IV OTHER FINANCIAL MARKETS

Investment and pension funds

The shortage of liquidity that emanated from the financial crisis of 2008 influenced the yield of investment funds even more in the last six months (see Figure 1). In autumn the crisis primarily affected the **yield** of high-risk funds, whereas by spring 2009 the yield had dropped regardless of the type of fund. At the end of February, the average yields of all funds (except money market funds) had reached historical lows. In March and April the yield slightly grew, as global financial markets started to ease. The average annual yield of interest funds turned negative for the first time and reached –8.6% at the end of April. The average yield of equity funds and voluntary pension funds stood at –52.6% and –32%. The average annual yield of the money market fund moved in line with the interest rate changes and posted 4.4% at the end of April.

Two of the risk capital funds that entered the market in the first half of 2008 have been liquidated. Currently only the GILD Arbitrage Risk Capital Fund is operating, with an annual yield of 14.58% at end-September. (After September the fair value of the fund is difficult to estimate due to the difficult market situation).

All mandatory pension funds also posted negative average annual yields. In the first quarter of 2009, the average annual yield of conservative and balanced pension funds amounted to –0.4% and –10.3%, respectively, and that of funds with an aggressive strategy reached –20.4%, improving to –14% by April. As the investment strategies have changed and are focused on low-risk markets, that is the old EU Member States, growth in the value of pension funds has stabilised since the beginning of 2009 and started to grow again at the end of the first quarter (see Figure 2). Since the second half of 2002, when the first second pillar funds were created, until mid-May 2009 their value has grown by 13–24% on average.

