FINANCIAL STABILITY ASSESSMENT

Financial markets

The sovereign debt problems in some euro area countries have continued to worsen, and consequently, the debt crisis in some euro area countries has remained to be Estonia's main external risk. While coordinated international efforts eased the tension somewhat in the financial markets in the summer and early autumn, the debt and banking crisis in Ireland in November brought a new wave of mistrust. Efforts have been made to solve the debt crisis, but despite this the international financial environment has failed to achieve the level of stability that it needs. Looking ahead, a further deepening or widening of the debt crisis cannot be ruled out, and if this happens, it could damage the economic recovery, and hurt the financial markets in countries that have been untouched by the debt crisis thus far.

Differences in the growth outlook and in the banking sector performance have increased in European countries over the last few months. Financial and political steps at an EU level must thus be designed so that they consider their different impacts in different countries. On the one hand, there is a need to provide sufficient liquidity and capital support to countries facing a debt and financial crisis, so as to avoid a further spread of systemic risk, but on the other hand, there is a risk that low interest rates facilitate excessive risk-taking or the creation of price bubbles.

Securities market yields have remained highly volatile against the backdrop of instability in the international economic and financial environment, affecting directly the value of the financial assets of Estonian financial intermediaries and the non-financial sector. Even though, as a rule, price movements on the Estonian stock market follow global trends, the risk level of the local securities market is raised further by problems stemming from the size of the market.

Due to the better budget positions and strong financial sectors, the Nordic countries are deemed to be less risky by the financial markets. This positive differentiation has gained further momentum in the last six months. The banks' funding situation has improved, encouraging the governments and central banks of the Nordic countries to adopt exit strategies for their stimulus measures. On the other hand, interest rates, which have remained at a low level for quite some time, add to the long-term risks in the region. Sweden, for instance, has witnessed quite a significant price hike in the real estate market and a rise in the debt level of households over the last year. If the prevailing market trends and conditions change, this could trigger a price correction, adding to the refinancing risk for mortgage lending dependent banks.

The real economy and loan quality

Growth in external demand in 2010 laid a good foundation for an increase in economic activity in Estonia, coupled with an improved confidence of Estonian companies and consumers. This is reflected, above all, in increases in corporate revenues and profits, along with a reversal of the drop in retail sales volumes. The recovery of domestic demand may well boost the economy further next year, when, alongside consumption, the demand for investments is expected to show moderate growth. Stable and balanced economic growth is crucial for solving the structural problems caused by a deep recession, including reducing the risks to financial stability.

In the summer of 2010, the euro area money market rates, which serve as the reference for a majority of Estonian loan agreements, began to rise. Since any further rise in key interest rates is expected to be relatively modest, the negative impact on the loan repayment ability of Estonian borrowers will remain fairly small. Unrealised credit risk problems may still arise, above all in the private loan portfolio. The labour market is seeing sluggish recovery, and the real income of paid labour is still decreasing due to consumer price hikes. For the banking sector, a bust real estate market still hides a potential credit risk, affecting the value of collateral and thus setting limits on the financial behaviour of borrowers.

The banks' credit risk may also be affected by the Debt Restructuring and Debt Protection Act, scheduled to enter into force in April 2011, which will give private persons the option of restructuring their debt obligations in court. The new law is not expected to add significantly to the credit risk, as the banks have already been restructuring the loan agreements of private persons and allowing them grace periods in order to prevent major loan losses. At the same time, we cannot rule out the possibility of banks wishing to eliminate any chance of a negative impact from the new law and consequently tightening their loan conditions, including raising the borrower's risk premium or the interest margin.

Most likely, the decline in the quality of the banks' loan portfolios was reversed in the third quarter of 2010. Even though next year will see more overdue loans, we expect more borrowers to be able to restore their loan repayment ability as economic conditions improve. At the same time, more and more uncollectible loans that have previously been written down will be written off by the banks. Eesti Pank expects that the share of loans overdue for more than 60 days will decrease to 5% by the end of 2011, being still considerably higher than would be customary in a stable economic environment.

The strength of financial institutions

Banks have been conservative in their expectation of the realisation of credit risks in previous periods. The level of write-downs has thus remained high, against a backdrop of impending loan losses. With a decrease in the numbers of overdue loans, the banks have started to reduce their provisions, as expected. The improvement in loan quality will also be the key factor in ensuring growth in profitability and capitalisation in the coming year.

