Investment funds

Since the end of March 2007, the **yield** of investment funds has been shaped by the key interest rates moving in opposite directions as well as uncertainty in global financial markets (see Figure 1). These factors primarily affected the yield of equity funds, which experienced a rapid downward trend. By the end of March, the yield of equity funds had dropped to 7% as a moving average; that is, to the level preceding the rapid growth on stock markets that started five years ago and lasted for several years. The average yield of interest funds declined to 1.3% by the end of March 2008, returning to the level recorded two years ago. The key interest rates remained at a relatively high level, which led to a

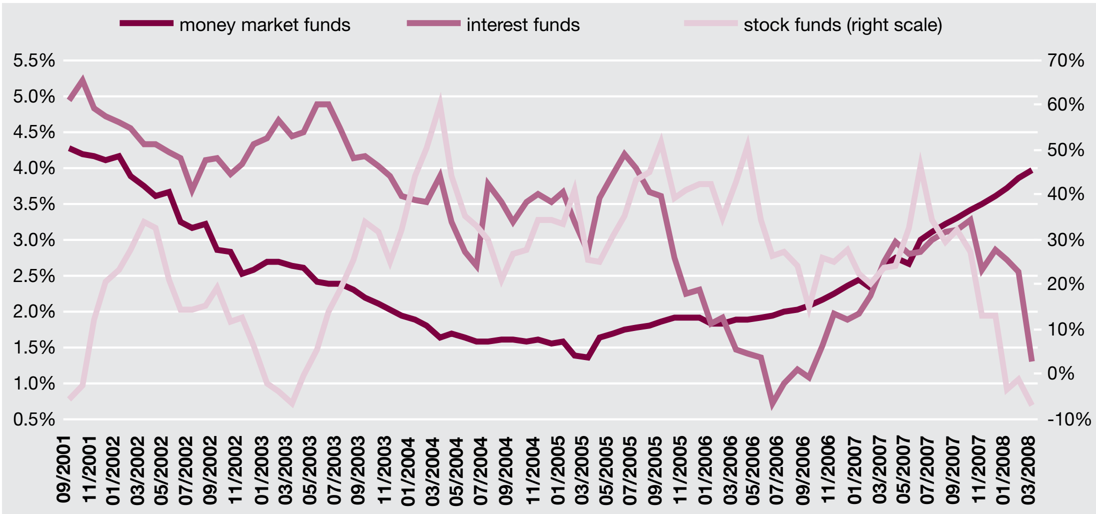

Figure 1. Average annual yield of investment funds at end-month

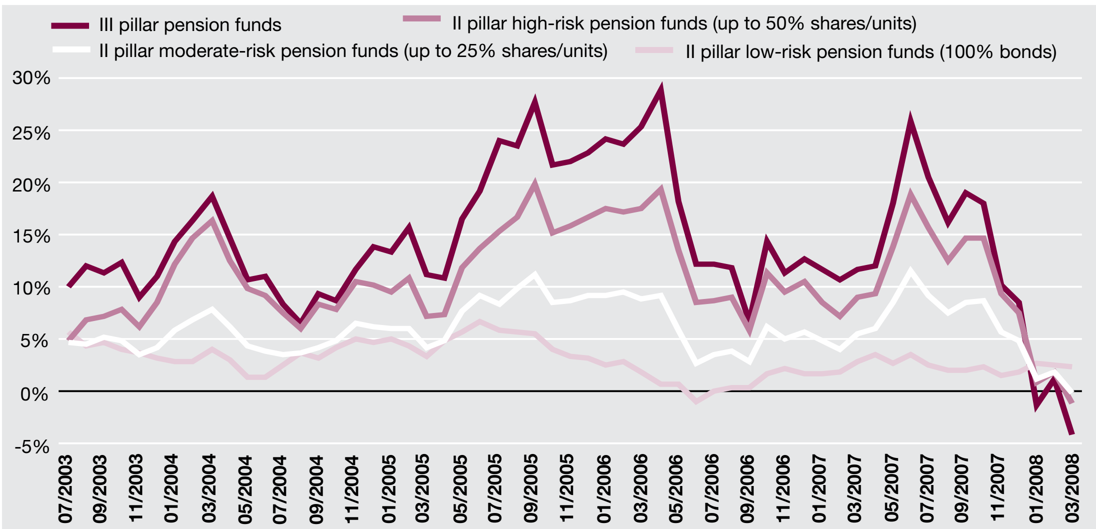

Figure 2. Average annual yield of pension funds at end-month

rise in the average yield of money market funds that posted the highest result in six years (almost 4%) at the end of March.

The yield of pension funds was generally in line with developments in global financial markets. Only second pillar low-risk pension funds had a positive average annual yield at the end of March 2008 (see Figure 2). The average annual yield of other pension funds fell to historical lows by the end of the first quarter: to nearly -1% in the case of second pillar funds and -4% in the case of third pillar funds.

