V OTHER FINANCIAL MARKETS

INVESTMENT FUNDS

Since the end of March 2005, the **yield** of investment funds has been mainly influenced by the increase in key interest rates and the rapid growth of developing markets, primarily caused by the foreign investment inflow, decreased risk premiums and the rise in commodity prices (see Figure 5.1). The development of Central and Eastern European and Russian markets as profitable investment regions in 2005 took the yield of equity funds registered in Estonia to 43% on average by the end of March 2006 as the sum of four consecutive quarters. The average yield of money market funds grew as well along with the rise in key interest rates, amounting to 1.9% at the end of March.

The **growth of investment fund assets**, which had lasted for several years, slowed down due to a high basis of comparison, reaching 58% at the end of March, year-on-year (see Figure 5.2). As investors increasingly prefer riskier but more profitable equity investments instead of the shares of the more stable and liquid money market funds, investment fund assets increased mainly owing to the multiple growth of equity fund assets. As a result, equity fund assets grew from 4.7 billion kroons at the end of March 2005 to 9.8 billion kroons within a year. Contrary to equity funds, the merely 23% annual growth of interest fund assets and the 7% growth of money market funds has remained considerably more modest. At the end of March 2006, 62% of the equity fund shareholders were residents, nearly half (49%) of whom were private persons.

The **share of foreign assets in the assets of funds** that has been constantly growing since 2003 decreased slightly in the first quarter of 2006 and comprised 77% at the end of March (see Figure 5.3). Investments to EU markets decreased to 64% of foreign assets by the end of the period (see Figure 5.4). Investments to the markets of Russia, Poland and Luxembourg grew the most. The total volume of instruments issued to the Estonian equity, bond and fund markets in the assets of investment and pension funds registered in Estonia again accounted for 12%, i.e. nearly 2.6 billion kroons, which is a third more compared to the end of September 2005 in nominal terms. Investments in domestic shares and units have nearly tripled, amounting to more than 0.9 billion kroons at the end of March.

During the last half-year, **eight new funds** were added to open-ended investment funds: Hansa Eastern Europe Bond Fund, Hansa Funds of Funds[1], Sampo Global Growth Fund, SEB Generic Pharmaceutical Fund, Kawe Investment Fund and Trigon New Europe Top Picks Fund. Hansa Funds of Funds and Sampo Global Growth Fund are funds that place capital in other funds. 50% of the assets of Hansa Funds of Funds are invested in Eastern Europe, and the rest in other international financial markets (USA, Asia). The assets of Sampo Global Growth Fund are primarily placed in the equity funds of global and European developing markets. SEB Generic Pharmaceutical Fund invests in the shares of global generic pharmaceutical manufacturers, at least 40% of which are channelled to Central and Eastern European countries. The assets of the Hansa Eastern Europe Bond Fund are invested in securities representing the debts of Eastern European issuers; the assets of the new Trigon fund, on the other hand, are placed in the ten most attractive shares of the same region. Unlike the aforementioned funds, the Kawe Investment Fund is a mixed fund where assets are invested mainly in shares and bonds without a focus on any specific economic sector or region.

PENSION FUNDS AND INSURANCE

In April 2006, the number of subscribers to the second pillar of the pension system amounted

[1] Hansa Fund of Funds 30, Hansa Fund of Funds 60 and Hansa Fund of Funds 100 are intended for investors with different risk preferences and they invest 30%, 60% or 100% of fund's assets, respectively, in equity funds.

