SUMMARY

Global financial environment

The uncertainty in financial markets that started off in the US mortgage market at the end of summer 2007 became a **global financial crisis** in autumn 2008. Several US and European financial institutions encountered difficulties as a result of write-downs on trading and credit portfolios. In order to ensure the functioning of financial intermediation in some countries governments decided to nationalise the struggling banks. Some financial institutions were able to continue operating with the support of other market participants. However, Lehman Brothers, one of the major US investment banks, had to end its activity in mid-September. The following sequence of events implied that the financial crisis would be deeper than initially thought.

Owing to the lack of confidence in financial markets, the solvency problems of a few major (incl. international) banks have largely affected **the liquidity of banks and the financing of the non-financial sector**. The lack of trust hit hard the interbank loan market that had been operating efficiently in major financial centres for decades. Furthermore, it became difficult to obtain collateralised financing from the markets and the cost of funding increased for banks. At the beginning of October, the yields of banks' debt securities grew by almost one percentage point. Markets' pessimism and risk awareness are reflected in the significant drop in stock prices. From the beginning of the year until mid-November European and US stock indices plummeted by 65% and 50%, respectively, to the levels recorded in 1995.

In order to alleviate the impacts of the financial crisis on the non-financial economy, various central banks decided to lower the monetary policy interest rates in autumn. Consequently, the euro area **interbank money market interest rates** also started dropping rapidly in mid-October. The six-month Euribor declined below 4% at the end of November, which is 1.5 percentage points lower than the peak reached in October. However, as the confidence in the interbank market has not improved, the Euribor quotations do not adequately reflect the easing of funding conditions for the banking system. This means that even though the pessimistic outlook of the European economy may significantly lower the monetary policy interest rates and money market interest rate quotations in the coming months, the cost of financing need not necessarily decrease that much.

At the onset of the financial crisis, new EU markets with traditional banking systems were considered less vulnerable to the problems hitting major financial centres. At present, funding has become more expensive for all banks that at least to some extent depend on wholesale funding. The current crisis has shown that countries where large and strong international banking groups prevail have been able to cope better with the crisis. Moreover, the home country's responsibility for the efficient and stable functioning of the banking sector often has a broader meaning, as it goes beyond national boundaries. For instance, Sweden's financial stability package for Swedish banking groups has provided additional support to the liquidity of their subsidiaries operating in Estonia.

Financial behaviour of companies and households and their risks

Estonia's economic growth started to slow in the middle of 2007, when the global financial crisis had not fully unfolded yet. As the implications of the crisis on Estonia's major trading partners in Europe might unfold more clearly than expected, it will probably also dampen hopes for a rapid recovery of growth in Estonia. According to the base scenario of the autumn 2008 forecast of Eesti Pank, real GDP growth will shrink by 2.1% in 2009 and grow by 3% in 2010. The negative risk scenario proposes -4.8% and 1.5%, respectively.

The profitability of the **corporate sector** has considerably decreased this year. The decline of profits has primarily been influenced by the significantly weaker sales income growth, which could not be offset on account of cutting expenses. Financial buffers are also shrinking, which may, under difficult economic conditions, start affecting the loan servicing capability of companies.

The growth of corporate debt has decelerated as a result of weakening investment demand. Growth in domestic debt has slowed the most in the real estate sector, but the changed economic environment has actually affected the loan behaviour of all sectors. Domestic borrowing has eased and companies have raised relatively more funds from abroad.

Household confidence reached a historical low at the end of the third quarter of 2008. Household credit growth has slowed significantly, which indicates lower confidence but also more conservative loan terms. In recent months banks have increased the interest margin on new housing loans as well as the minimum down payment. Although the interest burden of households is likely to decrease after the expected decline of the Euribor, the loan servicing capability of households might weaken along with the deterioration of the economy.

The risks of the real **estate market** remain high, as supply is clearly exceeding demand. In the coming years the supply of office space will grow by a third; vacancies are expected to increase primarily in the suburbs. Given the constrained funding environment, housing demand will decrease even further, which may also bring about a fall in housing prices. By the end of October, the price of two-room apartments in Tallinn had shrunk by 25% from record high levels and will probably continue declining.

Banking sector

Difficult times in global markets and the slowdown in credit growth have not caused any major institutional rearrangements in Estonia or changes in market shares. The four major banks belonging to cross-border banking groups still hold over 95% of the credit market. As of June 1, 2008 the former Sampo Pank is operating in Estonia as the Estonian branch of Danske Bank A/S. Consequently, the branches of foreign credit institutions now hold more than 25% of the Estonian credit market.