In addition to a reduction of provisions, the banks' profitability in the coming year will also be fuelled by the expected increase in net interest income, which will be achieved, above all, as a consequence of a rise in EURIBOR and the decrease of interest expenses as a result of changes in the structure of the resources involved. Fuelled by improved risk assessments, the banks' operating environment, which will change with the adoption of the euro, will have a strong positive effect on the banks' future profitability, covering the minor fall in revenue from payment services, currency exchange and conversion. The banks' revenues will also be curtailed next year by the increase in contributions to the Deposit Guarantee Fund as a consequence of accelerated growth in deposits and a rise in the maximum amount of compensation for guaranteed deposits to 100,000 euros.

The capitalisation of the Estonian banking sector has remained good. A majority of the banks are able to cover the current 10% minimum capital adequacy requirement with their own Tier 1 funds. As Eesti Pank is not expecting a significant increase in the risk assets of banks next year, their profitability, which will improve as there are fewer write-downs, will support the growth in capitalisation. Even in a negative risk scenario, the banks' existing buffers are sufficient to cover the foreseeable risks.

Accession to the euro area will add somewhat to the liquidity and operational risk of the Estonian banking sector. Adapting to the principles of the Eurosystem's monetary policy operational framework will bring major changes in how banks' organise their liquidity management, as up to now the minimum reserve requirement has played a role of a liquidity buffer. The lowering of the minimum reserves will add to the risks of miscalculation in liquidity management. It is therefore crucial that liquidity management in the group level would be as smooth as possible, and would consider the liquidity risks in the Estonian market. Even though changes always involve a degree of uncertainty, participation in the euro area monetary policy framework will significantly enhance liquidity management opportunities in the Estonian banking sector, which, in turn, will reduce the liquidity risk of the entire system.

Settlement systems

Like the risks of the banking sector, the main risks associated with the functioning of the settlement systems are related to the reduction of the minimum reserve requirement. The liquidity buffer will decrease and the assets kept with the central bank may occasionally prove insufficient for conducting payments. This will give rise to short-term operational risks, as active liquidity management with the aim of preventing a settlement deficit is new to the banks participating in the system. Maintaining a sufficient liquidity buffer will remain the banks' principal measure for ensuring smooth settlements, the latter is especially true for small domestic banks with a volatile settlement turnover.

Estonian settlement systems are in compliance with the Eurosystem requirements. In 2010, Eesti Pank worked with the European System of Central Banks to evaluate the securities settlement system administered by the Estonian Central Register of Securities (ECRS), focusing on evaluation of the monetary-policy transactions guaranteed by securities. The ECRS securities settlement system was deemed to be eligible for the Eurosystem for the settlement of receivables and liabilities arising from monetary-policy and intraday credit offer transactions. Despite the positive assessment, the ECRS system cannot be used for Eurosystem credit transactions, as the ECRS has not registered any securities suitable as collateral for the Eurosystem credit transactions. Eesti Pank therefore applied for a derogation from the Eurosystem, offering a solution which uses international CSDs for settlement.

TARGET2-Estonia has been operating as a component of TARGET2 since May 2008 in compliance with international requirements. Several Estonian commercial banks have been members of TARGET2-Estonia ever since its establishment, with the remaining banks joining up by the beginning of 2011.

Summary

Overall, Estonia's financial stability has not deteriorated in the last six months. Nevertheless, the risk factors are changing.

As regards domestic risks, the credit risk associated with Estonian households and companies is gradually diminishing as a result of an improved outlook for economic growth. Loan quality is expected to improve in the coming year, along with the increasing profitability of banks, facilitating capitalisation growth of the banking sector. Full euro area membership increases Estonia's credibility and will have a positive effect on the overall environment of the financial sector. However, the liquidity and operational risks related to the adoption of the Eurosystem's operational framework for monetary policy are somewhat greater during the next six months. Above all, these risks stem from a lack of experience of the new framework. The risks are reduced by the Estonian banks' access to the Eurosystem's monetary-policy operations.

As regards external risks, tensions are still high on the international financial markets. For the Estonian financial sector, these risks have been cushioned, as our major banks belong to Nordic banking groups, which have been less affected by recent events. At the same time, there is a danger of a further deterioration of the external environment, which could weaken the functioning of the financial markets and hit the economic recovery in Europe, including the Nordic countries and Estonia.