II. REAL ECONOMY AND LOAN QUALITY

CREDIT PORTFOLIO OF BANKS[1]

At the end of February 2011, the credit portfolio of banks totalled 16.3 billion euros. Loans make up over 90% of the credit portfolio, with leases and factoring contributing less than 10%. The credit portfolio has decreased by 10% from its peak in November 2008, showing a 3% decline from August 2010 to February 2011.

As new loan turnover has remained quite modest since the third quarter of 2010, the structure of the portfolio has been changed the most by the different amortisation rates of the loan segments. Owing to the slow amortisation of long-term housing loans, the share of these loans has grown by 2 percentage points year-on-year, amounting to almost 40% of the aggregate portfolio (see Figures 1-2). At the same time, the corporate loan stock has shrunk on account of the short term of these loans. Trade and agriculture constitute an exception, with the loan activity growing since the third quarter of 2010. The drop in the loan stock of these sectors has thus been smaller, and their share in the aggregate portfolio has grown to some extent.

In addition to natural amortisation, the loan portfolio has been affected by increased write-offs of bad debts, with the portfolio thus shrinking 0.5% in the fourth quarter of 2010.

The credit portfolio of banks contains an increasing amount of loans issued to real estate-related sectors. At the end of February 2011, over 57% of the loan stock was attributable to these sectors (see Figure 3). This is mainly conditioned by the long term of real estate-related loans.

Ultimately, the credit portfolio of banks is further bound to real estate through loans secured by mortgage. At the end of February, over 78% of the loans issued had been secured by real

[1] Includes loans, leases and factoring.