The weaker growth outlook has inhibited the growth of financing portfolios and undermined the **loan quality** of banks. At the end of October, loans overdue for more than 60 days constituted 2.2% of the loan portfolio. In recent months the share of such loans has stabilised, which may be explained by the fact that banks have engaged into closer cooperation with clients to prevent more loans from becoming overdue. Nevertheless, Eesti Pank expects overdue loans to reach 4–5% of the loan portfolio next year. Nearly half of the overdue loans are covered by provisions.

The **capitalisation** of banks is still high. The average capital adequacy ratio of the banking sector was 18.4% at the end of October. This is about twice higher than the 10% minimum required in Estonia. A **stress test** carried out by Eesti Pank on the basis of its autumn forecast confirms that, provided there are no major setbacks in banks' profitability, the whole banking sector as well as individual banks will be able to fulfil the capital adequacy requirement, even if the next few years will see loan losses.

As credit growth has slowed, banks need less additional resources. Meanwhile, clients' loyalty to credit institutions has suffered at the time of great uncertainty in the market and many customers have changed bank, which was especially the case in autumn. However, banking groups could more or less cope with the slight decrease in deposits by drawing additional funds from parent banks when necessary.

Given the uncertain behaviour of depositors, the 15% reserve requirement for buffering the **liquidity risk** has proved to be useful. As depositors have become more risk sensitive, the possibility that a number of customers would like to reduce their claims to credit institutions can not be fully excluded. Thus, it is important that market participants maintain enough liquid assets to be able to meet the demand of customers.

The liquidity of major banks operating in Estonia largely relies on the ability and will of their parent banks to provide funds. The cost of funds depends on the risk estimates of funding providers with regard to the entire group. In the rapidly changing economic environment it is possible that not all risks have been adequately assessed and might materialise in the case of some groups, entailing a change in the cost of funds for all group members.

The **profitability** of banks has remained high, even though the market situation has became less favourable. In recent periods profitability has been curbed by loan write-downs, unfavourable developments in financial markets and slowing credit growth. On the other hand, cut-down on expenses, sale of assets, one-off incomes from the reduction of the reserves accumulated earlier, and the decrease in contributions to the Guarantee Fund have all contributed to profitability.

Owing to the large share of net interest income in the income structure of local banks, future profitability will be influenced by the cost of new funds obtained. Higher estimates concerning the riskiness of the banking groups operating in Estonia may manifest themselves in higher funding cost. Considering slow credit growth, however, it is difficult to pass the rise in cost fully on to customers. Another factor boosting the cost of funding for banks is the increasing share of time deposits. Meanwhile, markets are awaiting the impact of governments' and central banks' measures to take effect, which should lower the cost of funding.

Future expectations regarding the economy, however, do not lead one to expect that banks' fee and commission incomes will decrease substantially in the near future, even if loan growth decelerates further. Presumably, banks will also be able to cut down on operating costs.

Other financial markets

The primary **bond market** has cooled in the last six months compared to the previous active period. By the end of September 2008, the total bond market capitalisation had dropped to 14 billion kroons, as the value of issues has declined, and comprised 5.2% of GDP. The **Tallinn Stock Exchange** continued the downward trend in the backdrop of the global financial turmoil. The stock market capitalisation on the Tallinn Stock Exchange had plummeted to 26 billion kroons by the end of October, being about 63% smaller than a year ago.

The world-wide crisis has also influenced the performance and assets of the Estonian **investment and pension funds**. It primarily affected the yield of equity funds, which had decreased to the historical low of nearly -37% at the end of September. Over the year, the value of investment fund assets has diminished by a quarter; 63% of that can be attributed to lower yields. Although the developments on the global financial markets have turned the annual yield of riskier pension funds negative, the value of funds has increased by an average of 13–25% since their establishment. The global crisis has had the strongest direct impact on the SEB Liquidity Fund, causing in a write-down of units held in that Fund. However, later SEB Pank incurred the losses instead of the unit holders.

The impact of crisis on **insurance companies** has been modest, but the continuing recession in the securities markets is undermining the profitability of insurance companies. The decline in profits in the life insurance market is above all related to the decreasing yield of investment. Although low investment profitability also affects the profitability of **non-life insurance companies**, the market is still making profit thanks to cost-efficiency and the decrease in the loss ratio.

Payment and settlement systems

There were no such incidents in the operation of the Estonian payment and settlement systems in the past six months that would have threatened the stability of Estonia's financial sector. The volume of transactions processed in the payment and settlement systems increased as a result of the global financial crisis. However, thanks to sufficient buffers the payment and settlement systems experienced no failures that would have triggered the systemic risk in the systems or the financial sector in general.

