IV OTHER FINANCIAL MARKETS

Investment and pension funds

Since the end of March 2008, the **yield** of investment funds has been influenced by the ongoing global credit and liquidity crisis. The crisis has primarily affected the yield of equity funds, which experienced a robust decline (see Figure 1). By the end of September, the yield of equity funds had reached its all-time low; that is nearly -37% as a moving average. The same developments also characterised the yield of hedge funds, which nevertheless remained positive with about 15%. Contrary to riskier funds, the yields of interest and money market funds continued to increase. By the end of September, the average yield of both types of funds exceeded 4.5%. The last time the yield of funds reached so high was 7 and 8.5 years ago in the case of interest funds and money market funds, respectively.

The SEB Liquidity Fund differed from other interest funds with its units being written down by 13%. This was caused by the losses from owning securities of Icelandic financial institutions that encountered major difficulties as a result of the global financial crisis. A few days after informing about the write-down, the management of SEB Pank decided to compensate for the unit holders' losses incurred by the revaluation in order to save the reputation of the SEB Group.

Although the developments on the global financial markets have turned the annual yield of riskier pension funds negative, the value of the funds has increased by an average of 13–25% since their establishment (see Figure 2). The value of the second pillar pension funds is approximately the same as in 2005. Over the years, the funds harbouring a conservative strategy have increased their value by 13%, the funds with a balanced strategy by 17% and the funds with an aggressive strategy by 25%.

Influenced by the events on financial markets, **growth in investment fund assets** started to slow at the beginning of 2008, followed by the start of a decrease in assets in mid-summer (see Figure 3). At the end of September, they stood at the level of end-2006 with 18.3 billion kroons, having lost a quarter of their volume with the year.[1]

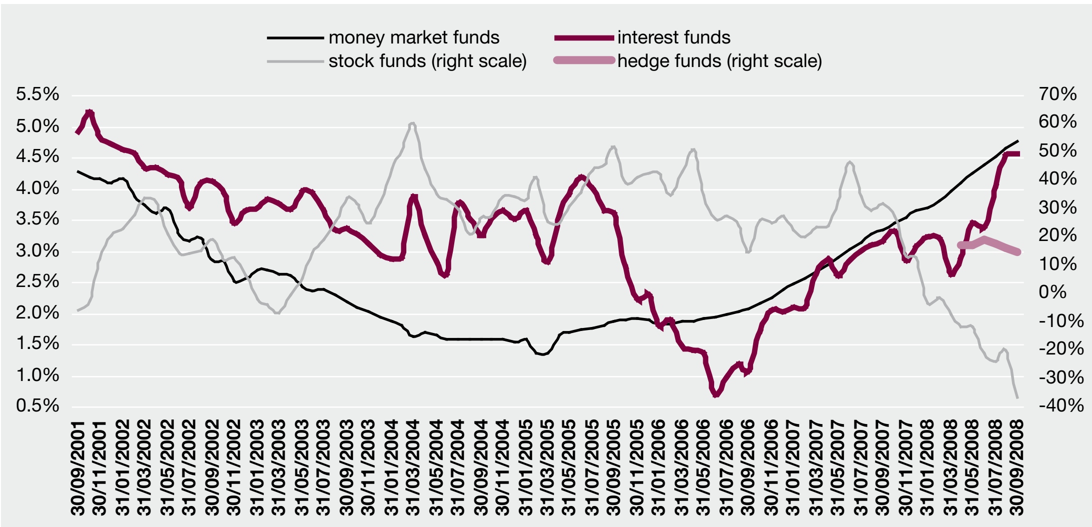

Figure 1. Average annual yield of investment funds at end-month

[1] Owing to changes in investment strategies the SEB Liquidity Fund and the Sampo Liquidity Fund, which used to operate as money market funds, are now operating as interest funds since the beginning of 2008 and October 2006, respectively.