Figure 1. Structure of banks' credit portfolio as at 28/02/2011 and change y-o-y

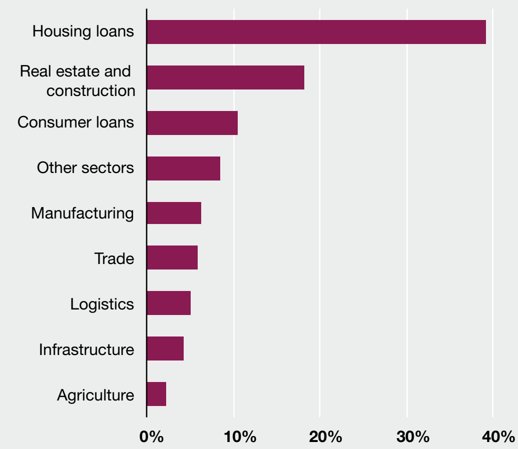


Figure 2. Year-on-year change in the credit portfolio structure as at 28/02/2011

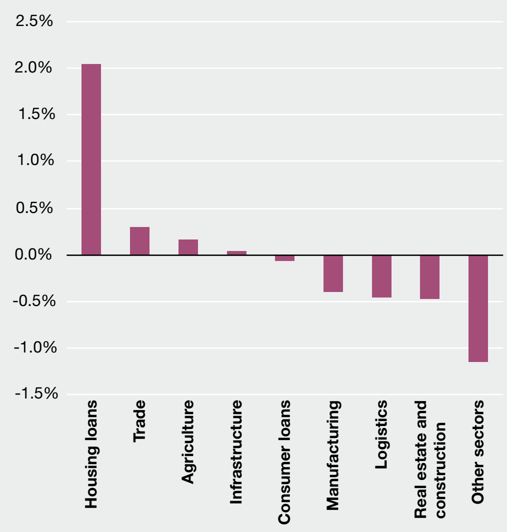


Figure 3. Real estate loans and other loans

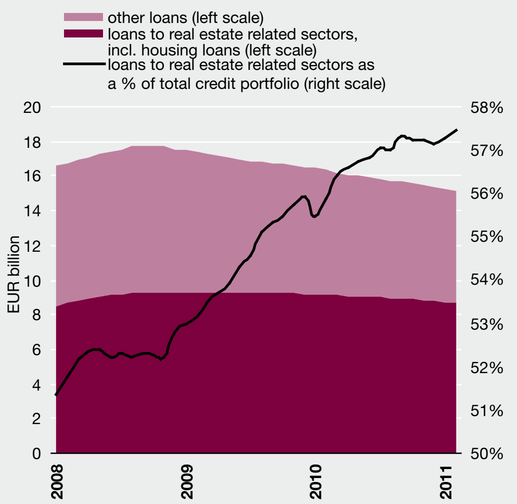
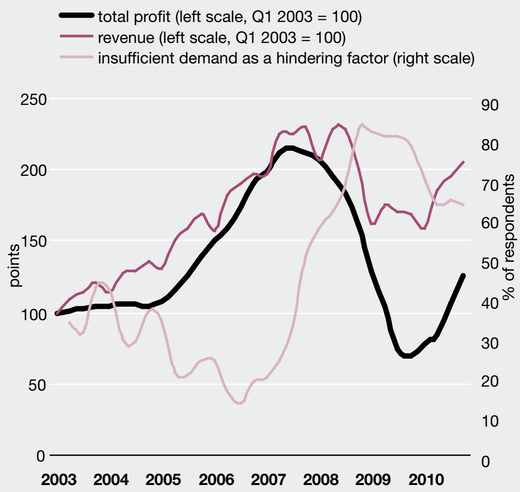


Figure 4. Corporate sector's economic results and demand for products and services



Sources: Statistics Estonia, Estonian Institute of Economic Research, Eesti Pank

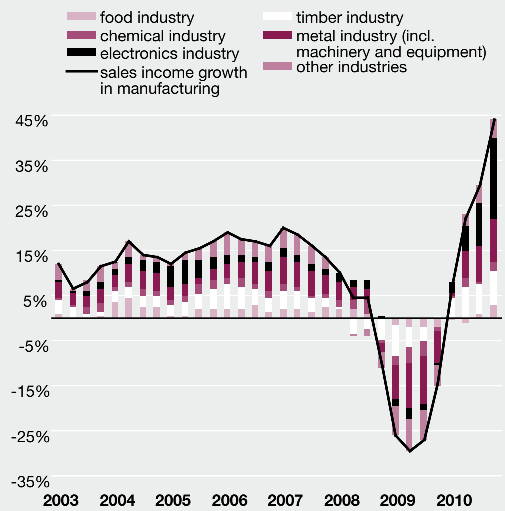
estate. The risks faced by the banking sector are thus closely related to the development of the domestic real estate market.

LOAN REPAYMENT ABILITY OF COMPANIES

Along with the growth in GDP, the loan repayment ability of companies has improved ever since the second quarter of 2010 along with the gradual recovery of GDP growth. The economic recovery has been stimulated, above all, by strong external demand, which has further expedited growth in corporate sales revenues since the second quarter of 2010 (see Figure 4).

Sales have grown in both the trade sector built around domestic demand and other branches of the service sector. The manufacturing sector was an especially remarkable contributor to sales revenues (see Figure 5). In December, **industrial production** grew by 39% from last year, with quite a few branches of industry exceeding their pre-crisis production volumes by

Figure 5. Determinants of sales income growth in the manufacturing sector



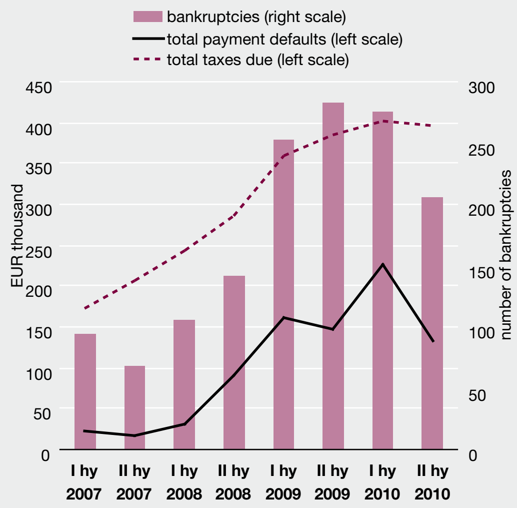
Sources: Statistics Estonia, Eesti Pank

the end of the year. Production of capital goods showed an especially rapid growth – supported by fine electronic products, the volume of capital goods exceeded the pre-crisis peak by half. The total output of the manufacturing industry still fell short of the pre-crisis level. In all major sectors, companies have positive expectations of a growth in demand in the next three months. Nonetheless, the speed of growth in cash flows is expected to decelerate in the long run.