The turmoil on financial markets affected also **investment fund assets**. Their growth started to slow at the beginning of 2008 and reached an annual aggregate of -11% by the end of March (see Figure 3). With 19.2 billion kroons, investment fund assets stood at the level recorded at the beginning of 2007, having lost over 20% of their volume with six months.

Growth in second pillar funds decelerated from 56% to 36% by the end of March. Their total volume amounted to 11.3 billion kroons (see Figure 4). The total value of third pillar assets was over 3 billion kroons; the share of funds rose to 34%. However, growth in fund assets has slowed by over two times to 23% with the year.

According to imputed estimates, 29% of the year-on-year decrease in investment fund assets was caused by a **decline in the yield of assets**. The rest of the decline, that is approximately 2.5 billion kroons, can be attributed to capital paid out from investment funds. The majority (2.3 billion kroons) of the reallocated capital was withdrawn from equity funds, resulting in a nearly 20% decrease in equity fund assets. Money market fund assets decreased by 25% by the end of March owing to the 1 billion kroon outflow of funds. The decrease was slightly offset by the improved yield of these funds. As a result of the relocation of investment only interest fund assets increased, 98% of the increase in assets coming from newly invested capital.

The **share of foreign assets** in total fund assets started to descend again at the end of the fourth quarter of 2007 and reached approximately 76% at the end of March 2008 (see Figure 5). Foreign assets have decreased mainly on account of residents' investment in bonds and deposits, which increased from 14% in September to 18% in March in terms of total fund assets.

