuming that the indicators of Estonian banks converge towards the EU average, in the long-run competition pressures should continue to decrease the net interest margin.

Table 3.1. Banks' profitability on solo basis (%)

	2002	2003	2004	Q1 2005	Q3 2005	2005	Q1 2006
Asset utilisation	9.3	7.9	7.4	7.2	7.1	6.7	6.4
Return on assets	1.55	1.70	2.13	2.06	2.12	1.96	1.94
Profit margin	16.8	21.7	28.8	28.6	30.0	29.4	30.3
Return on equity	14.7	14.1	20.0	20.3	22.3	21.0	21.3
Cost-income ratio	61.6	53.0	45.8	46.2	45.0	45.6	45.0
Net interest margin	3.59	2.91	2.39	2.27	2.08	2.04	2.01
Spread	3.44	2.78	2.30	2.18	1.99	1.95	1.92

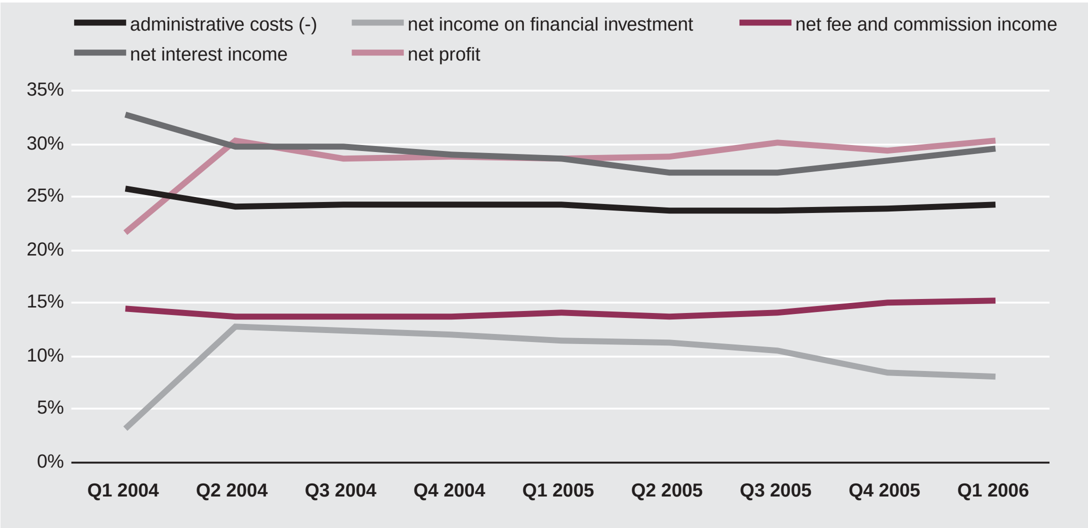

Figure 3.12. Income and expense items by type (% of total income)

Table 3.2. Banking groups' profitability on consolidated basis (%)

	2002	2003	2004	Q1 2005	Q3 2005	2005	Q1 2006
Return on assets	2.12	2.07	2.22	2.15	2.18	2.08	2.03
Return on equity	20.3	20.0	22.8	22.8	23.9	23.5	23.5
Cost-income ratio	60.9	52.3	49.7	49.1	47.5	46.6	46.9
Net interest margin	4.55	3.94	3.42	3.27	3.02	2.89	2.81
Spread	4.41	3.80	3.28	3.14	2.88	2.76	2.68