Even though corporate expenses increased in the second half of 2010, the **total profit** posted by the business sector more than doubled from the same period last year. Nonetheless, the total profit of the sector is still at the level of 2005-2006. Both large and small enterprises have improved their operating results in most fields of activity, while manufacturing still contributed a third of the profit of the business sector. The greatest contributors to the profit of the manufacturing sector in the fourth quarter of 2010 included the production of electronic equipment, machinery and equipment, and food commodities.

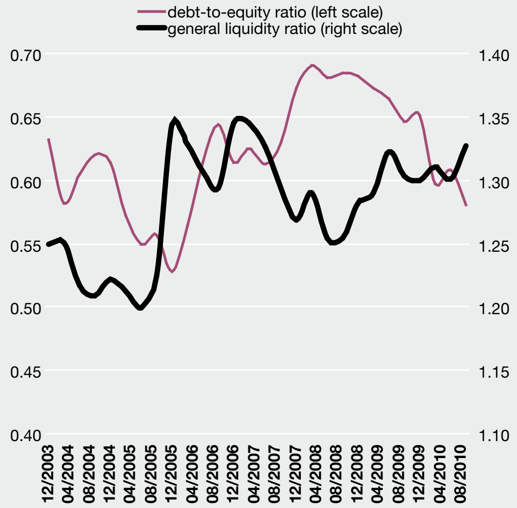
The loan repayment ability of companies is supported by a gradual improvement in economic results and the current business environment. While the **number of bankruptcies** remained high in the fourth quarter of 2010, the indicators for the last months of 2010 and the first months of 2011 fell below the average level for the last two years. According to the statistics of the payment default register, the number of companies with payment defaults in the second half of 2010 is on par with the second half of 2009. At the same time, the volume of **payment defaults and tax arrears** has shrunk (see Figure 6). Furthermore, the amount of overdue loans of credit institutions has fallen in the last few months. The volume of problem loans is not expected to grow substantially in the upcoming periods, as evidenced by further economic recovery and a drop in corporate loan expenses.

Figure 6. Companies' payment defaults, taxes due and bankruptcies



Sources: Krediidiinfo, Estonian Tax and Customs Board, Eesti Pank

Figure 7. Indicators of companies' loan repayment ability



The drop in corporate loan expenses can be associated with the fall in interest-bearing liabilities, which have lessened the financial risks. The **debt burden**, too, has decreased in comparison with the last four years. The lower the debt-to-equity ratio and the higher the current ratio, the easier for the companies to serve the increasing loan expenses in the future. Both of the above indicators are showing a positive trend (see Figure 7).

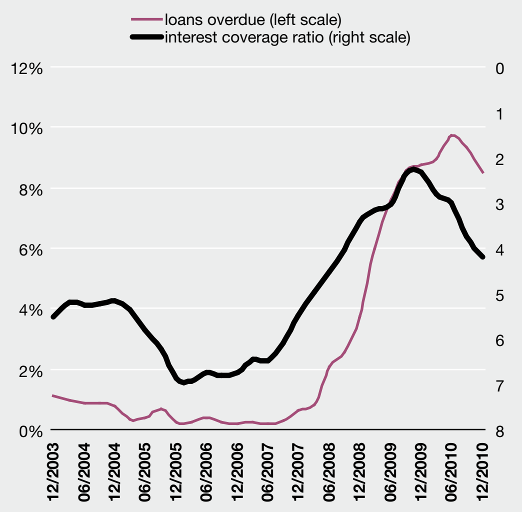
The improvement in loan repayment ability is confirmed also by the continual rise in **interest coverage ratio**, which shows that the companies' ability to cover loan liabilities from current cash flows has improved (see Figure 8). Even though the interest rates on the loan stock have risen to some extent over the past six months as a result of the Euribor rising by around 0.25 percentage points, these interest rates are still low, keeping the loan service expenses down.

