V
FINANCIAL SECTOR

In the third quarter of 2000 current trends continued in the financial sector (see Figure 5.1). About half of the 3 billion kroons involved as deposits by banks were lent to financial institutions, a third to undertakings and private individuals, the rest was placed into external liquid assets.

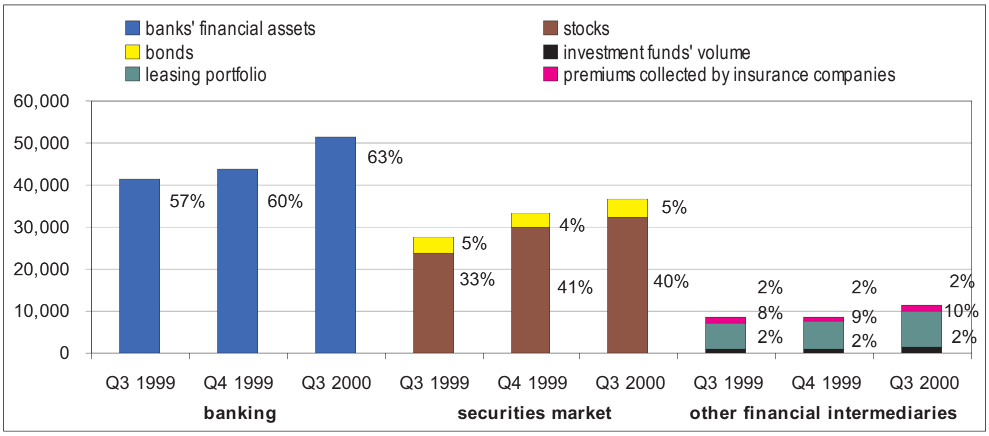

Figure 5.1. Estonian financial intermediaries (volume in EEK mn and structure by % of GDP)

The profitability of banks keeps sinking, mainly because margins shrink and liabilities' interest expenditure keeps growing faster than interest income. In other words, banking has acted as a kind of buffer, preventing the full infusion of the euro's growing interest rate implications into the real sector.

In the third quarter the core shareholders in *Eesti Ühispank* and *Optiva Pank* offered a take-over bid to other shareholders. *Skandinaviska Enskilda Banken* (SEB) acquired 95.1% of the shares in *Ühispank* and *Sampo* 93.4% of the shares in *Optiva Pank*. The accompanying decline in Estonia's banking risks is well characterised in the announcement made by Moody's Investors Service in November that ratings of both banks have been raised to Baa1/P2, ie to the same level with *Hansapank* and the Republic of Estonia.

On the stock market take-over bids have been dominant since the second quarter, temporarily increasing the exchange turnover and raising stock prices. After summer holidays bond issues started to grow and recovered their previous volumes.

Insurance premiums increased during the first three quarters both in non-life and life insurance. The growth in the consolidated portfolio of leasing and factoring was suspended in the third quarter. Most of the growth falls to car and to some extent also to real estate leasing. The share of private contracts in the leasing portfolio has not changed significantly.

Banking

Banks' Assets and their Quality

In the third quarter the banks' consolidated balance grew by 6.3%, reaching 55 billion kroons (see Figure 5.2). The first-half-year trends continued deepening, meaning that financial

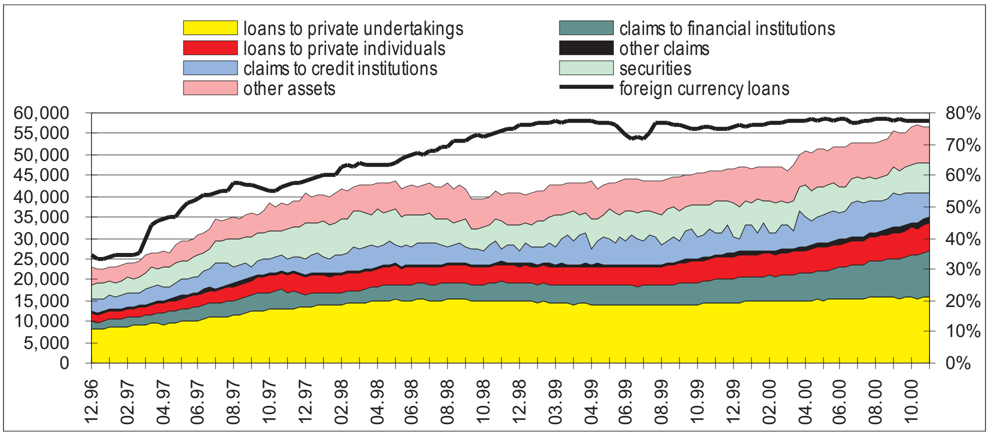

Figure 5.2. Banks' total assets (EEK mn, the left scale) and share of foreign currency loans in loan portfolio (%, the right scale)

institutions were still responsible for most of the growth in the loan portfolio, their loan stock increasing by 23% over a quarter, reaching 9.4 billion kroons (see Figure 5.3). **This was the largest ever nominal growth of the financial institutions' loan stock – by 1.8 billion kroons.** The lending to other customers (ie consolidated portfolio minus financial institutions) was significantly more inhibited, growing by 5.4%. The private individuals' loan portfolio increased by 11% due to seasonal factors (study loans).