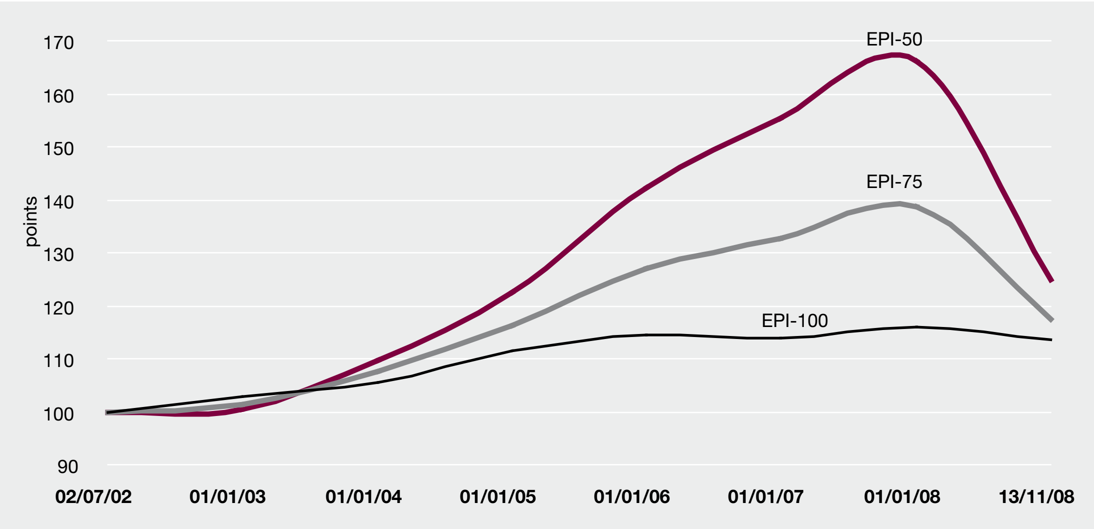

Figure 2. Second-pillar pension fund indices

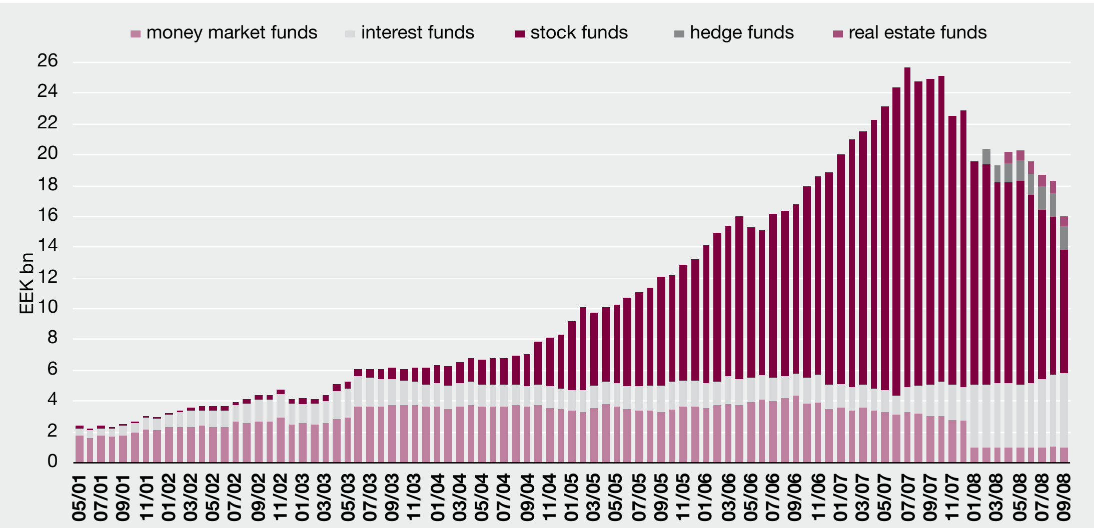

Figure 3. Value of investment fund assets at end-month

The rapid decrease in assets was slightly offset by the market entry of new hedge and real estate funds. They comprised 13% of total investment fund assets at the end of September.

The growth rate of the second pillar funds continued to decline due to the high comparison basis and the shrinking yield, reaching 30% at the end of September (see Figure 4). The total volume of second pillar funds reached 12.9 billion kroons. The total volume of the third pillar exceeded 3 billion kroons. The share of funds in the total third pillar dropped to 32% as a result of a sharp deceleration in the annual growth of assets.