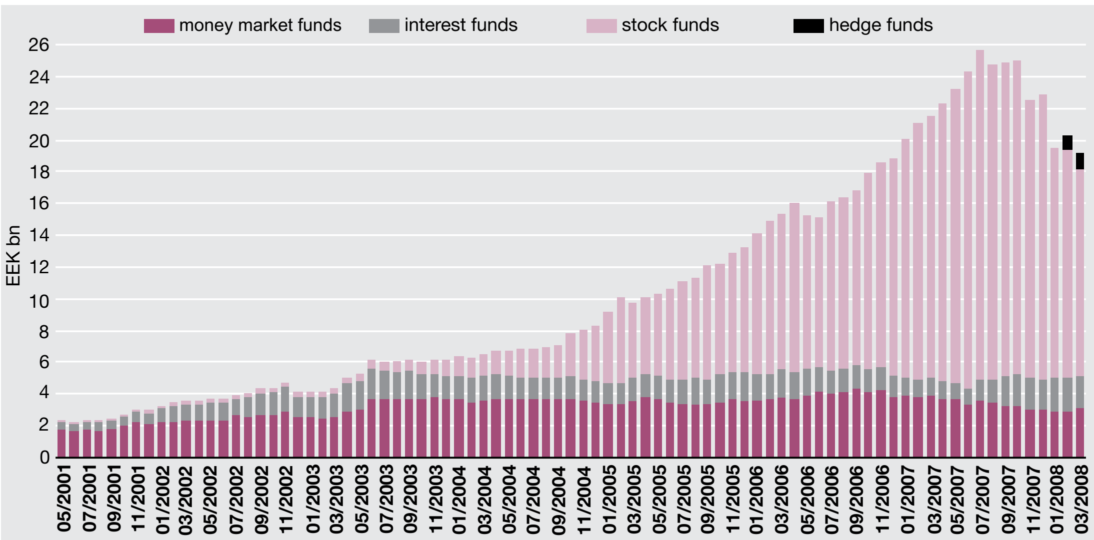

Figure 3. Value of investment fund assets at end-month

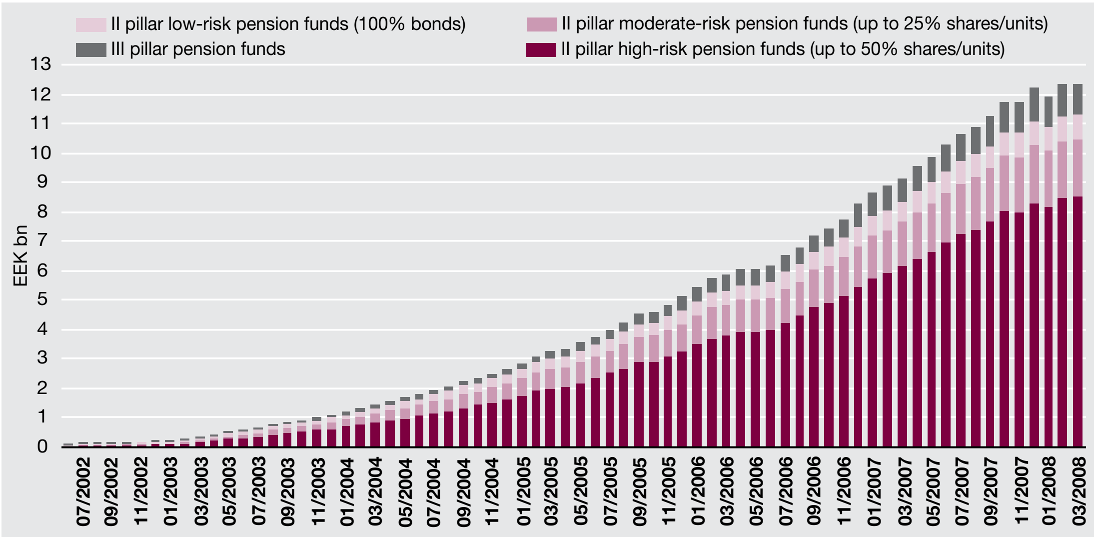

Figure 4. Value of pension fund assets at end-period

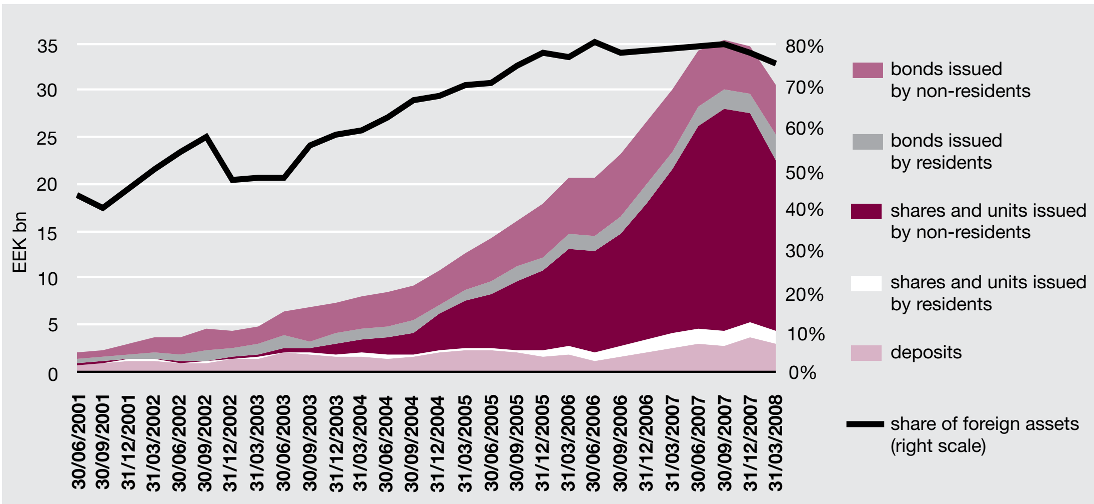

Figure 5. Structure of investment and pension fund assets and the share of foreign assets

The percentage breakdown of investment regions did not change significantly; however, changes occurred within the regions (see Figure 6). For instance, in the European Union, capital investment in the markets of Romania, Austria, the United Kingdom and Poland decreased remarkably, whereas investment in the markets of Ireland, Cyprus, Finland and Sweden increased.

The total value of instruments issued to the Estonian stock, bond and fund market among the assets of investment and pension funds registered in Estonia rose to 13% (4.0 billion kroons) by the end of March 2008, after a decline to 10% in autumn 2007. Over 20% (865 billion kroons) of the capital invested in the Estonian securities market was channelled to the funds of Hansapank. Investment in shares listed

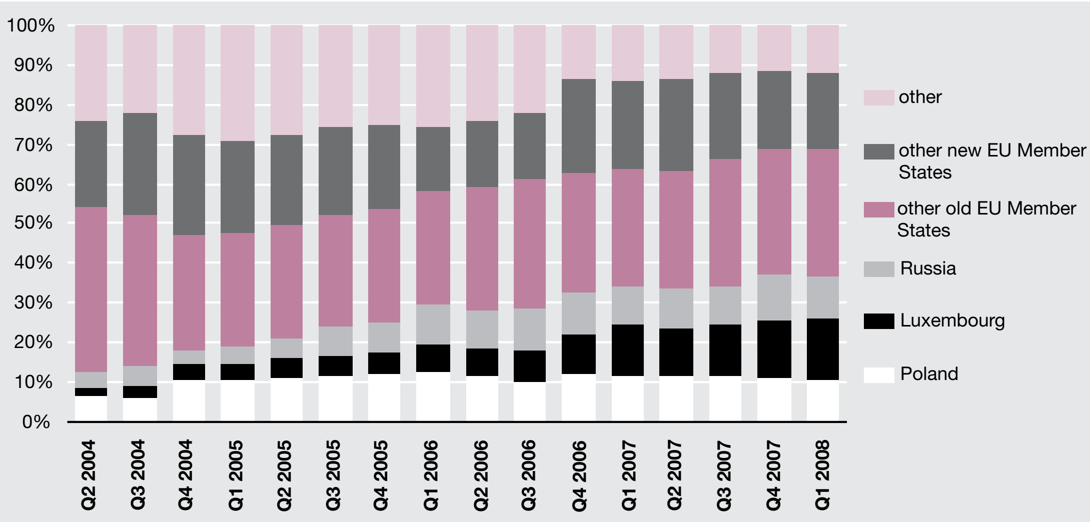

Figure 6. Foreign investment of investment and pension funds by residency at end-period

on the Tallinn Stock Exchange totalled only up to 234 billion kroons.