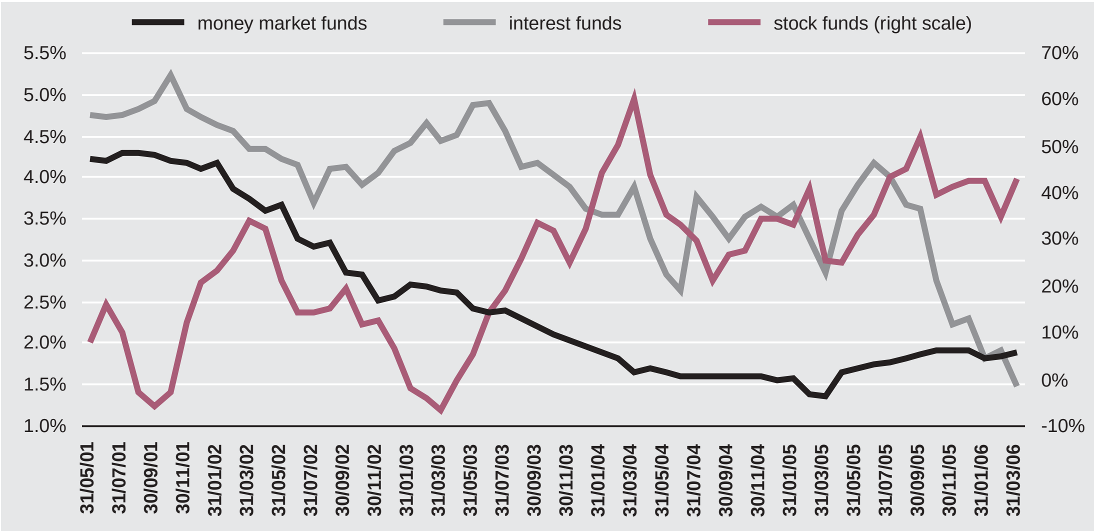

Figure 5.1. Average yield of investment funds (%)

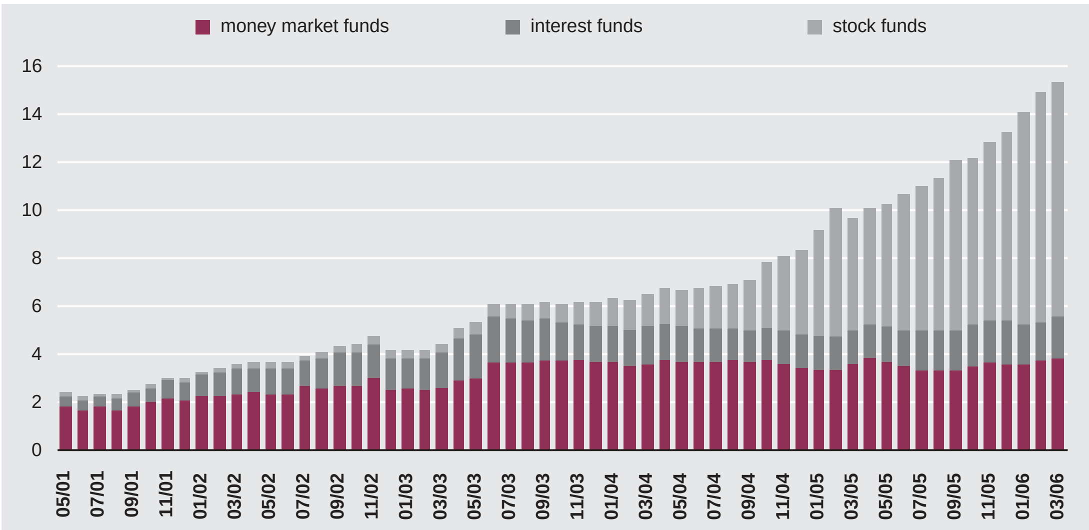

Figure 5.2. Volume of investment fund assets at end-month (EEK bn)

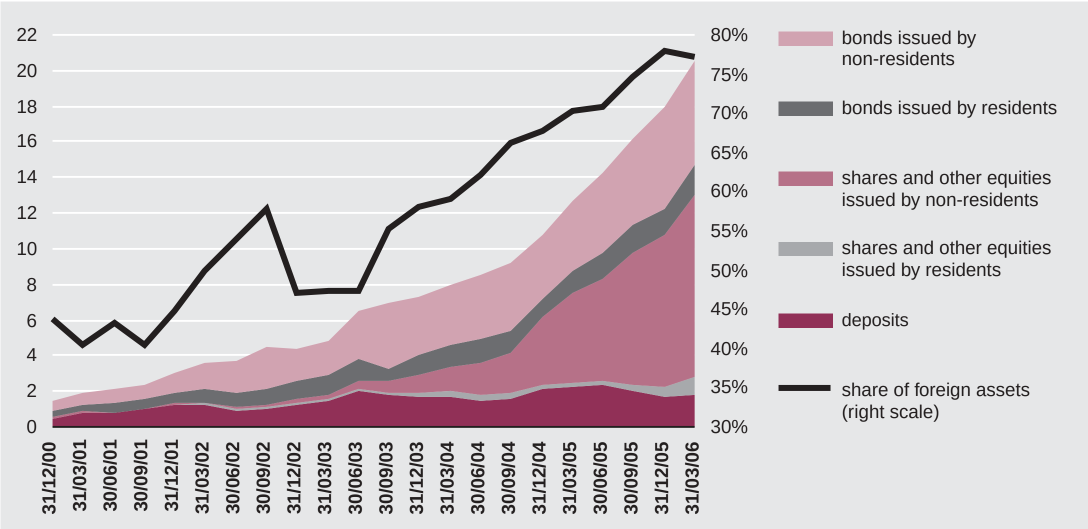

Figure 5.3. Structure of investment and pension fund assets (EEK bn) and share of foreign assets (%)