According to imputed estimates, 63% (7 billion kroons) of the year-on-year decline in investment fund assets stemmed from the **decreasing yield of assets**. The rest (that is 37% or approx-

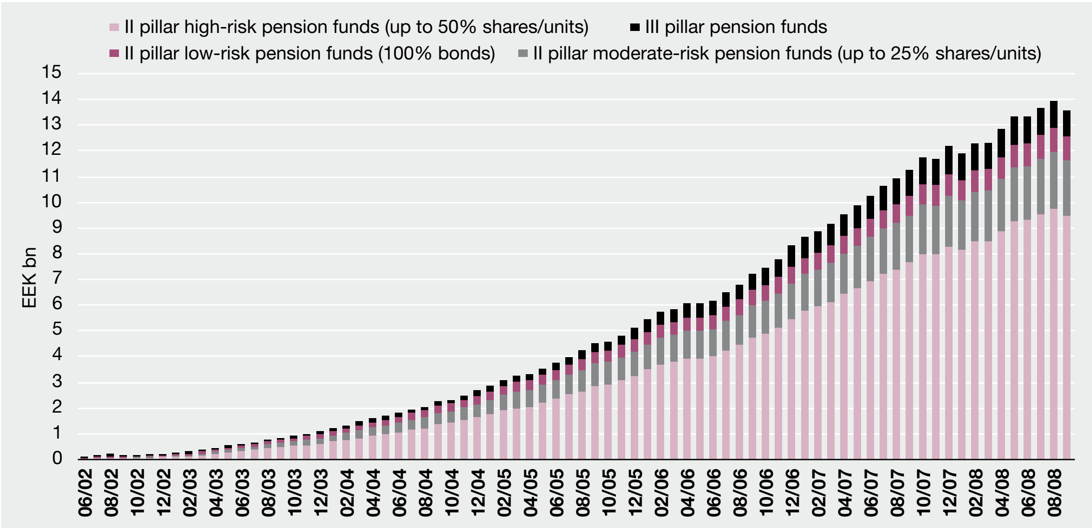

Figure 4. Value of pension fund assets at end-period

imately 4 billion kroons) consisted of capital withdrawn from investment funds. The majority (4.5 billion kroons) of the relocated capital was withdrawn from equity funds, causing their assets to diminish by nearly a quarter with the year. The slight decrease in the assets of money market funds (about 75 million kroons were withdrawn over the year) was somewhat alleviated by the increasing yield of those funds. As a consequence of the relocation of investment only the value of interest fund assets increased, whereas 74% of the increase can be attributed to new capital.

The **share of foreign assets** in fund assets, which had been rising moderately, started to descend again at the end of the fourth quarter of 2007. By end-September 2008, foreign assets comprised about 70% of total assets (see Figure 5). Foreign assets have decreased mainly on account of residents' investment in bonds and deposits. The share of such investment grew from 22% half a year ago to 28% of total fund assets by the end of September. The main reason for investing in Estonia, especially in the deposits of the credit institutions operating in Estonia, is the relatively high interest rate on deposits in Estonian kroon and a comparatively stable income base compared to the highly volatile securities markets.

As regards investing in foreign markets, the popularity of riskier and emerging markets is waning, while focus has shifted towards more stable markets (see Figure 6). For instance, investment in the EU countries has remained at 77% of total foreign investment for the last few years, but the share of the old and more advanced member states has risen to almost 70%. In autumn 2007 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 decreased to 10%. By the end of September 2008, it had risen to 18% and totalled about 5 billion kroons. 14% (708 million kroons) of the capital invested in the Estonian securities market was channelled to the funds of Swedbank (former Hansapank).