In general, pension management companies preferred to **invest the assets of pension funds registered in Estonia in other funds**. However, this does not apply to second pillar pension funds, as the percentage of capital invested in other funds decreased in second pillar pension fund assets (see Figure 7). At the end of March, all pension funds had invested in investment fund shares or units; third pillar pension funds had invested over two thirds and second pillar pension funds 46% of their assets in other funds. More than half of equity and interest funds had invested in other funds; meanwhile, the value of investment continued growing and reached 15% in the case of equity funds and 5% in the case of interest funds. Money market, hedge and real estate funds did not have any shares or units invested in other funds.

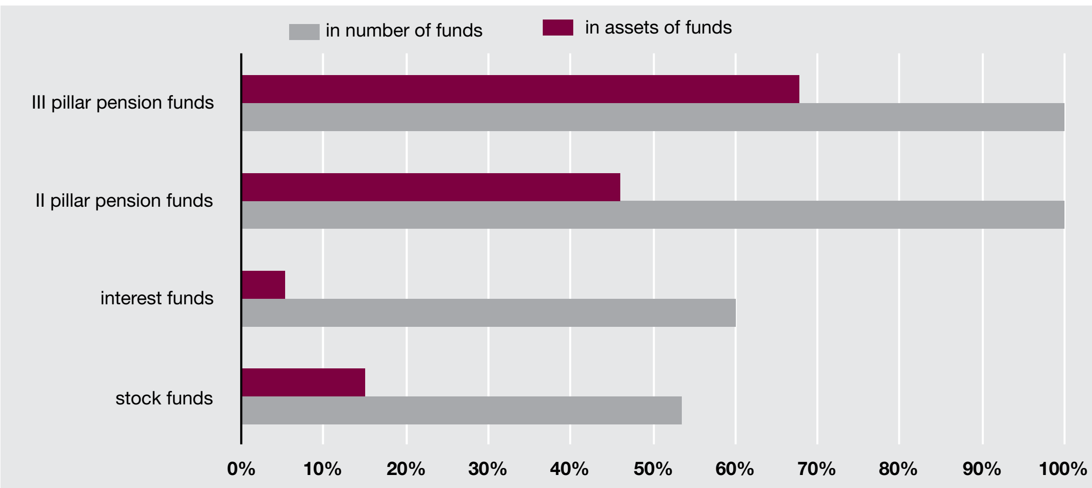

Figure 7. Share of investment funds invested in other funds at end-period

Two new equity funds entered the market in the last half-year, as well as the **first hedge fund and the first real estate fund**.

Insurance

Direct insurance gross premiums collected from Estonian residents in 2007 comprised 2.3% of GDP. Payments collected by life insurance companies accounted for 0.8% and those of non-life insurance companies for 1.5%. According to the European Insurance and Reinsurance Federation (CEA), the share of insurance payments in the GDP of EU Member States at the end of 2006 stood at an average of 8.8%, which is nearly four times higher compared to Estonia's respective indicator. Luxembourg clearly stands out with 37.4%, which probably arises from the fact that relatively many international companies have been registered there (see Figure 8).

Life insurance

Life insurance companies registered in Estonia concluded 97,099 new life insurance contracts in 2007. 5,901 contracts were terminated, comprising 1.3% of total life insurance contracts. New contracts formed 22% of total contracts. Increase in the number of new contracts was facilitated by the intra-Baltic merger of some life insurance companies in 2007. Therefore, this indicator also includes contracts concluded between life insurance companies registered in Estonia and non-residents.

Premiums collected on contracts concluded with Estonian residents totalled 1.9 billion kroons (24%) in 2007. In the first quarter of 2008, 37% less life insurance premiums were collected compared to the first quarter of 2007 (see Figure 9).

The majority of premiums are unit-linked life insurance payments; their share increased by 37% year-on-year. However, in the first quarter of 2008, 42% less such payments were collected compared to the first quarter of 2007.

The popularity of unit-linked life insurance products mainly lies in the exemption from income tax on investment incomes after a 12-year investment period. The situation in the securities markets is another substantial factor affecting the sale of investment products. With this type of insurance, single or irregular payments are common, whereas in the case of traditional life insurance regular payments prevail. Thus, traditional life insurance provi-