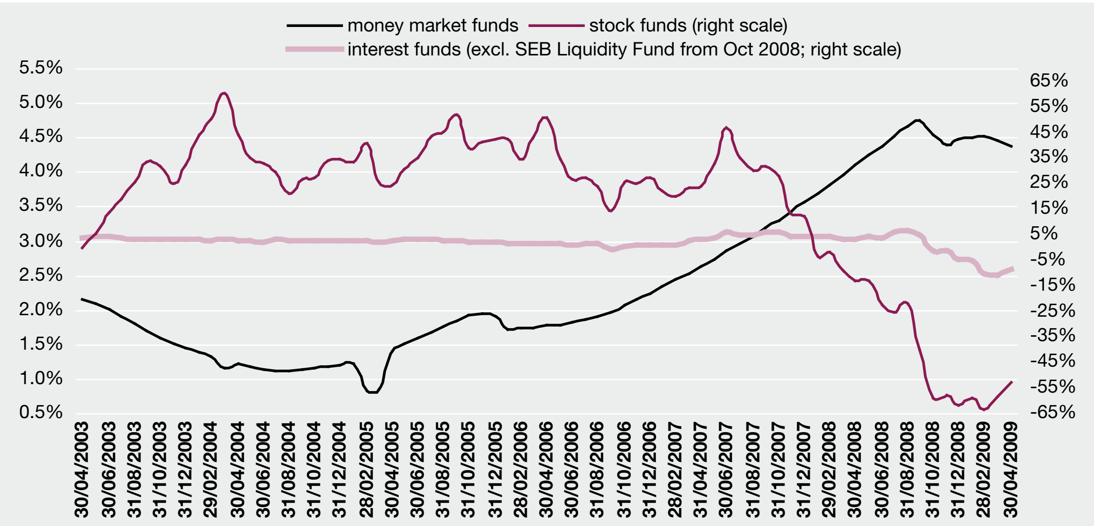

Figure 1. Average annual yield of investment funds at end-month

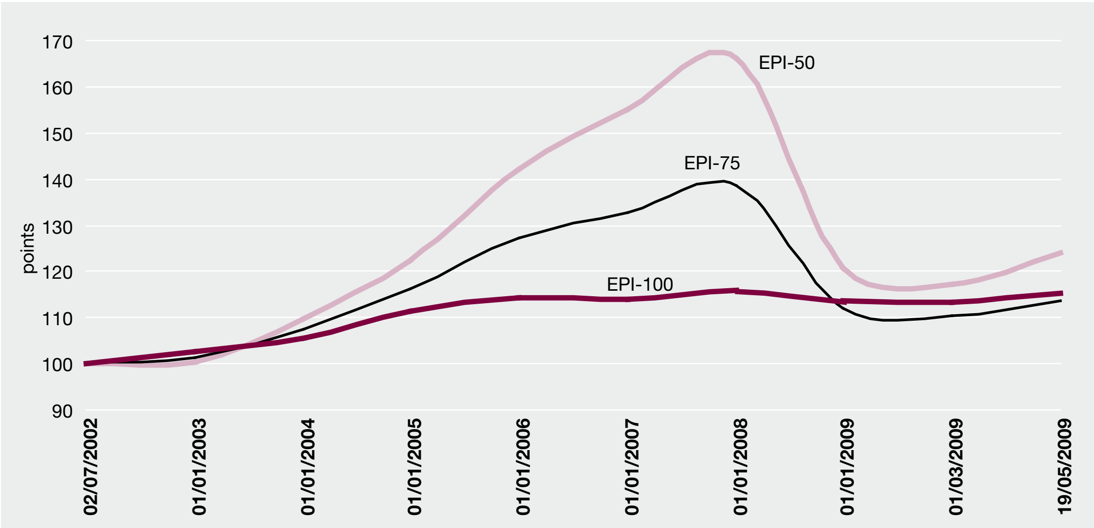

Figure 2. Second-pillar pension fund indices

The assets of investment funds have been shrinking since the summer of 2008. The value of investment fund assets value dropped about 48% in the past two quarters and at the end of March the value had dropped to only 8.3 billion kroons (see Figure 3). Equity funds suffered the most serious setback (60.5%, i.e. 4.9 billion kroons), but also money market and interest funds lost about a half of their value (45.7% and 52.6%, respectively). During the last six months only the assets of real estate funds grew (by 43%), comprising 10.4% of total investment fund assets at the end of March (3.8% in September 2008).

In autumn 2008, also the total stock of mandatory pension fund assets started to decrease owing to the decline in high-risk pension fund assets (see Figure 4). Although at the beginning

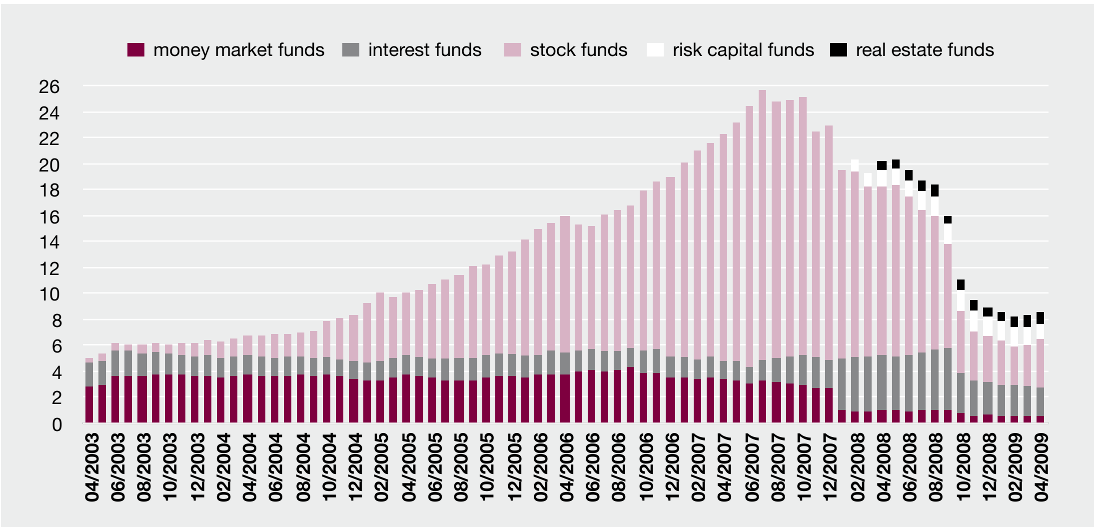

Figure 3. Value of investment fund assets at end-month

of 2009 **asset growth** became positive again, at the end of March their value was still about 500 million kroons lower than half a year ago, posting 12 billion kroons. In April, the stock of the second pillar pension funds grew rapidly, reaching the autumn level again and amounting to 12.8 billion kroons at the end of the month.