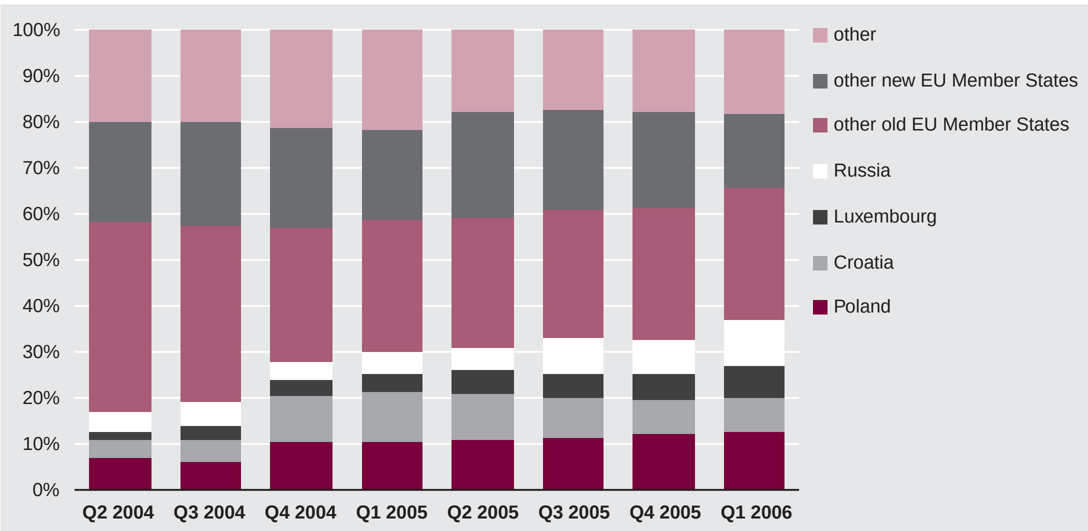

Figure 5.4. Foreign investments of investment and pension funds by residency at end of period (%)

to approximately 489,000 persons, comprising about 80% of the employed. Within the past year, the volume of the second pillar funds increased 76%, i.e. by 2.3 billion kroons (see Figure 5.5). Their total volume at the end of March amounted to 5.3 billion kroons. The fast growth period of the second pillar funds, when many new subscribers joined the system, is now over and presently funds mainly grow as a result of the increase in wages and profitability. Therefore, the growth rate of the volume of second pillar funds is modest compared to the previous year (in March 2005, the annual growth was 125%). Within the last year, the volume increased by 190 million kroons per month on average.

The number of subscribers to the third pillar reached 95,000 by April 2006, accounting for approximately 15% of the employed. The year-on-year growth of the third pillar pension funds stood at 115%; the volume of funds grew by 284 million kroons (86% and 113.4 million kroons in March 2005, respectively). While the second pillar's growth potential is limited by the number of new subscribers and wage increase, the growth of the third pillar very much depends on the sales of funds and insurance companies offering the respective products. Including pension insurance, the volume of the third pillar stood at 1.57 billion kroons at the end of 2005, of which pension funds comprised 30%. The share of pension funds in the structure of the third pillar pension fund system is continuously heading upwards on account of insurance.

The structure of pension fund assets had some changes within the past year. The percentage of shares in the second pillar pension fund assets increased due to the popularity of high-risk funds, whereas the share of bonds decreased (see Figure 5.6). Moreover, the share of residents' shares and bonds also grew. The share of residents' as well as non-residents' shares and equities in the assets of the third pillar funds has grown significantly (see Figure 5.7). While a year ago shares and equities comprised 39% of the assets of third pillar funds, this year the respective figure rose to 72%. The higher percentage of shares affected also directly the increase in the return on the third pillar pension funds: while in March 2005 the average return stood at 11.25%, in March 2006, the average return on different third pillar funds accounted for 25.31%. Investments in non-residents' shares and bonds rose remarkably too: from 68% to 79%, year-on-year.