The risks to the loan repayment ability of companies have decreased. With the recovery of economic activity, the loan repayment ability will improve further. Nonetheless, external risks will persist. Should these risks be realised, external demand may fall, causing cash flow problems for companies. The loan repayment ability may be also hampered by a faster-than-expected rise in interest rates.

LOAN REPAYMENT ABILITY OF HOUSEHOLDS

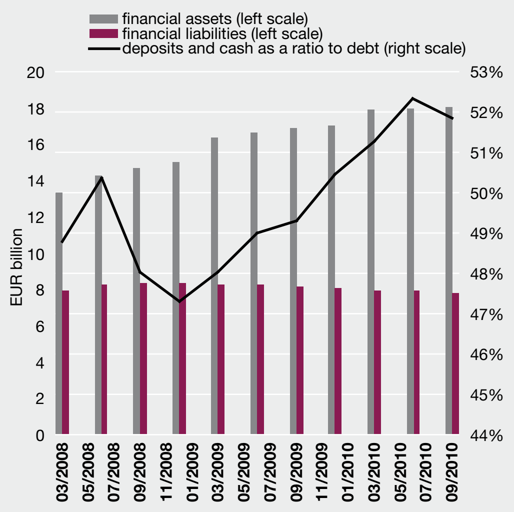
Households' confidence and expectations of the future have improved alongside the economic recovery. For the first time since August 2007, the consumer confidence indicator was positive at the beginning of 2011. Confidence in the upturn is fuelled by macroeconomic indicators. The risks related to household incomes are lower, as the labour market situation has improved. Unemployment dropped to 13.6% in the fourth quarter of 2010, with employment rising by 2.5% year-on-year. Furthermore, annual growth in average wages was positive for the third quarter in a row. However, with consumer prices rising rapidly in the period, the real incomes of households continued to shrink.

Figure 8. Loans overdue for more than 60 days and interest coverage ratio



Sources: Statistics Estonia, Eesti Pank

Figure 9. Financial position of households



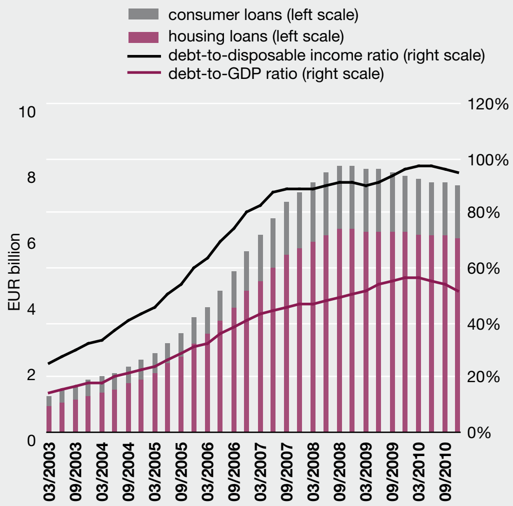
Regardless of the drop in real incomes, households are confident in the continual improvement of their economic position, and are increasingly positive about their ability to save. Larger capital buffers of households are reflected in the **financial position** indicators (see Figure 9). Financial account data shows that financial assets have grown by almost 7% from last year. Private deposits with credit institutions have increased on a similar scale. In the third quarter of 2010, cash and deposits of households covered 52% of their total debt. With the decrease in debt liabilities, the asset buffer of households has grown, while their debt as a ratio to GDP and disposable income remains relatively high. At the end of 2010, the household debt burden amounted to 52% of GDP and 94% of disposable income (see Figure 10).