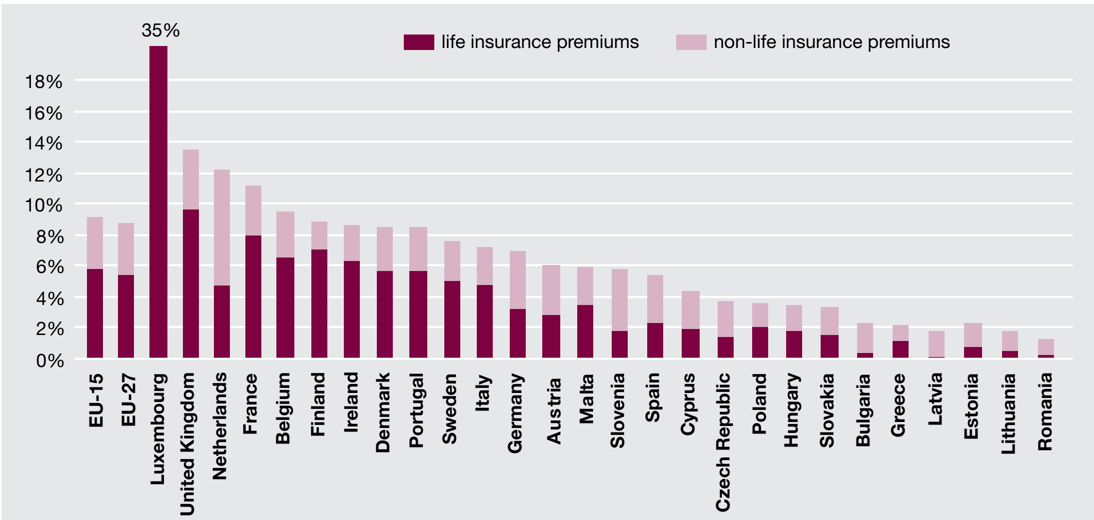

Figure 8. Insurance premiums as a percentage of GDP in EU countries (as at end-2006)

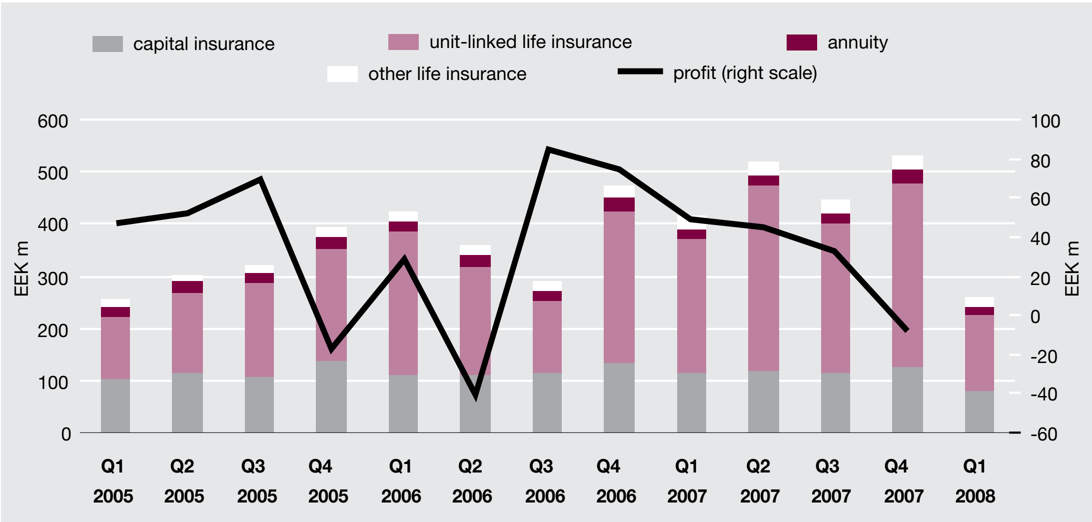

Figure 9. Profits of life insurance companies and gross premiums from residents

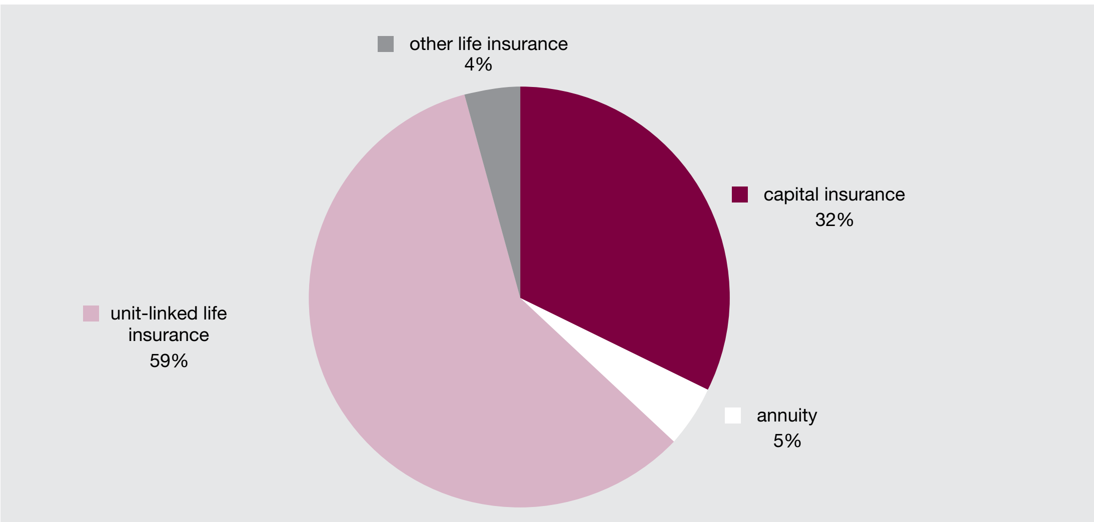

Figure 10. Insurance benefits paid in 2007 by types of life insurance

des a steady inflow of funds. As regards unit-linked life insurance, a decrease in premiums might mean that no further premiums are to be expected and thus, the inflow of funds may decrease and the structure of funds may change significantly. As the share of unit-linked life insurance grows, insurance risk in the portfolio of insurance providers decreases and financial risk increases.