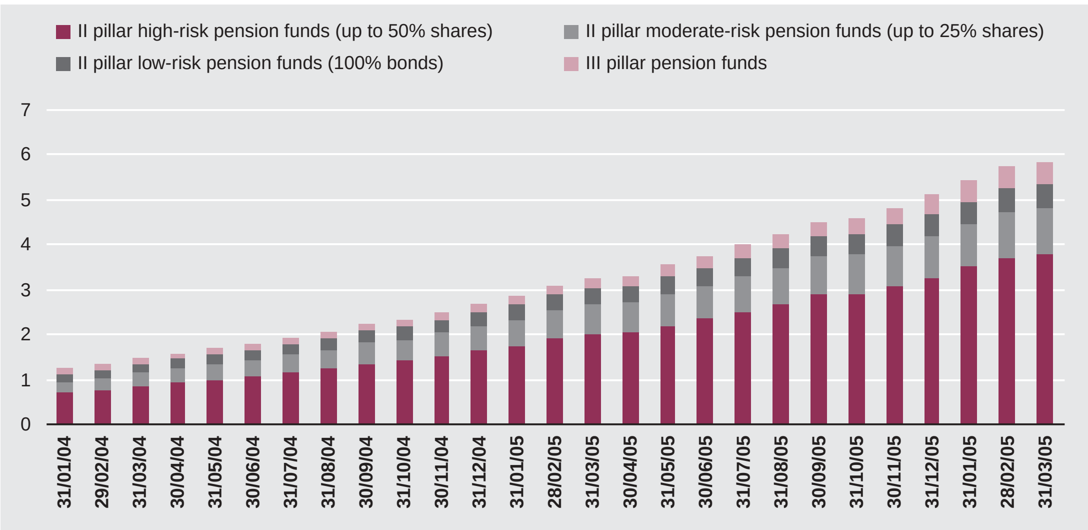

Figure 5.5. Volume of pension fund assets (EEK bn)

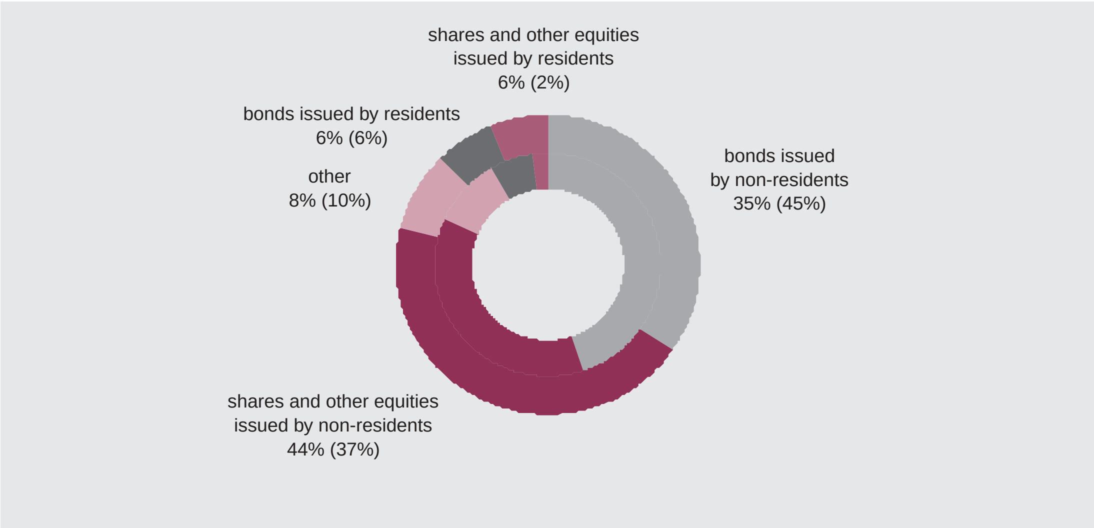

Figure 5.6. Structure of II pillar pension fund assets as at 31 March 2006 (position on 31 March 2005 indicated in brackets)