The recovery of the residential housing market has alleviated the risks related to household loan collateral. The real estate market is slowly but persistently becoming more liquid. Real estate prices have risen, as well. As the prices have only reached the level of 2005, the loan-to-value ratio of approximately a third of the borrowers remains higher than 100%. This does not pose a credit risk as long as borrowers are able to cover their monthly loan liabilities from income. Forced sales more than doubled from 2009, with bailiffs selling over 700 real estate objects to cover outstanding problem loans.

Even though fixed interest lending increased during the recession, over 90% of the household loan agreements have a floating interest rate. So, the greatest risk to the loan repayment ability of households is the rise in key interest rates which increase the loan service expenses. For loans with a floating interest rate, the effect of the change in the 6-month Euribor is reflected in the household loan interest after a time lag of approximately six months. The household **interest burden**[2] stood at 3.7% at the end

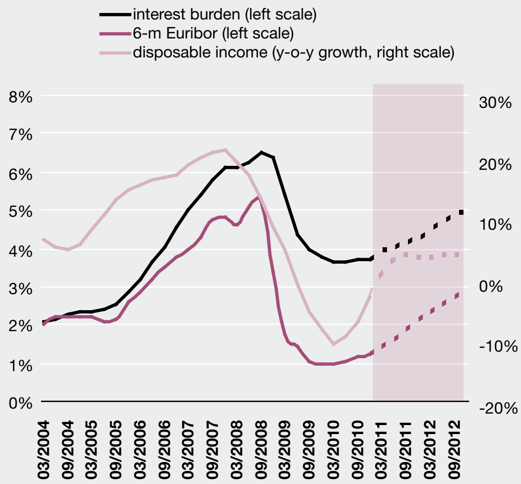
[2] Interest burden is the annual ratio of interest expenditure to disposable income.

Figure 10. Household debt burden



Sources: Statistics Estonia, Eesti Pank

Figure 11. Household interest burden and disposable income



Sources: European Central Bank, Eesti Pank, Statistics Estonia of 2010. As the autumn forecast of Eesti Pank expects a further drop in loan stock and an increase in disposable incomes in 2011, the annual interest burden of households will not increase significantly in the coming quarters. Considering the higher key interest rate and the smaller loan volume, the annual interest expenses of households are estimated to be about 32 million euros higher at the end of 2011, with the interest burden amounting to 4.3% (see Figure 11).

Estonia's real estate market

Housing market

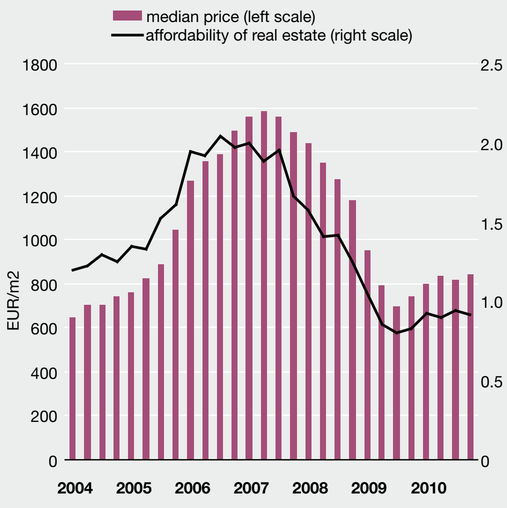
The real estate market in Estonia is recovering against the background of economic revival. Even though the volume and prices of apartment transactions remained volatile throughout 2010, the housing market in Tallinn grew in both transaction numbers and total value. 22% more transactions were concluded in 2010 than in 2009, with the total value of transactions rising by 24%. The recovery of the housing market is also evident in the increase in real estate offers in the first months of the year 2011, and the modest growth in the credit demand of households. The current indicators are still several times lower than five years ago.

This has fostered launch of new development projects. The development projects started at the end of 2009 have, for the most part, been realised, with the gradually increasing number of building permits for new dwellings suggesting upcoming projects on the market.

While in the European Union residential prices rose by an average of 3% in 2010, the annual increase in the median price of real estate transactions in Tallinn stood at 7%. Even though the price per area unit dropped in the first months of 2011, it is still slowly rising year-on-year. Nonetheless, the price per area unit is almost two times lower than the pre-boom level. The median price per square metre was 820 euros in February 2011.