In general, the invested capital of the investment and pension funds registered in Estonia to other funds decreased over the last six months (see Figure 7). At the end of September, 90% of the third pillar pension funds and 75% of the second

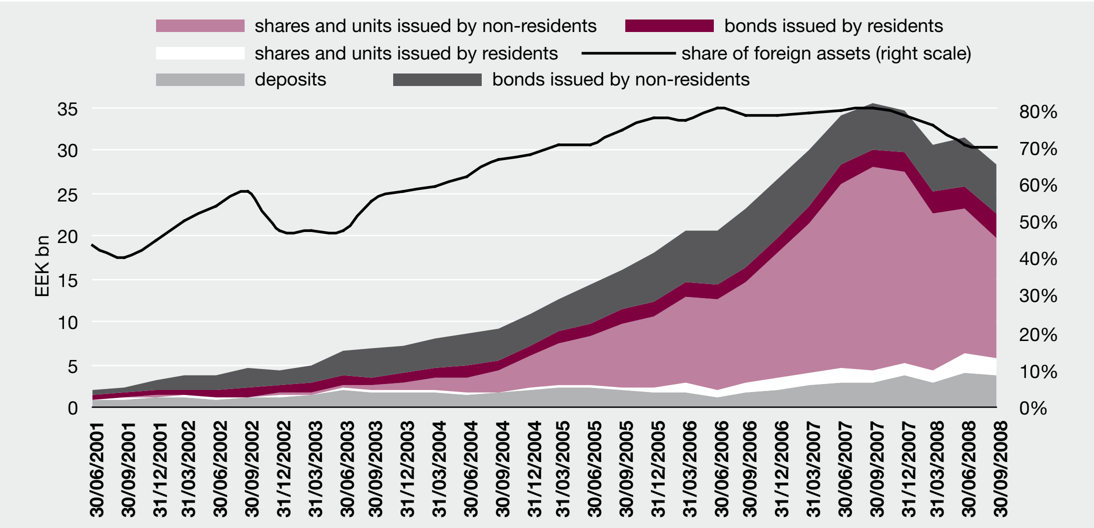

Figure 5. Structure of investment and pension fund assets and the share of foreign assets

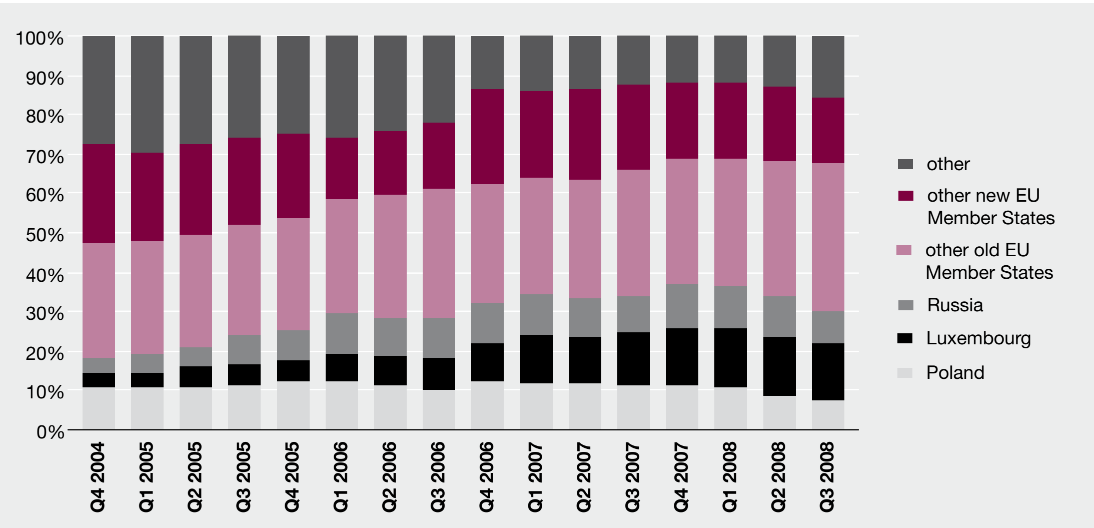

Figure 6. Foreign investment of investment and pension funds by residence at end-period

pillar pension funds had invested in investment fund shares or units. Third pillar pension funds had invested over two thirds and second pillar pension funds 44% of the assets. Over half of the equity and hedge funds had invested in other funds. Meanwhile, the investment made by equity and hedge funds in other funds continued to grow, reaching 21% and 3%, respectively. Interest funds considerably cut their investment in other funds. Money market and real estate funds did not have any shares or units invested to other funds.