In 2007, 550 million kroons of claims (incl. occurrence of insured event, maturity of policy, cancellation or lapse) were paid to residents, which is 53% more than in 2006. Over a half of that were claims paid by unit-linked life insurance companies (see Figure 10).

Although a loss was recorded for the fourth quarter of 2007, in annual terms life insurance companies earned 118 million kroons of profit in total (20% less than in 2006). The poor results for the fourth quarter were primarily caused by the losses of two life insurance companies with significant market shares. Results of life insurance companies, on the other hand, mostly depended on investment yield and cost efficiency.

The majority of the portfolio of life insurance companies consists of shares and undertakings, bonds and other fixed-income securities. Owing to unfavourable conditions in the securities markets the profitability of investment has been declining since the end of 2006, decreasing to 0.07% in the fourth quarter of 2007 (see Figure 11).

Operating expenses of insurance companies totalled 307 million kroons in 2007, of which 197 million were acquisition costs[1] (year-on-year growth 75%) and 111 million kroons administrative expenses (year-on-year growth 124%). Rapid growth in expenses arose from the establishment of European companies in Estonia and a merger of insurance companies, but apparently also from increased wage pressures on the Estonian labour market.

The volume of equity capital of life insurance companies totalled 890.6 million kroons at the end of 2007, having grown by 29% with the year. Return on equity declined from 22% to 13%, primarily as a result of a substantial decrease in profits.

The required solvency margin of life insurance companies was nearly 217 million kroons in 2007, which is almost twice higher than the indicator for 2006. At the same time, in 2007 the solvency of life insurance companies exceeded the required margin by four times, which means that the amount of available own funds has been constantly growing (see Figure 12).

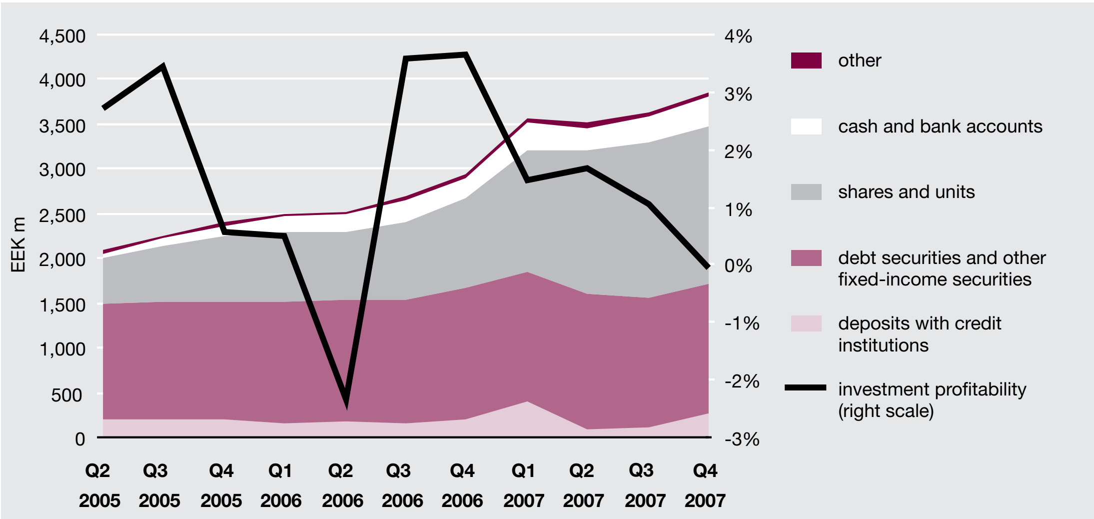

Figure 11. Structure and profitability of life insurance companies' investment

[1] Acquisition costs are costs related to sale, formulation of insurance contracts and product development; their estimated amounts are added to insurance premiums.