As of 1 June 2009, both the state and the indivi-duals terminate their **payments to the mandatory pension funds**, which will entail a significant slowdown in the growth of pension fund assets during the following year-and-a-half. Further developments depend on whether individuals wish to continue the payments as of the beginning of 2010 or wait until 2011 when also the state resumes payments in half (1% is paid by the individual and 2% by the state). The payments to the second pillar pension funds will be fully restored as of 2012.

The total assets of the voluntary pension funds have diminished slightly over the last six months. At the beginning of 2009, the third pillar funds totalled approximately 2.8 billion kroons and their share in the total assets of funds dropped to 29%.

According to rough estimates, the total stock of investment and pension fund assets diminished year-on-year, mainly as a result of a decrease in annual yield. Most of it was caused by a decline in the assets of equity funds, nearly 77% (7.6 billion kroons) of which can be attributed to the shrinking yield. As for the interest funds, on the other hand, the majority of the decrease (79%, i.e. 1.5 billion kroons) was caused by the outflow of funds, mainly capital withdrawals from the SEB Liquidity Fund. The annual yield of Swedbank's money market fund generally followed a positive trend during the year, whereas in the past six months the outflow of funds exceeded yield growth and assets decreased by 406 million kroons.

The share of **foreign assets** in total investment and pension fund assets declined further in the last six months (see Figure 5). At the end of the first quarter of 2009, the share of foreign assets had dropped to the level of end-2004 (65.1%). This occurred primarily as a result of a 38% decrease in non-residents' investments in the shares and other equities. Funds' investment in domestic securities and deposits comprised about 31.8% of total assets.

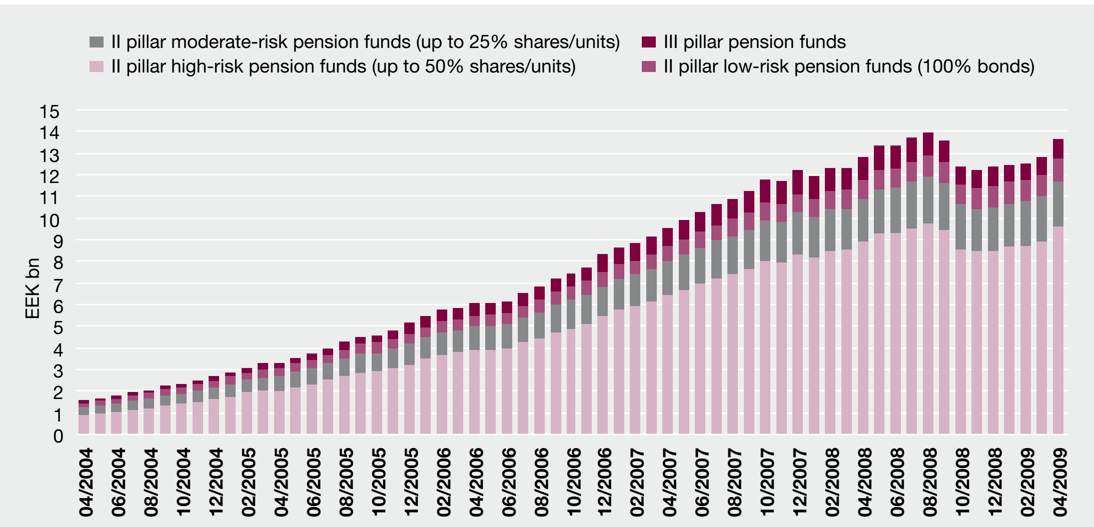

Figure 4. Value of pension fund assets at end-period

In spring 2009, investment in the European Union accounted for 84% of total investment in foreign markets, 75% of which were channelled to developed EU Member States (see Figure 6). Investment in France increased considerably in the last quarters (to 14%), whereas investment in Russia diminished (to 4%). Increased investment in old Member States reflects changes in the investment strategies that occurred already in mid-2008, and laid the focus on more stable markets rather than riskier ones.