Eight new pension funds (four second pillar and four third pillar funds), one equity fund, one interest fund, two hedge funds and three real estate funds entered the market in the last half-year.

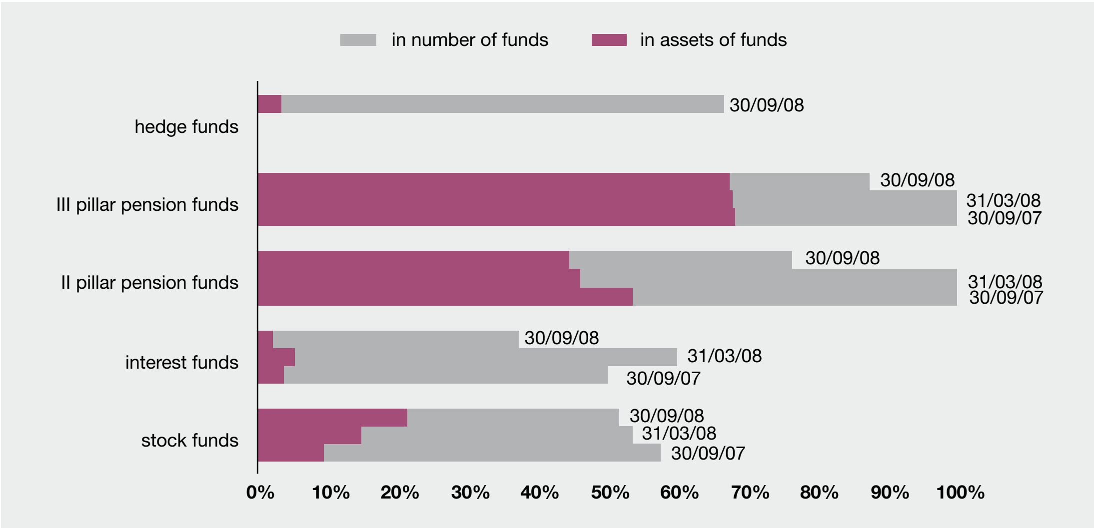

Figure 7. Share of investment funds invested in other funds at end-period

Insurance

The IMF expects the losses stemming from the financial crisis of the global insurance market to amount to 17% of the financial sector's estimated total expenses.[2] In September, the US government rescued the world's largest insurance company AIG in order to avoid an even greater collapse in the financial sector. In October, a small Japanese life insurance company Yamato Life Insurance Co filed for bankruptcy after the failure of alternative investment strategies. So far, the financial crisis has had a limited impact on the European insurance companies, but the persisting turmoil in the financial markets – primarily the dropping stock prices and the shrinking yield of long-term debt securities – is already undermining the creditworthiness and profitability of insurance companies. Currently, the insurance sector is mostly facing technical risks as well as risks related to the decreasing value of the investment portfolio and reputation.

Life insurance

In the first quarter of 2008, the loss of the life insurance companies registered in Estonia totalled 82 million kroons. Along with the slight stabilisation of the financial markets also the profitability of insurance companies improved in the second quarter, posting only a 4.2 million kroon loss. In the third quarter the loss increased again; this time to 75 million kroons (see Figure 8). In conclusion, while the profit earned in the first nine months of 2007 reached 127 million kroons, the loss for the same period in 2008 amounted to 161 million kroons. The poor results have been largely caused by the total losses on investment and the decrease in sales turnover.

968 million kroons[3] of insurance payments were collected in the first nine months of 2008; that is 30% less than in the same period last year. The sales turnover has been adversely affected by the cautious financial behaviour of households. The majority of collected gross premiums are unit-linked life insurance payments, although the life insurance premiums of this type have shrunk by 49% compared to premiums collected in the first nine months of 2007. The sale of unit-linked life insurance has largely been affected also by the insecurity in the stock and securities markets.

[2] "Global Financial Stability Report – Financial Stress and Deleveraging Macrofinancial Implications and Policy", World Economic and Financial Surveys.
[3] Including only the insurance payments paid pursuant to insurance contracts concluded in Estonia.