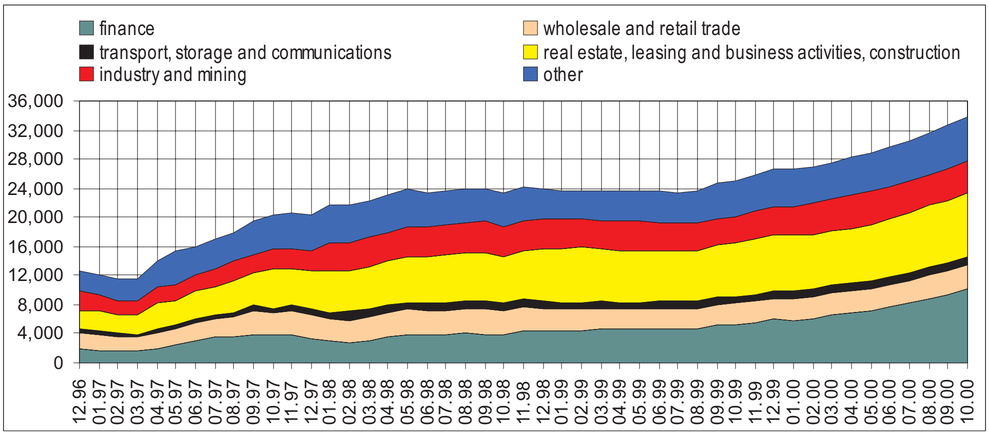

Figure 5.3. Banks' loan portfolio by sectors of economy (EEK mn)

Financing preferences by sectors undertook a slight modification: instead of industry, real estate business was financed most, infrastructure enterprises and trade followed. The loan stock in industry and transport even shrank. Quarterly loan turnover has grown from 4 billion kroons to 4.5 billion kroons over the year. The most significant change has taken place in the growth of the share of short-term lending, especially in financing trade and industry. The share of the open sector has increased by three percentage points, ie to 56% during 2000 whereas the share of the export sector has shrank equally, being 18%.

Both in the open and export sectors the share of overdue loans in the loan portfolio has started to go up again against the end of the second quarter, considering the growth of the above sectors this is only logical. **The share of overdue loans in the banks' loan portfolio reached 6.4% by end-September and fell to 4.8% by end-October** (see Figure 5.4). By maturities the loan stock overdue up to 30 days grew most, ie by 40% whereas the stock of loans overdue more than 60 days increased by 21%. This signals the continuous improvement of loan quality. By sectors loan quality has improved in industry, transport and trade. It is worth mentioning that

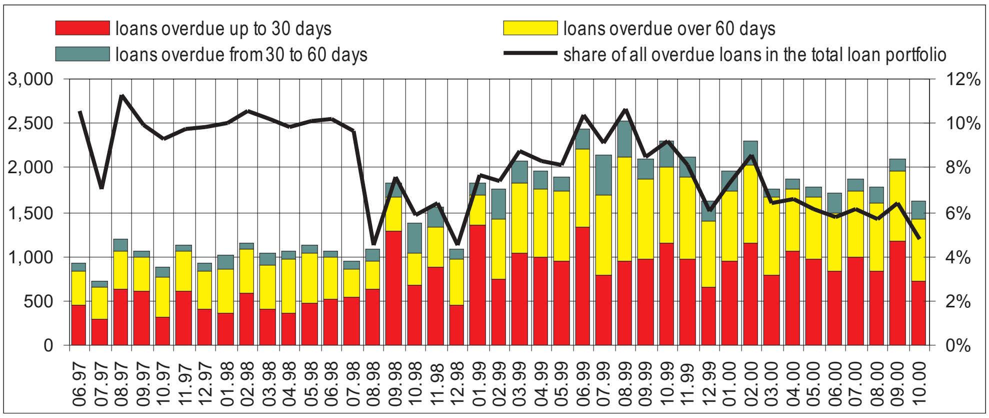

Figure 5.4. Volume of overdue loans (EEK mn, the left scale) and their share in banks' loan portfolio (the right scale)

the share of unlikely collectable claims in leasing and elsewhere on the consolidated level has risen even more.

In the aftermath of the first-half-year shrinkage, banks increased the securities portfolio by 2.7%, ie up to 6.1 billion kroons in the third quarter due to better yield on euro bonds and sustained deposit inflow. Investments in bonds were responsible for most of the growth. Money moved through banks' security investments out of Estonia. Although the share of the trading portfolio placed abroad had the highest nominal growth, the stable growth trend of long-term financial investments goes back to 1999 whereas short-term financial investments have had relatively stable growth in 2000. This was brought along by the post-recession recovery of the real economy and the sustained key role of the banks in intermediating idle resources involved as deposits.