The number of investment and pension funds registered in Estonia and the investment to other funds has not changed significantly in the last six months. Second and third pillar pension funds still make relatively more investment in other funds, whereas money market and interest funds do not own any shares or units of other funds.

Nine new investment funds entered the market in the last six months: one equity fund, one real estate fund, three mandatory pension funds and four voluntary pension funds.

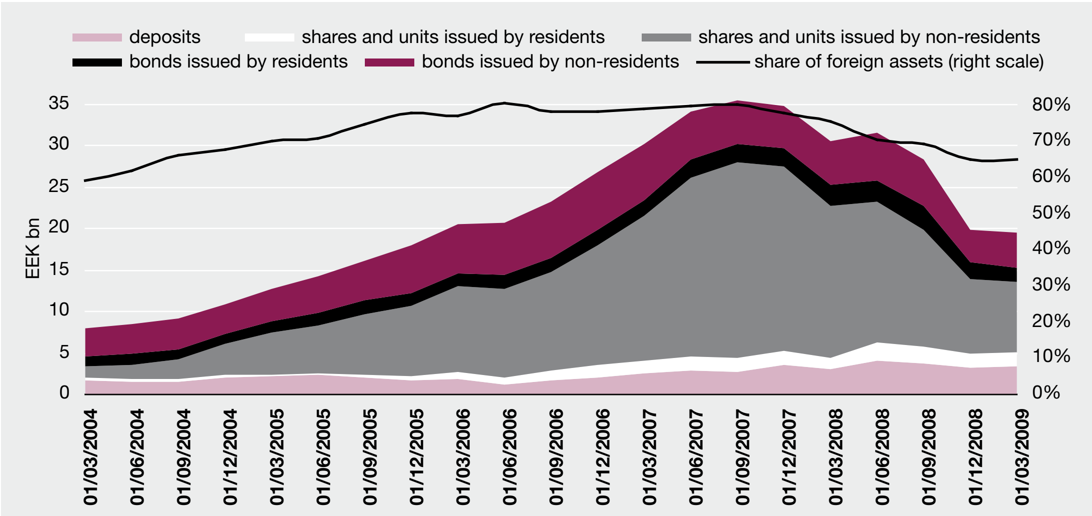

Figure 5. Structure of investment and pension fund assets and the share of foreign assets