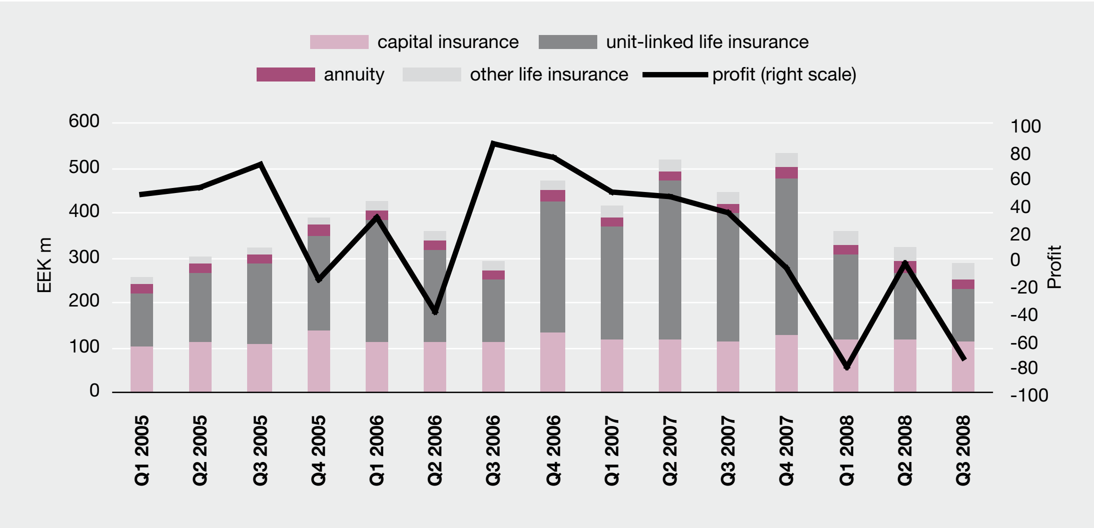

Figure 8. Profits of life insurance companies and gross premiums from residents

Consequently, this year the yield of investment has diminished by 2% on average.

Insurance companies have set a goal to maintain the liquidity of financial instruments when making investment decisions. Only securities with high ratings are obtained to curb the credit risk. Compared to the third quarter of 2007, the share of bonds and other fixed-income securities in the investment structure as well as that of shares and units has dropped. At the same time, time deposits in credit institutions have grown by about 60% (see Figure 9). Currently, banks are offering securer interest income than stock markets. In terms of volume, unit-linked life insurance investment has shrunk by 1.36 billion kroons since the beginning of 2008, comprising 44% of the 7 billion-kroon balance sheet total of life insurance companies in the third quarter.

The number of paid insurance claims has substantially increased over the year, namely 123%. The benefits paid in the second and third quarters of 2008 totalled 503 million kroons; 67.4% of the benefits were unit-linked life insurance payments. The termination rate of insurance contracts has also risen, to 1.7% in the third quarter, especially as regards endowment insurance. A year earlier this indicator stood at 0.95%.

The ratio of operating expenditure to insurance premiums has increased over the year, but this has been caused by a decrease in insurance payments rather than an increase in expenditure. In the third quarter, the expenditure stood at 237 million kroons; conclusion costs totalled 62.1%, administrative costs accounted for 3.6% and claim handling costs for 1.9% of the expenditure. Loss adjustment expenses have increased the most year-on-year (45.7%). Administrative costs have soared by 20%, but their share in total operating expenditure has declined by 1.13%.

The equity capital of insurance companies totalled 809.4 million kroons as at September 30, 2008. The return on equity for the four last quarters stood at -19.7% at the end of September. The first half of 2008 also witnessed a violation of the minimum requirement of own funds, when the own funds of one life insurance company were below 3.2 million euros.