For two years, low real estate prices have kept the real estate purchasing power of Tallinners earning average wages at a good level. The affordability of real estate was also supported by the quicker increase in gross monthly wages in the fourth quarter of 2010. The affordability indicator for real estate stood at 0.92 in the fourth quarter of 2010 (see Figure 12).

Figure 12. Affordability of real estate with average wages and median price in Tallinn



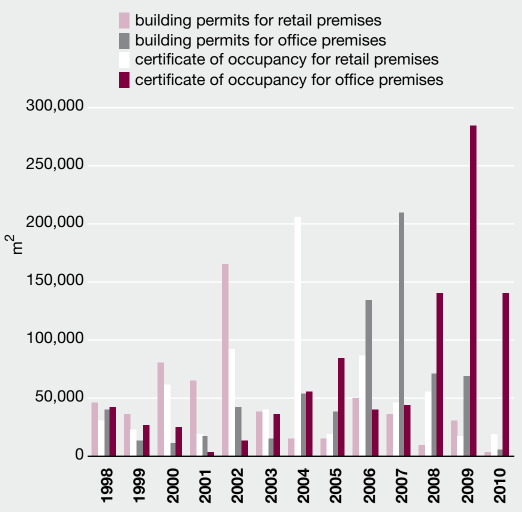
Sources: Land Board, Statistics Estonia, Eesti Pank

Office and commercial premises market

There is a time lag between changes in the residential premises market and commercial premises market. The operating environment is the key factor affecting the demand for office and commercial premises. The commercial premises market stabilised at market bottom in 2010 with respect to both rental prices and vacancies. The market demand is served predominantly by higher-quality commercial premises in front of lower-quality rental space. With the supply not expected to increase in the near future (see Figure 13) and the economic recovery enhancing the demand, the vacancy rate of higher-quality premises is predicted to drop further. According to market participants, the vacancy rate stood at 13% at the end of 2010.[3]

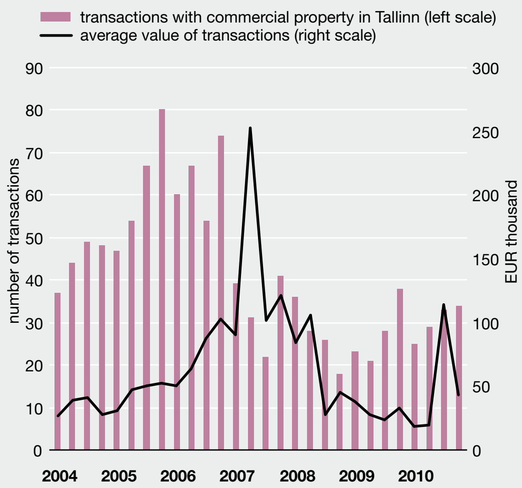
The decrease in vacancies has an effect on the rental prices. But as the overall vacancy rate on the market is still high and the demand remains modest, no price increase can be expected. The offered rental prices have risen to some extent since the beginning of 2011 but remain significantly lower than in the boom-time years. Even though the situation has somewhat improved for real estate owners, rental income remains low (see Figure 14). Some assurance could be found in the increasing interest of foreign investors in the Estonian real estate market against the backdrop of economic recovery in Estonia.

Figure 13. Retail and office buildings with building and use permits in Tallinn



Sources: register of construction works, Eesti Pank

Figure 14. Transactions with commercial property in Tallinn



Sources: Land Board, Eesti Pank

[3] Source: Newsec.

QUALITY OF ASSETS

The quality of the loan portfolio[4], measured in loans overdue for more than 60 days, has improved further, as expected. From September 2010 to February 2011, the volume of these loans shrank by a total of almost 144 million euros. Their share in the loan portfolio dropped by 0.8 percentage points to 6.4%, a level comparable with July 2009 (see Figure 15).