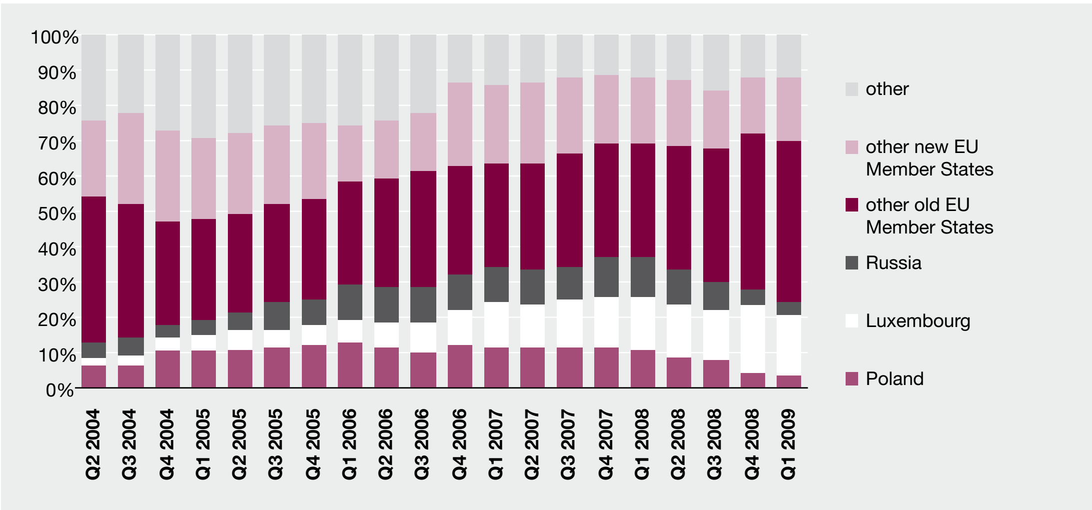

Figure 6. Foreign investment of investment and pension funds by residency at end-period

Insurance

Conservative investment policy has protected the insurance sector from the worst but the year 2008 was still pivotal. The amount of insurance premiums decreased significantly, the number of new contracts shrank compared to 2007, whereas the number of cancelled contracts grew. As financial markets suffered from a decrease in the rate of return, insurance companies gained losses on their investment portfolios, and the tightening competition in the insurance market added extra pressure on their economic results. The near-term outlook for the European insurance market is still negative; however, it is believed that insurance does not cause such systematic risk as the banking sector.

In 2008, preparations were started for making mandatory funded pension payments as of 1 January 2009. According to the Funded Pensions Act, persons who have acquired units of a mandatory pension fund and have reached the pensionable age can conclude a pension contract with an insurer who deals in life insurance. Under this contract, the insurance undertaking will pay a person a lifetime pension irrespective of the length of person's life. The options of making second-pillar funded pension payments depend on the value of a pension account belonging to a person of pensionable age. If the value of the pension account is 50 or more times the national pension rate, that is over 95,657 kroons, the person must sign a pension contract with a life insurer in order to get regular payments until the end of his/her life. If the value of the pension account is below 50 times the national pension rate, the person is entitled to regular payments straight from the pension fund; if the value of the pension account is 10 times the national pension rate or less, the person has the right to withdraw the total amount as a single payment.

Life insurance

During the last year, the development of the life insurance market has been mainly influenced by people's increased uncertainty about the developments of the coming years, which is why more liquid investments are preferred to life insurance as regards saving. People's choices are affected by differences in the profitability of financial products and the generally waning interest in life insurance.

The **amount of insurance premiums** in the life insurance sector had been growing steadily for seven years but decreased 33% last year, when the premiums collected by life insurers registered in Estonia totalled only 1.3 billion kroons. In the first quarter of 2009, the volume of collected premiums was 238 million kroons, which is approximately as much as in 2004 (see Figure 7). Most of them were still unit-linked life insurance premiums and capital insurance premiums (83% in total), but since the fourth quarter of 2008 the percentage of these premiums has changed in favour of the latter. Comparing the life insurance premiums collected in the first quarter of 2009 to last year's figures, only insurance on death (including loan insurance) has increased remarkably (31%). Loan insurance is focused on loan risk management and is most often bought in connection with housing loan contracts. Although growth in the housing market has slowed, the coverage of the current loan portfolio by life insurance contracts has increased.

Last year, life insurance companies concluded altogether 90,737 new insurance contracts (97,099 in 2007)[1], whereas the number of cancelled contracts doubled. The cancellation rate of main contracts increased to 2.8% after the first quarter of 2009; as expected, the number of cancelled unit-linked life insurance contracts was the highest.

[1] Including life insurance contracts concluded with non-residents.