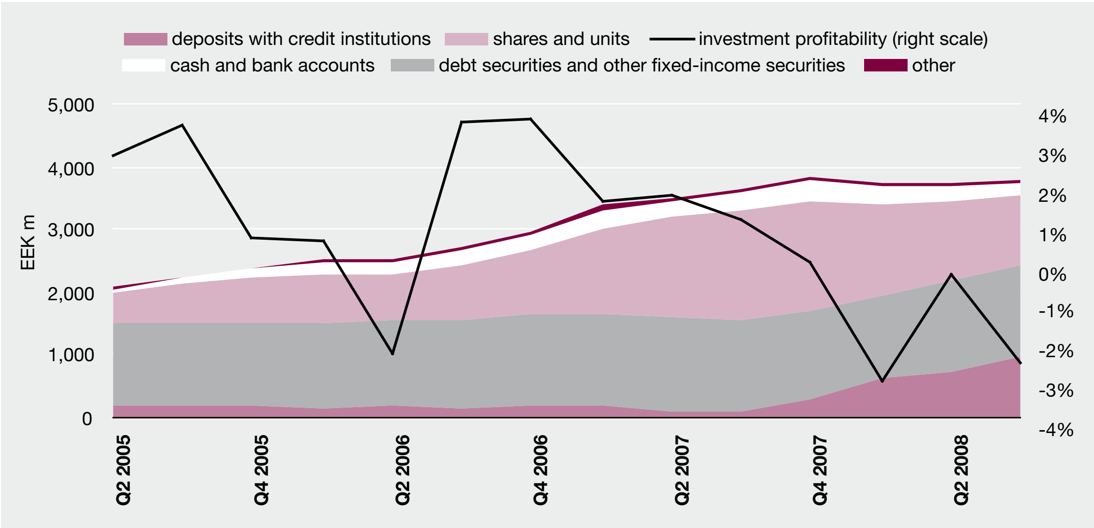

Figure 9. Structure and profitability of life insurance companies' investment

Non-life insurance

The non-life insurance market is expanding in line with the real economy and mainly on account of the compulsory insurance of vehicles and housing purchased by loan or lease. Since economic growth has slowed and domestic consumption has declined, the volume of the gross premiums of non-life insurance companies also shrank in the third quarter of 2008. 952 billion kroons of insurance payments were collected in the third quarter, which is 4.7% less than in the second quarter when the value of payments reached 999 million kroons. In the third quarter, the share of both the third party motor liability and casco insurance in the structure of insurance payments decreased. The share of property insurance, on the other hand, increased by 1.3% (see Figure 10).

The sale of land vehicle insurance grew by only 2.8% owing to tight competition in the non-life insurance market and waning car sales. The number of new cars registered in the first nine months of 2008 was nearly 16% lower than a year ago.

Although gross premiums decreased slightly in the third quarter of 2008, insurance payments have nevertheless grown this year by 6.1% compared to the first nine months of 2007. The profit of non-life insurance companies was 504 million kroons as at September 30, 2008 and exceeded the profit of the same period in 2007 by 61%. Thus, given the current economic situation, the non-life insurance companies operating in Estonia have even been able to improve profitability.

Profits have been stimulated by a decrease in the expense and loss ratio. The latter stood at 23.6% in the third quarter of 2008, being 0.5% lower than nine months ago. More efficient traffic supervision and the dropping traffic intensity along with the past warm winter and the price rise of motor fuel, have reduced the number of traffic accidents by 28% compared to the first nine months of 2007.[4] As a result, the net loss ratio for the first three quarters of 2008 was 60.3%, having declined from the 64.8% registered at the end of 2007.

Although the effects of the economic downturn may appear somewhat later, the profitability of insurance companies should remain high in view of their conservative investment decisions and cost-effective operation.

[4] Source: Road Administration.