The loan quality of real estate related sectors was lower than in other sectors at the beginning of the economic decline. By the end of February 2011, the situation was quite the opposite. Loans overdue for more than 60 days in the real estate-related sectors made up 60% of the total of non-performing loans at the end of February, while the aggregate loans of these sectors amounted to 63% of total loans issued (see Figure 16).

In the last five months, the biggest decrease in the loans overdue for more than 60 days – over 80 million euros – could be seen in the real estate and construction sector (see Figure 17). Most of the other sectors also witnessed a drop in overdue loans from September to February, improving the quality of assets, even though the loan stock has decreased too. Trade and logistics constitute an exception, with the volume of overdue loans growing to some extent.

With the economy recovering, the quality of banks' assets has been improved by the restored loan repayment ability of some loan customers. Writing off uncollectible receivables has had an even greater effect on the quality of the loan portfolio in the last five months. In the fourth quarter of 2010, banks wrote off a total of 84 million euros worth of loans – over a half of the decrease in overdue loans in the period (see Figure 18). The write-offs of uncollectible receivables will remain the key to improving loan

[4] This chapter only considers bank loans without leases and factoring, which make up over 90% of the aggregate portfolio.

Figure 15. Loans overdue for more than 60 days

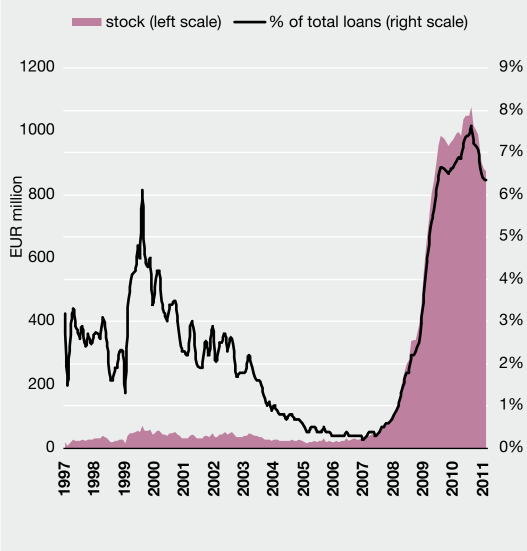


Figure 16. Loans overdue for more than 60 days and their share in respective portfolio as at 28/02/2011

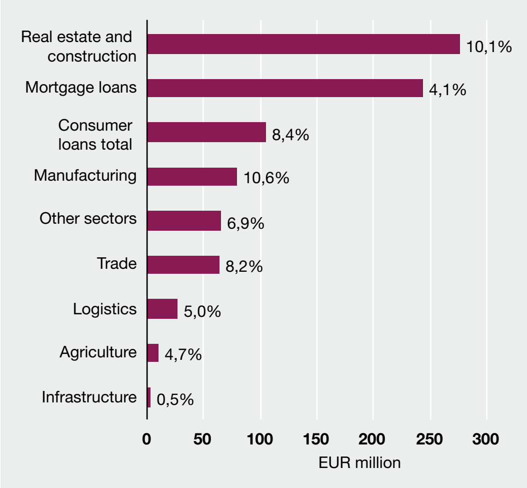


Figure 17. Change in loans overdue for more than 60 days (Sept 2010–Feb 2011)