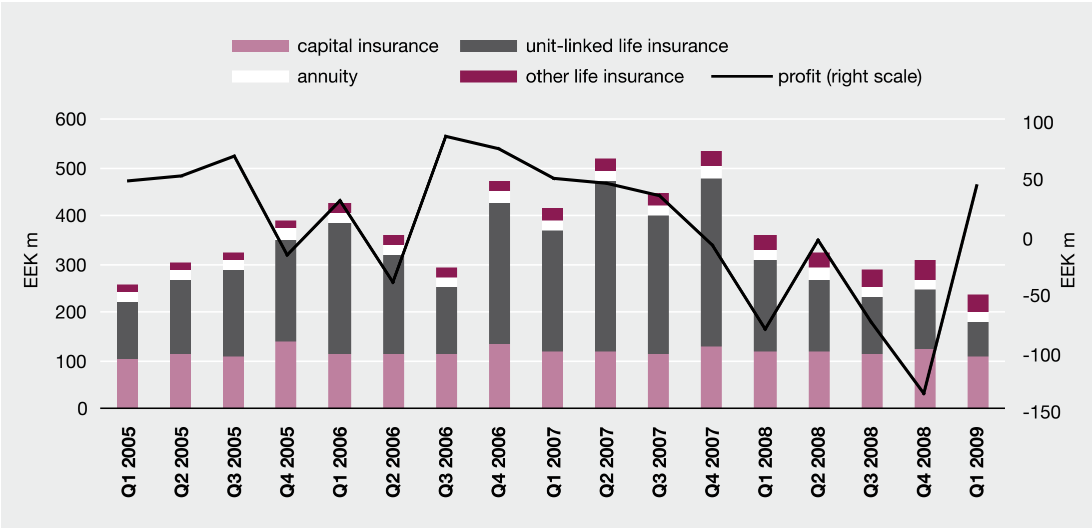

Figure 7. Profits of life insurance companies and gross premiums from residents

In 2008, the amount of **indemnities paid** to Estonian residents (1.1 billion kroons) increased 101% compared to 2007. Such a large amount of payments was due to the cancellation of unit-linked life insurance contracts or just because of withdrawal of money from investment funds in order to protect one's investment from the slump in global stock markets. The data for the first three months of 2009 show that payments of unit-linked products have already decreased 38% in just one quarter.

In 2008, the earlier profitability enjoyed by life insurers was replaced by a 298 million **loss**. However, in the first three months of 2009, undertakings again managed to earn 42 million kroons of profit. Their economic results have been adversely affected mainly by a 317 million kroon loss on investment. Throughout the year, a lot of effort was put into the management of investment portfolio in order to guarantee the highest possible security and profitability, yet the investment risk still remained high. The share of stocks – the riskiest assets – has been considerably reduced by shifting funds into European government bonds and time deposits (see Figure 8).

At the end of 2008, the **equity capital** of life insurance companies totalled 671 million kroons, which is 24% less than in the previous year. Return on equity decreased even further as a result of losses in the insurance sector, falling from 13% to –44%.

The amount of available solvency margin of insurance companies has decreased too. At the end of 2008, the required solvency margin for life insurance undertakings was 245 million kroons, whereas they exceeded the margin by 2.7 times (by 4 times in 2007). Year-on-year, the amount of available solvency margin has shrunk 40%. Nevertheless, in 2008 all insurance companies complied with the requirements for committed assets and own funds as set out in the Insurance Activities Act.

Non-life insurance

While the downward trend of life insurance figures was apparent already a year ago, at this point also the sales of non-life insurance policies have gone down. In 2008, the non-life insurance undertakings operating in the Estonian market collected 4.2 billion kroons of **insurance premiums** in total, which is approximately 11% more than in