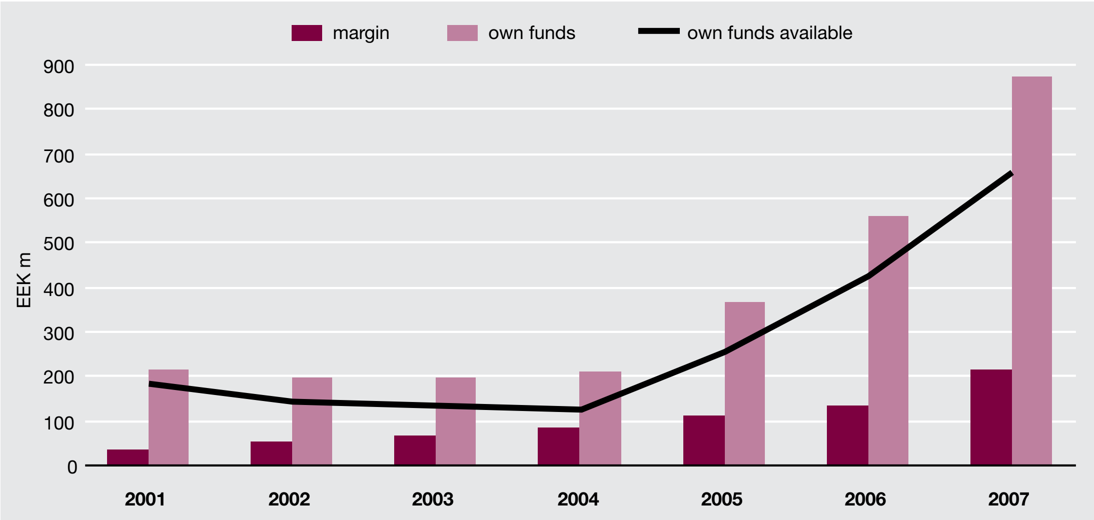

Figure 12. Own funds of life insurance companies and required solvency margin

Source: Financial Supervision Authority

Non-life insurance

In 2007, non-life insurance companies collected 3.6 billion kroons of insurance premiums, which is 15% more than in 2006. In the first quarter of 2008, they collected 949 million kroons – 11% more than in the first quarter of 2007. Benefits paid to residents in 2007 totalled 2 billion kroons (incl. occurrence of insured event, maturity of policy, cancellation or lapse), which is 25% more than in 2006.

As regards types of insurance, the insurance of land vehicles and third party motor liability prevailed (see Figure 13). Growth in the non-life insurance market is primarily facilitated by the compulsory insurance of motor vehicles and housing obtained by loans or leasing. Consequently, if growth in housing loans and car leasing slows, the growth rate of non-life insurance premiums will most probably decrease as well.

The total profit of non-life insurance companies registered in Estonia reached 423 million kroons in 2007, exceeding the figure for 2006 by 10%. The results of non-life insurance companies mainly depend on product prices and cost efficiency.

Estonian non-life insurance market is rather competitive, which hinders adequate pricing. Tight competition keeps prices low in most non-life insurance markets in Europe. Low tariffs, in turn, have influenced the loss ratio[2] of non-life insurance companies, which rose by 7.5% to 64.8% (net) in 2007. However, as the increasing loss rate calls for a more efficient cost management, the expense ratio of non-life insurance companies has been declining steadily. In 2007, the net expense ratio[3] stood at 24.1% (7.9% lower than in 2006). The profitability of insurance companies is characterised by the combined ratio of net expense and loss ratio[4], which

[2] Net loss ratio = (claims incurred, net of reinsurance + change in other technical provisions, net of reinsurance) / (premiums earned net of reinsurance + other technical income net of reinsurance).

[3] Net expense ratio = (net operating expenses + other technical expenses net of reinsurance) / (premiums earned net of reinsurance + other technical income net of reinsurance).

[4] Net combined ratio = net loss ratio + net expense ratio.

rose to 88.9% in 2007. All in all, profitability suffered a decrease (see Figure 14).

The required solvency margin for non-life insurance companies was nearly 618 million kroons in 2007, which is 100 million kroons more than in 2006. Actually, their own funds increased to 2.5 billion kroons with the year and exceeded the margin by four times. The amount of available own funds of non-life insurance companies has also been constantly growing (see Figure 15).[5]