By now, all major Estonian credit institutions have joined the new payment and settlement system TARGET2-Eesti launched on May 19, 2008. This means that Estonian bank customers now have an alternative to settle express payments in euro. Compared to the previous similar scheme, the number of pan-European euro payments has surged significantly as more and more participants have joined the new system.

The implications of crisis on interbank payment and settlement systems were apparent from mid-September to mid-October. Namely, then the number of interbank transactions increased robustly, credit institutions used the central bank's forex window, and the demand for cash increased.

Assessment of financial stability and risks

The global financial environment deteriorated sharply in autumn 2008. Although restoring financial stability was made the most important economic policy goal by governments all over the world, uncertainty still prevails as to when the financial crisis will start to subside. It is also likely to affect the real economy to a considerable degree and cause financial distress for companies and households throughout Europe. The resulting second-round effects on the solvency of banks and the liquidity of the European banking system are difficult to estimate at present. However, regarding the next year, it remains one of the key risks increasing the uncertainty surrounding future developments in the external financial environment.

The sudden increase in the **liquidity risk** throughout the world this autumn shook the confidence of banks as well as customers. Trust in Estonian banks depends on confidence in their parent banks and other important members of the group. Belonging to strong Nordic banking groups has so far helped the major local banks to hedge the additional liquidity risks specific to Estonia.

Besides strong institutions, also the smooth operation of financial markets is essential to maintain the financing of banks. Considering the liquidity constraints in global financial markets, the Swedish central bank and government adopted several extraordinary measures in autumn to support the liquidity of the local banking system. The positive effect of these measures has spread across borders to the various units of the banking groups and has contributed remarkably to reaffirming confidence in Estonia's financial system.

The Estonian interbank payment and settlement system has been operating smoothly in the past half-year, without causing any additional tensions for market participants. The present high reserve requirement has helped to ensure sufficient settlement buffers for the larger transactions resulting from the global financial crisis.

Estimates to Estonia's macroeconomic developments have become more pessimistic in the past six months, which is why the **credit risk** is also more likely to materialise. As the incomes of companies and households may prove to be considerably smaller, they may experience bigger difficulties with the repayment of debt. The general macroeconomic outlook supports the estimate that the amount of loan losses may increase in the coming years.

So far, loan servicing problems have occurred mostly in the construction and real estate sectors. These sectors have experienced the biggest setbacks in demand and revenue at the current stage of economic decline. Borrowing has become even more complicated for potential loan customers, which is why the recovery of the real estate market might be delayed even if there will be moderate price adjustments. In case liquidity constraints persist, companies with high financial leverage will not be able to meet their debt liabilities. Sell-off pressures may cause a larger than expected decline in the value of loan collaterals, which may result in bigger loan losses for banks.

The indebtedness of the Estonian economy will decrease in the near future. As investment demand has weakened in the current economic cycle, loan demand and the need for external financing are expected to ease soon. Furthermore, banks have become more conservative in granting loans and are applying more adequate risk estimates; that is, higher loan interest margins. However, it is important that the behaviour of banks would not inhibit the financing of good investment projects in the future.

Given that the economic environment has changed rapidly, the profitability of banks has remained quite high, and so has capitalisation. Future profitability is affected by the continuing growth in loan write-downs, although the high rate of provisions for current overdue loans partly alleviates the potential effects of write-downs. The stress test of banks' loan portfolios conducted by Eesti Pank indicated that if banks' profitability will not decrease more than expected, it will suffice as a buffer to cover the estimated loan losses. The expected buffer, drawn on account of profit, will provide additional security to the relatively high level of capitalisation.

In conclusion, until this autumn the impact of the global financial crisis on the Estonian financial sector could be considered relatively modest. The impact has mainly manifested itself in slightly higher funding costs for banks and a price decline on the stock market. **In light of increased uncertainty and tensions in the world, the risks related to the functioning of the Estonian financial system have increased in the past few months.** This especially applies to the liquidity risk of banks because of the liquidity constraints on global financial markets.

As the adjustment of the Estonian economy has been harder than expected, the credit risk is also materialising to a somewhat greater extent than earlier forecasted. **Nevertheless, the liquidity and capitalisation of banks operating in Estonia has remained relatively high even in the volatile market situation, as they are part of strong Nordic banking groups.** The Estonian banking sector has also been supported by various measures adopted to guarantee financial stability, including the central bank's earlier decisions to set higher capital and liquidity requirements for banks. In the conditions of the current global financial crisis, it is necessary to maintain these buffers, should the external and Estonian economic environment or risk estimates regarding individual banks or banking groups deteriorate.