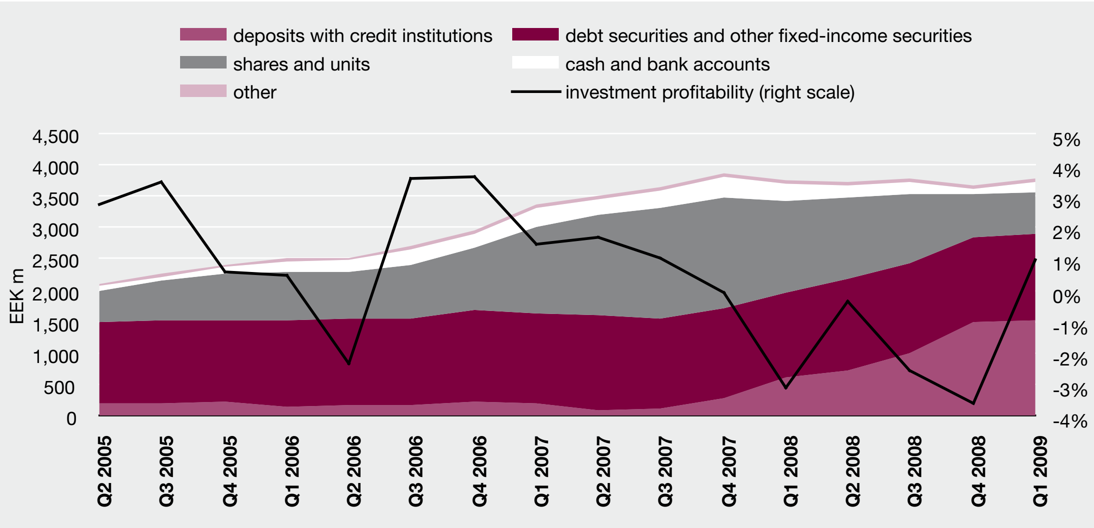

Figure 8. Structure and profitability of life insurance companies' investment

2007 (see Figure 9). The increase in premiums is mostly related to the increase in the market share of foreign branches. At the end of the first quarter of 2009, the branches accounted for 13% of the market (7% in the first quarter of 2008). The quarterly sales of non-life insurance undertakings has decreased on average 5% already from the third quarter of 2008; in the first quarter of 2009, non-life insurance companies collected 854 million kroons of premiums in total.

The volume and structure of **indemnity** payments did not change much in 2008: the insurance companies operating in Estonia made payments in the amount of 2.4 billion kroons, the majority of which were claims for the insurance compensation of land vehicle damage.

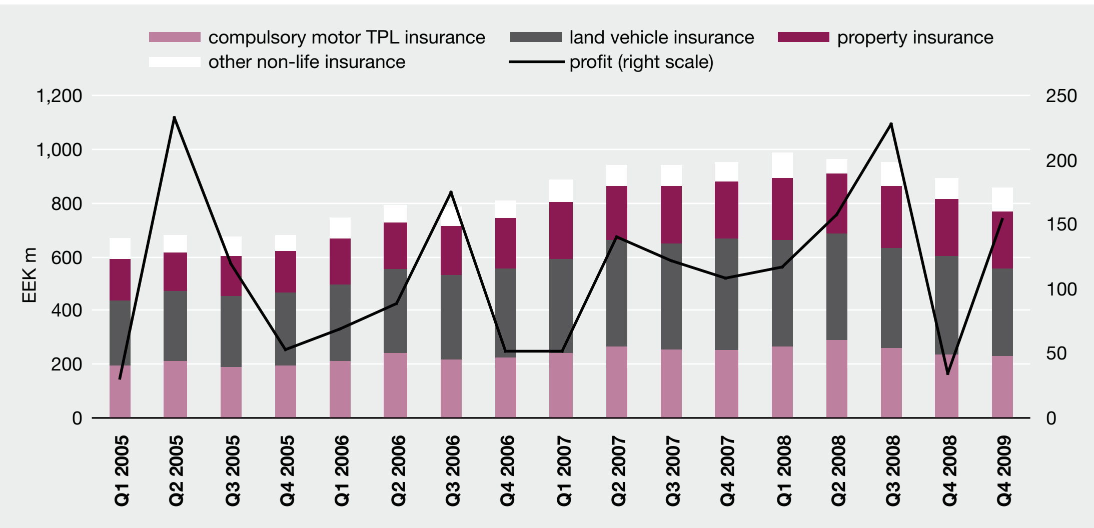

Figure 9. Profit of non-life insurance companies and insurance premiums collected from residents