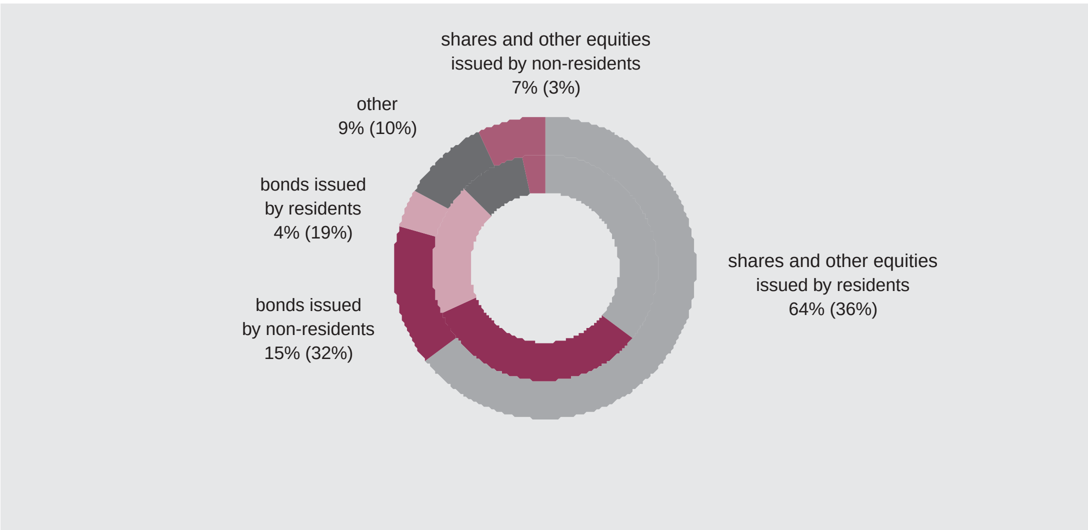

Figure 5.7. Structure of III pillar pension fund assets as at 31 March 2006 (position on 31 March 2005 indicated in brackets)

At the end of March 2006, 80% of the assets of third pillar funds included investments in foreign markets. The total volume of domestic shares, equities and bonds in the investments of these funds reached 108 million kroons. Despite the fact that the total volume of domestic shares, equities and bonds increased by 30 million kroons, year-on-year, their share in the total third pillar investments has declined from 32% to 20%. The share of Western Europe (France, Luxembourg and Switzerland) in the third pillar fund investments has significantly increased: from 8% in the past year to 32%.

LIFE INSURANCE

In 2005, life insurance companies earned a profit of 149.6 million kroons, i.e. 55% more than in 2004. The return on equity of life insurance companies has been increasing since 2001, reaching 30.3% in 2005.

The year-on-year growth of the volume of gross premiums on the life insurance market stood at 62%, and the total amount of gross premiums collected was 1.4 billion kroons (see Figure 5.8). The gross premiums collected by unit-linked life insurance contracts increased the most with the annual growth of 141%.

Unit-linked life insurance differs from ordinary life insurance mainly for the fact that while traditionally, a life insurance contract is concluded to hedge the risks (e.g. death, illnesses) of an insurance policy holder and accumulate a fixed sum of money, then in case of unit-linked life insurance the policy holder carries the investment risk. Also, there is no guaranteed interest as in the case of an ordinary insurance product, the direct insurance cover is small and the investor can earn unsecured income depending on their risk tolerance. The policy holders can channel their payments in different funds and the value of the insurance policy accumulation reserve depends on the price change of fund shares. In case of unit-linked life insurance, payments made after 12 years since the conclusion of the contract are exempt from income tax. Therefore, in a sense, unit-linked life insurance is an ordinary financial investment concluded through a life insurance policy in order to reduce future income tax paid on capital growth.

It is difficult to explain the extraordinary increase in the number of unit-linked life insurance contracts and based on the available data it is too early to tell whether it is a one-off change in the behaviour of consumers or a long-term trend. As unit-linked life insurance contracts have been concluded in Estonia already since 1997, it is not very likely that this type of insurance was discovered as a form of investment only now. Therefore it is reasonable to assume that the excessive growth premiums collected by unit-linked life insurance contracts was a one-time event.

At the end of 2005, the total investment volume of life insurance companies amounted to 2.27 billion kroons, which formed 61.3% of the balance sheet total (76% at the end of 2004; see Figure 5.9). The percentage of shares and other securities increased in the investment structure mainly on the account of bonds and other fixed income securities. Investments of insurance companies are being reinvested mainly because it is difficult to find eligible investments for insurance contract commitments.

NON-LIFE INSURANCE

The profit of non-life insurance companies for the financial year 2005 stood at 442 million kroons, which is 27% more than in the previous year. The return on equity was 28% in 2005. The development of the non-life insurance market has remained relatively stable in recent years, which is also illustrated by the fact that the market shares of non-life insurance companies have fluctuated only within the range of a few percents for a while already.