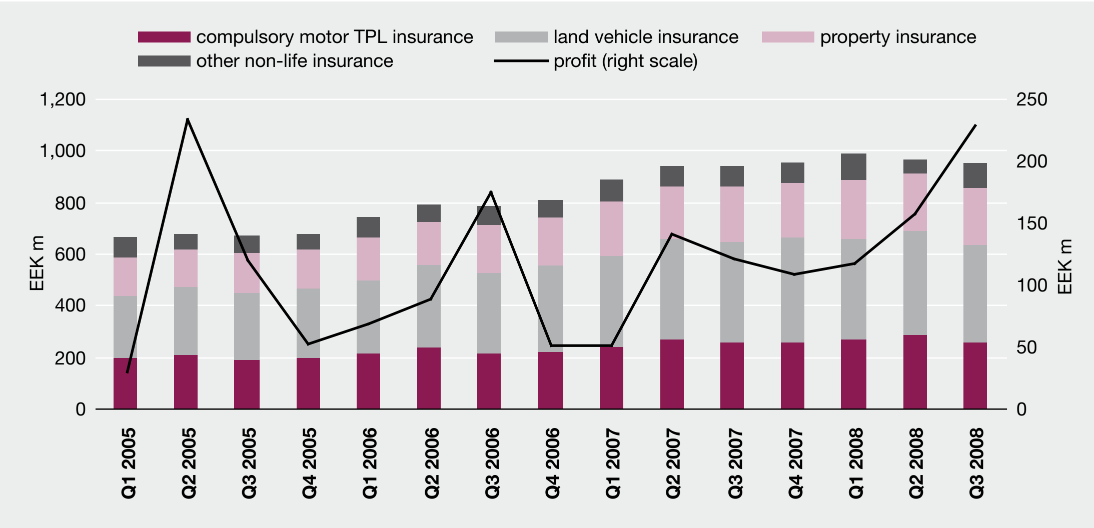

Figure 10. Profit of non-life insurance companies and insurance premiums collected from residents

The volume of investment is growing steadily. At the end of the third quarter, it totalled 4.8 billion kroons and comprised 87% of the balance sheet total of non-life insurance companies. The structure of investment witnessed considerable growth in the share of deposits, which have increased by 86% since end-2007. Investment in debt securities and other fixed-income securities still holds the largest share with 52.5%. The profitability of investment reached the lowest level in the first quarter of 2008 when it became negative (-0.2%). The third-quarter profitability, however, was 0.5% (see Figure 11). Although investment in time deposits earns less interest, the related financial risks are much smaller.

The minimum requirement of own funds was also violated in the non-life insurance market, but the own funds were restored by the end of August after increasing equity capital.

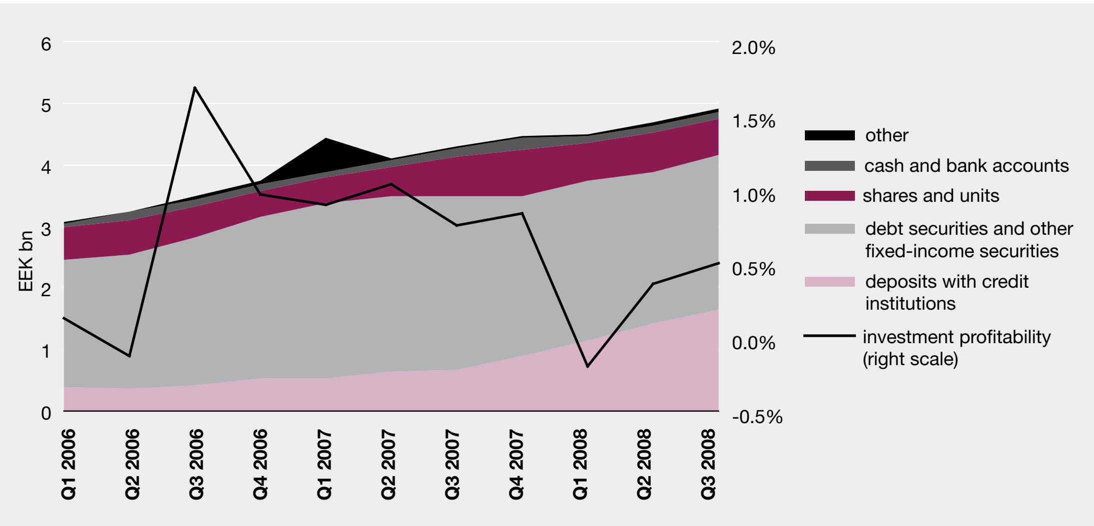

Figure 11. Structure and profitability of non-life insurance companies' investment