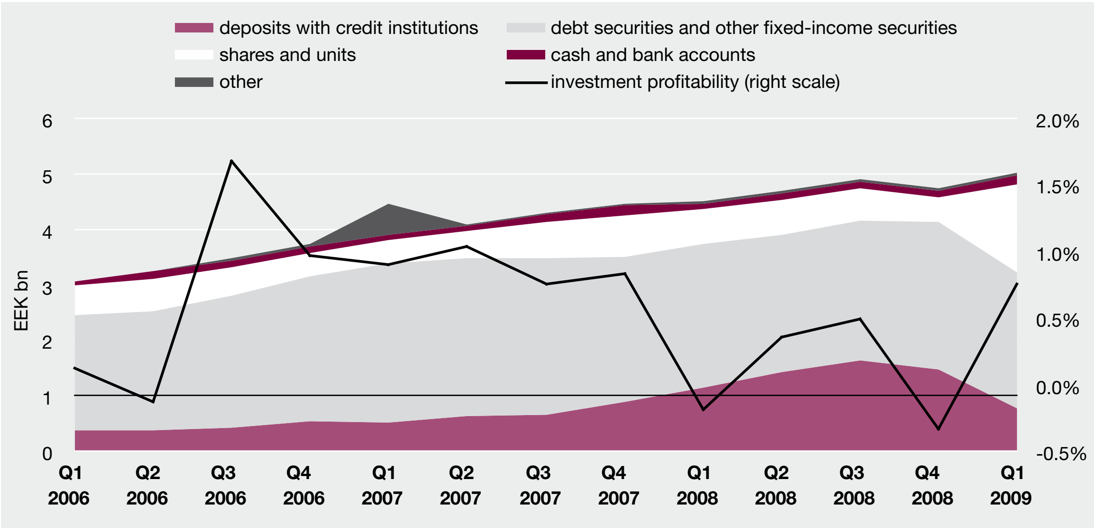

Figure 10. Structure and profitability of non-life insurers' investment

Unlike in the life insurance sector, in 2008 the **profitability** in the non-life insurance market (538 million kroons) was 27% higher than in 2007, although annual growth in insurance premiums was considerably more modest than in previous years or even negative due to low economic activity. Profitability was supported by sufficient diversity of invested assets, positive rate of return and decrease in the loss and expense ratios. Although in the last quarter of 2008 insurance companies earned only 34 million kroons of profit, the profits for the first quarter of 2009 were 119 million kroons bigger.

The structure of investment has changed considerably this year. At the end of 2008 insurers had deposited 1.5 billion kroons in banks, whereas in the first quarter of 2009 the deposits decreased 48%. The amount of stocks and units in the investment portfolio experienced a considerable increase: from 437 million kroons in the fourth quarter of 2008 to 1,602 million kroons in the first quarter of 2009. This was related to the restructuring of two major insurers in the Baltic States. The rate of return on investment in the first quarter was still modest, reaching only 0.75% (see Figure 10).

In 2008, the **required solvency margin** for non-life insurance undertakings was 634 million kroons, having increased only 2.6% year-on-year. The solvency margin increased 22% over the year and amounted to almost 3 billion kroons. The available solvency margin increased by 477 million kroons.[2] Thus, the capitalisation of non-life insurance undertakings is still high.

Considering the cooling of the real economy, the low of the insurance market is likely to continue because the economic environment generally affects the insurance sector with a lag. The life insurance market has already declined to the level of 2004 but a further fall cannot be ruled out either. Since household incomes and corporate earnings have decreased and loan and leasing market activity has waned, the market trend of non-life insurance remains in decline. The improvement of economic performance primarily depends on the ability of insurers to respond rapidly to changes in the economy, maintain good customer relations and sound cost management.

[2] In 2007, the minimum requirement to solvency margin increased to 3.2 million euros, which is why the amount of the available solvency margin for 2007 has been adjusted.