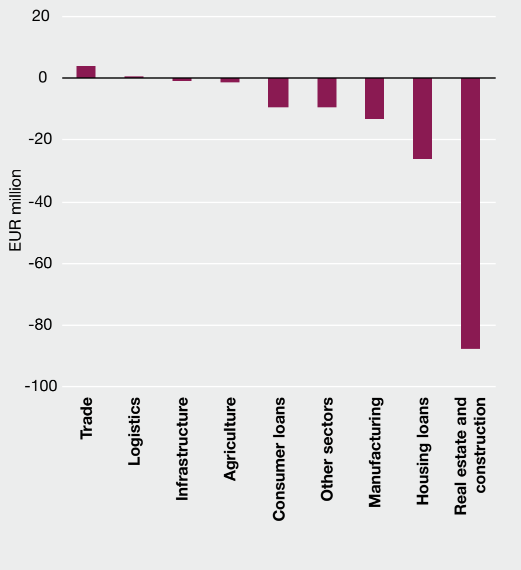
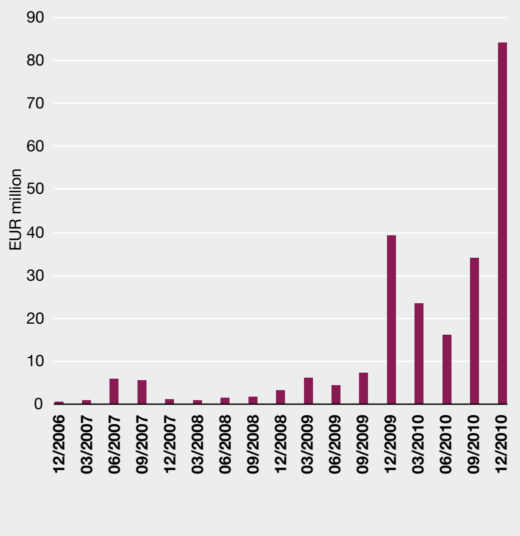


Figure 18. Banking sector gross write-offs



quality in the next quarters, with a portion of overdue loans starting to perform once again.

Stemming from the write-offs and the regained performance of a portion of the loans, the total provisions of the banking sector shrank by 85 million euros in the last five months. The ratio of provisions to overdue loans did not fall. At the end of February 2011, banks had recorded under losses 82% of the loans overdue for more than 60 days; that is 5.2% of total loans issued.

Restructuring of private mortgage loans[5]

Ever since the second half of 2009, banks have actively sought to restructure loans in order to prevent and solve the consequences of the realisation of the credit risk. By and large, restructuring can be divided into ordinary restructuring and restructuring of problem loans. Ordinary restructuring mostly involves short-term payment leaves and minor changes in the payment schedule. In the other case, the restructuring is initiated because the customer is already experiencing or is about to experience (long-term) difficulties in making the scheduled payments.

As a rule, the payment difficulties of private retail customers can be associated with the labour market situation, for instance sudden unemployment or a decrease in (real) wages, and are of temporary nature. A common solution is the payment leave which usually involves (temporary) suspension of the contractual fine for delay calculation. The volume of private mortgage loans that have been restructured is estimated to be twice the volume of loans overdue for more than 90 days.

[5] The assessment is based on the analysis of the Financial Supervision Authority.

At the same time, restructuring cannot simply be treated as concealment of overdue loans. Rather, restructuring allows to select customers with temporary payment difficulties and better payment behaviour from among customers whose loan has been deemed uncollectible. For example, 25% of the customers whose contracts had been restructured due to payment difficulties as at 30 June 2010 but whose payments were not yet overdue, had delayed scheduled payment by one day and 5% by over 60 days six months later. We must, however, keep in mind that the reference period is six months – a possible duration of an average payment leave with suspension of the fine for delay calculation. A bulk of the overdue loans can still be considered uncollectible. At the end of 2010, contracts had been terminated, pending final solution, on almost a half of the loans overdue for more than 90 days.

In restructuring problem loans secured by mortgage, the common practice among banks in the last six months has been not to significantly extend the term of the loan agreement. The changes in the interest margin fall between –0.25% and 1.5% (including 0%). The raising of the interest margins in the above limits should be interpreted as adjustment of the risk, which was inadequately assessed during the boom times, to a normal level, rather than as punishment to the customer.

It must be noted in credit risk assessment that, in making provisions, banks have treated problem loans which have been restructured under the same principles as non-performing loans. Provisions cover approximately 30% of the loans deemed default on the basis of the banks' internal criteria. The banks have made provisions on quite conservative basis – in cases where the collateral has been realised, the average loss rate has been lower than 10%. The realisation of the collateral is a relatively lengthy process and it is used in exceptional circumstances. For example, only 5% of the collateral of loan customers deemed permanently insolvent in 2008 have been realised so far. The potential damage will be further reduced by the expected recovery of the real estate market.