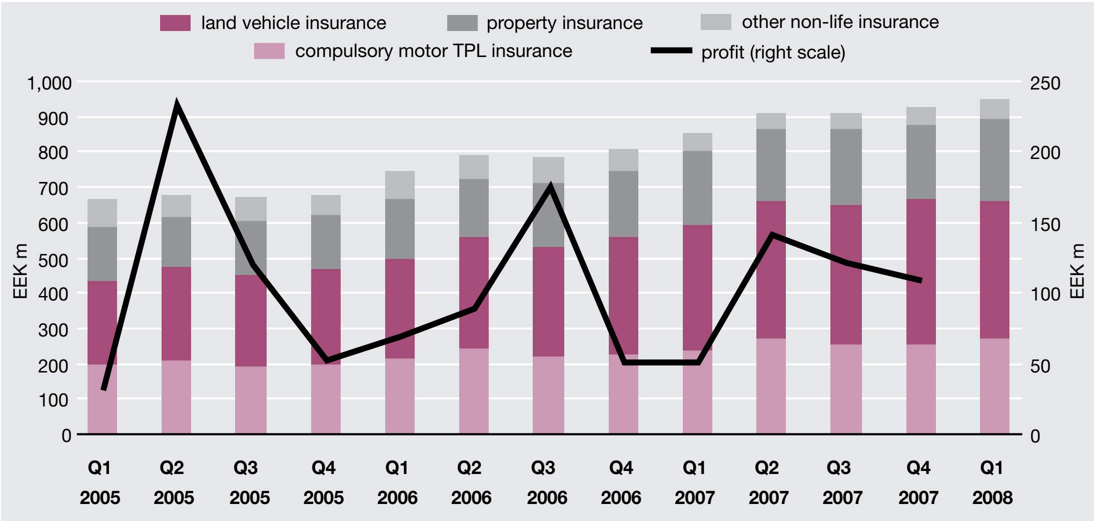

Figure 13. Profit of non-life insurance companies and insurance premiums collected from residents

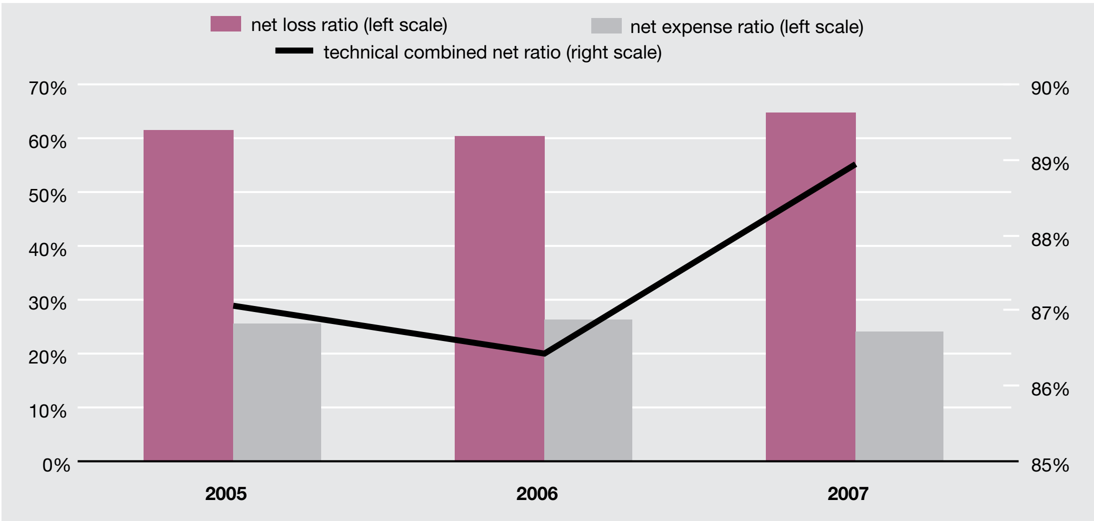

Figure 14. Ratios of non-life insurance companies

[5] Current data does not include the Estonian Traffic Insurance Fund.

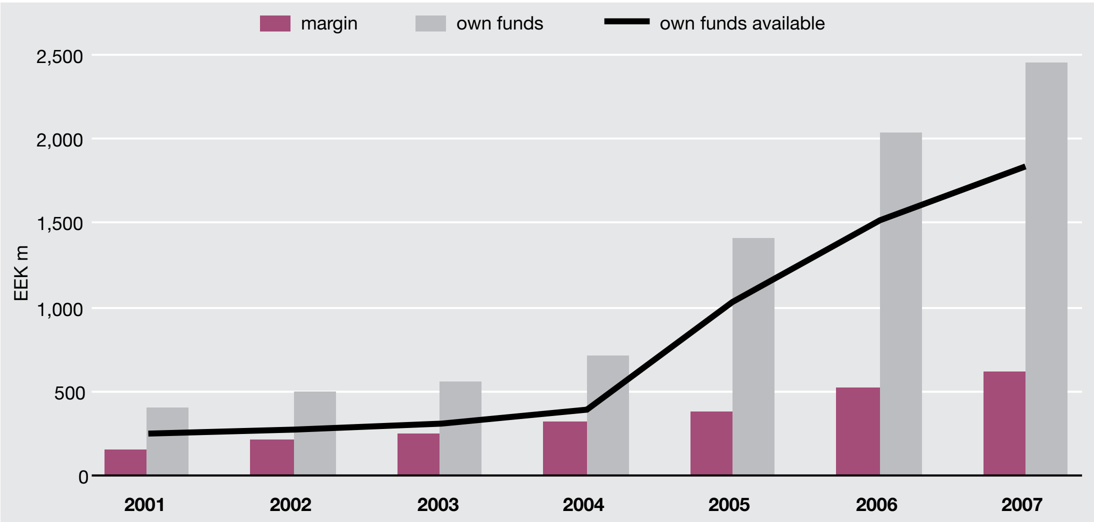

Figure 15. Own funds of non-life insurance companies and required solvency margin

Source: Financial Supervision Authority