

FINANCIAL STABILITY ASSESSMENT

Financial markets

The international financial environment deteriorated significantly at the end of the summer of 2011. In spring, the tensions brewing on the financial market concentrated on single euro area countries, with the liquidity and financing position of banks showing signs of improvement elsewhere in Europe. By the beginning of autumn, however, there was evidence of the sovereign debt crisis spreading to several other euro area countries. Mistrust towards the European banking system built up, distressing the interbank market and complicating banks' funding on the securities market. The conditions of growing mistrust added to the role of the Eurosystem central banks in liquidity mediation. While the increased inflationary pressures were fought by raising monetary policy rates, the Eurosystem maintained an unlimited liquidity support to the euro area banks.

Nordic banks deserve positive mention against the backdrop of the euro area crisis. Thanks to their high capitalisation and their small exposure in countries with problematic public finances, the Nordic banks are relatively better positioned compared to many other banks in Europe, as regards the uncertain funding situation. The stronger macro-economic and fiscal position of these countries adds to their reliability in the eyes of investors. Even though the funding conditions have become tense even for Nordic banks, and the cost of funding has gone up, risks are alleviated by the fact that the banking sector's need for long-term funding has largely been covered for the year. At the same time, the availability of short-term funding could drop significantly if the financial market sentiment deteriorated, as the banks' funding structure remains highly vulnerable to any negative market developments.

The deterioration in the outlook for global economic growth and the tensions brewing on

the financial markets have exerted immense negative pressure on the equity and bond prices in the last few months. With the decrease in investor risk appetite, the markets are likely to remain very volatile in the next six months. Of the Estonian financial intermediaries, the investment and pension funds as well as insurance companies are the most vulnerable to negative changes on the securities markets.

Real economy and loan quality

In the first half of 2011, net sales and profits of the Estonian business sector were significantly boosted by the quick growth in export. The positive economic indicators must, however, be viewed by considering that these were generated by a small number of large companies, while the financial position of businesses in general was much more diverse. The volume of payment defaults and tax arrears has dropped during the year, but remains relatively high. Future risks can, above all, be associated with the deterioration of the external environment, as the cash flows from export undertakings may prove lower than estimated due to the drop in external demand. A drop in income would quickly spill over to other business areas, complicating the fulfilment of loan commitments in the entire business sector.

The recovery of economic activity was also reflected in the improvement of the labour market situation. Even though this was accompanied by a rise in confidence, households remain cautious in their financial behaviour. The persistent tendency to save is reflected by the annual growth in deposits (nearly 13% at the end of the summer). In the next six months, the loan repayment ability of households will be supported, in addition to the financial buffers, by the low level of interest rates. At the same time, real wages have yet to climb against inflation, and the labour market risks are liable to increase with the deterioration of the economic environment.

The favourable macro-economic environment in the first half of 2011 helped to improve the loan portfolio quality of banks. Even though the increase in external demand has allowed some companies of the manufacturing industry to repay their overdue loans, the decrease in the share of non-performing loans falls short of the spring forecast. The volume of overdue loans has thus dropped, above all, due to the write-off of bad debts, which is a lengthy process. The slow decline in the share of loans overdue for over 60 days is expected to continue in the forthcoming months, dropping from this year's 6% below 5% by the end of 2012. The deterioration of the macro-economic environment may add new problem loans, further decelerating the improvement in the loan quality.

Strength of financial institutions

The drop in loan losses in 2011 has helped to enhance the net profitability of banks. Even though there are still problem loans in the loan portfolio that may start performing once again, the recoveries will likely be smaller than thus far. Decline in loan losses will thus have a less significant effect on the banks' net profit in the future.

In the next half-year, increase in the pre-provisions profitability of banks will be curtailed. Above all, the growth in interest income remains limited because of the postponement of rise in Euribor and the potential contraction of the loan portfolio. Global liquidity tensions may also significantly increase the cost of the banks' market-based financing. At the same time, the share of retail deposits in the resources engaged by banks has significantly increased in the last year. Besides positively affecting banks' liquidity and funding risk, this will also help to reduce the banks' risks related to earnings.

The share of liquid assets in the banks' balance sheet has increased in the last few months,

reflecting the contraction of the loan portfolio and the relatively strong growth in deposits on the one hand, and the banks' interest in maintaining a liquidity buffer on the other. The banks operating in Estonia continue to participate in the Eurosystem's monetary policy operations mainly as liquidity providers, while the use of credit instruments is much less popular in liquidity management. The liquidity management of major Estonian banks is mainly centralised in the parent bank group, which has supported their liquidity in the financial crisis.

Due to the decrease in own funds, the aggregate capital adequacy ratio of the Estonian banking sector dropped to 15.9% by the middle of 2011. The forecast for economic growth and banks' profitability allows to expect a further growth in capitalisation in 2012. To cushion against poorer-than-expected developments, the banking sector has set up a high capital buffer which is able to cope with problem loans twice the current volume, while adhering to the 10% minimum capital adequacy rate. The scenario of doubling of the loan losses is, however, unlikely to materialise.

Settlement systems

The dependence of settlement systems on the TARGET2 settlement platform increased significantly upon the changeover to the euro. Important settlement systems had no major failures in 2011, except for an incident where a failure in TARGET2 caused a postponement of the commencement of the settlement day in the retail payments settlement system ESTA and the ECSD's securities settlement system. This has brought about the need for measures that would prevent the transfer of TARGET2 day-offs or failures to the local settlement systems.

Even though the liquidity reserve required for smooth functioning of the settlements has

decreased and certain operational risks have materialised, no systemic liquidity risk has emerged in the settlement systems. As the banks have implemented preventive measures, operational risks evident in the first half-year have decreased by today. These risks were caused by the local bank's insufficient experience in the management of the liquidity required for conducting settlements in the Eurosystem framework.

Conclusions

In the next six months, the risks faced by the banks operating in Estonia will depend, above all, on the sovereign debt crisis in the euro area. Even though the governments and central banks of euro area countries, along with the International Monetary Fund, have implemented measures for preventing the spread of the crisis, the crisis has yet to achieve its breaking point. The effect of the crisis on the Estonian real economy and the stability of the financial system is thus yet to be determined.

The debt crisis can affect the Estonian financial sector through two channels. Firstly, should the liquidity and funding tensions looming in the euro area strongly affect the parent banks operating in the Nordic countries, the subsidiaries and branches located in Estonia will be affected through a rise in funding cost. Secondly, should the external demand, which has kick-started economic activity in Estonia, experience a significant contraction, the income of the banking sector and the improvement in loan quality could suffer a setback. The probability of both risks materialising has increased, compared to spring.

In the current stage of the debt crisis, the risks to Estonia's financial stability have been reduced, among other factors, by the financial markets' confidence in the Nordic banking system and in the economic and fiscal policies. The economic development in Estonia has also contributed to

financial stability in the last twelve months. The sufficient capitalisation of the banking sector helps to withstand potential external risks.

The deepening of the crisis and the deterioration in the global macro-economic environment lay a heavy burden on the liquidity and capital buffers of European banks. Any decisions regarding profit distribution and capital/liquidity management in the banks operating in Estonia and their parent banks must thus consider that substantial and sustainable buffers are necessary in the unpredictable economic and financial environment.