In the past year, insurance companies collected 2.7 billion kroons in gross premiums, which is 14.5% more than in 2004 (see Figure 5.10). As land vehicle insurance, property insurance and compulsory motor third party liability insurance contributed the

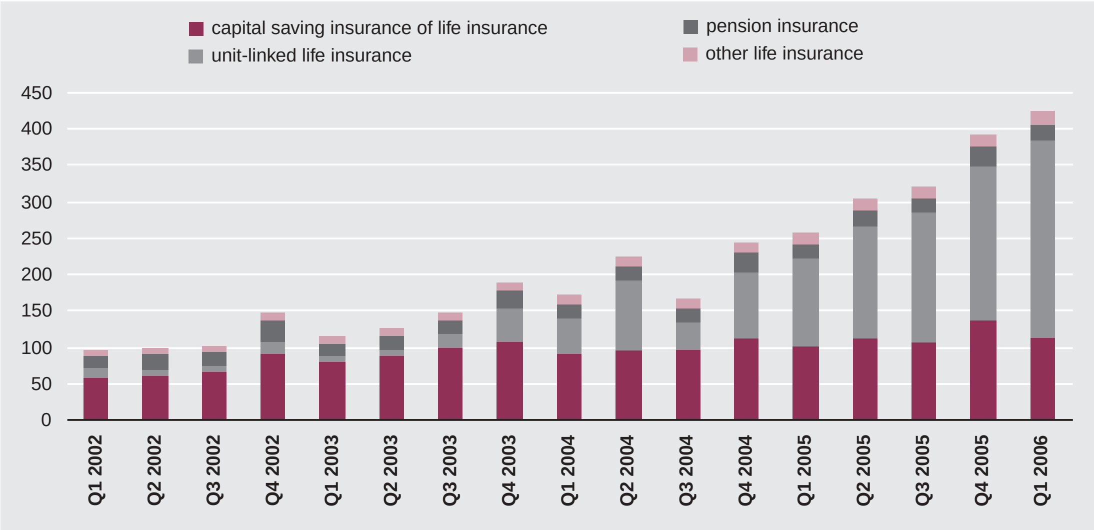

Figure 5.8. Gross premiums collected by life insurance companies (EEK m)

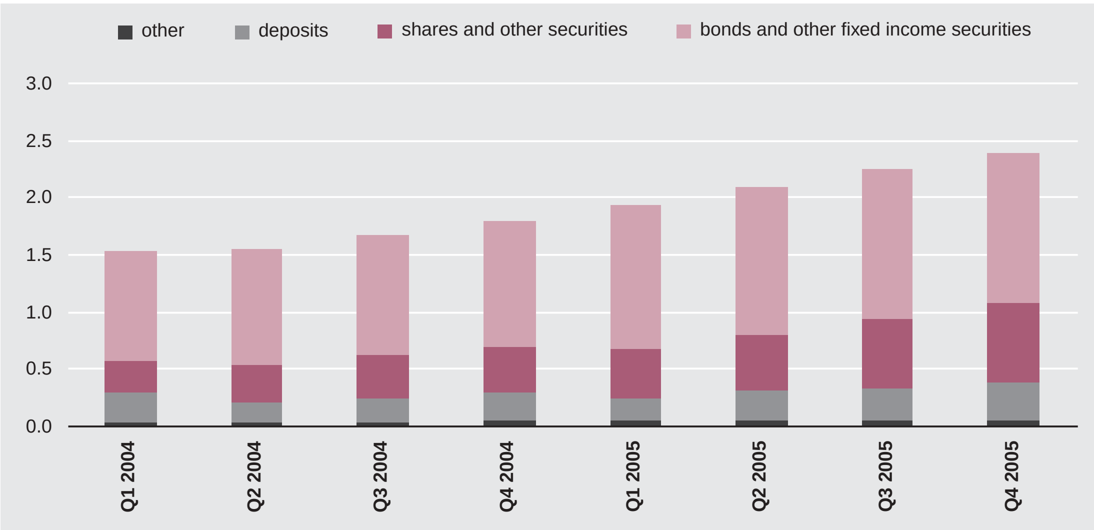

Figure 5.9. Investment structure of life insurance companies (EEK bn)

most to the growth, the gross premium growth of non-life insurance may be explained by favourable economic situation and the continuous high loan volume.

At the end of 2005, investments comprised 89% of the balance sheet total of non-life insurance companies, which was 3.2 billion (see Figure 5.11).

As non-life insurance companies invest in more liquid assets than life insurance companies, the majority of non-life insurance assets are placed in fixed income securities and the share of credit institutions' deposits is also significantly greater. In 2005, the share of bonds and other fixed income securities increased approximately 12% primarily on account of shares and other securities.

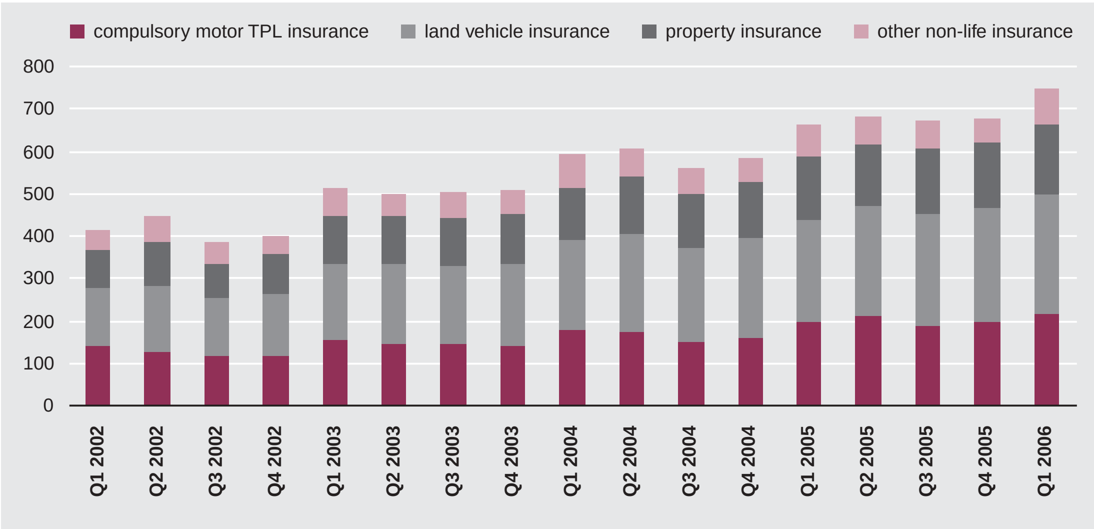

Figure 5.10. Gross premiums collected by non-life insurance companies (EEK m)

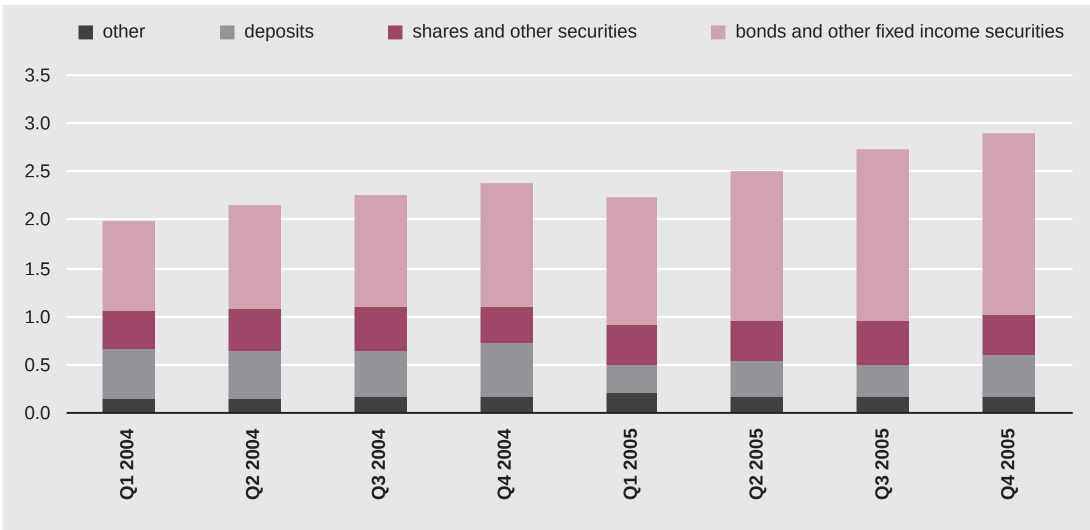

Figure 5.11. Investment structure of non-life insurance companies (EEK bn)