Liabilities

Deposits displayed ongoing rapid growth in the third quarter. Their gross volume increased by 10.8%, ie up to 33.4 billion kroons; banks' liabilities together with other entries reached 44.4 billion kroons. Against the second quarter the growth of deposits by private individuals slowed down and private corporate deposits were once again responsible for the highest nominal growth (see Figure 5.5). By maturities up to three-months deposits were dominant both in the stock and turnover. Still the longer-term (3–6 months and 6–12 months) deposits underwent a significant growth as well, reflecting gradual lengthening of the deposit maturities.

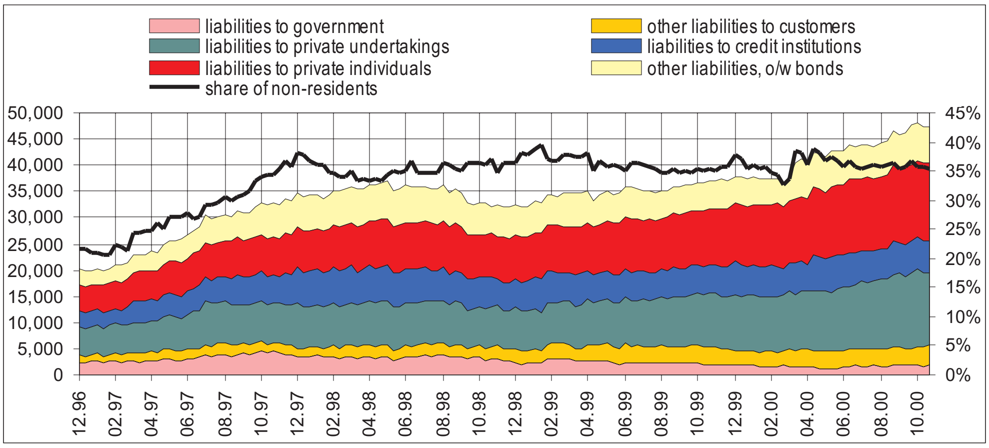

Figure 5.5. Banks' external liabilities (EEK mn, the left scale) and share of non-residents (%, the right scale)

The ongoing preferential growth of deposits against loans and restricted earning alternatives on the Estonian market are also reflected in banks' liquidity whereof various long- and short-term resource involvement and utilisation strategies get mixed. **Long-term external borrowing repays expiring external liabilities and finances long-term loans and strategic development projects. Short-term resources are involved as domestic deposit and placed either in working capital loans or short-term financial instruments – deposits and securities.**

Lending preferences and banks' regular profitability were visible also in the structure of capital adequacy components – risk assets increased by 1.9 billion kroons in the third quarter and by involving banks' current year's profit in the equity, swelled consolidated profits of the system to 14.1%. The same factors pushed consolidated capital adequacy from 14.4% to 14.6%.

Return on Equity

The banks earned 179 million kroons of profit in the third quarter, which is about 20% above the year-ago period. Like in the second quarter profit margin slid downward and took along return on assets and return on equity as well (see Table 5.1). Although the growing profit base has quantitatively supported the profit side, investment income has been insufficient in offsetting dropping interest rate margins and rising interest rates on external markets.

Table 5.1. Banks' profitability indicators

	Q2 1998	Q3 1998	Q4 1998	Q1 1999	Q2 1999	Q3 1999	Q4 1999	Q1 2000	Q2 2000	Q3 2000
Equity multiplier	8.92	8.66	7.08	6.25	6.35	6.31	6.37	6.27	7.01	7.34
Return on equity	-6.66%	-4.53%	-9.42%	2.04%	2.38%	2.13%	2.63%	3.24%	2.55%	2.45%
Return on assets	-0.75%	-0.52%	-1.33%	0.33%	0.37%	0.34%	0.41%	0.52%	0.36%	0.33%
Profit margin	-24.11%	-16.02%	-37.84%	10.43%	11.56%	12.12%	14.32%	18.76%	13.64%	12.28%
Assets utilisation	3.10%	3.26%	3.51%	3.13%	3.24%	2.79%	2.88%	2.75%	2.67%	2.71%

Return on equity declined primarily due to falling profit margin, which was only partially offset by assets utilisation. Growing **assets utilisation** reflects mostly structural changes, leading to thriving interest income on deposits and bonds. In the third quarter banks' **interest income** was apart from deposits supported by investments into bonds as well, recovering, thus, a source of revenue which shrank in the second quarter. Regardless of the growth in net interest profit, average interest income on loans keeps dropping. The **interest expense** reflected negative implications of euro interest rates and banks' interest expense went up in all entries. Soaring liabilities have increased banks' interest expense also on the **consolidated level**. Larger interest expense has successfully been offset by non-interest income, primarily by service charge and exceptional income.

Both **spread** and **net interest margin** (NIM) reflect clearly interest income gain. The spread slide was fully caused by continued expense growth. Opportunities to earn interest income have recovered by now and spread dynamics is going to be more exposed to the behaviour of external-world-related financial costs in near future. The NIM downfall is sustained by the same factors.

Contemporaneously **non-interest revenue** diminished in all components as well. The service charge income, having grown in the second quarter, shrank by 6% despite stringent cost control. The entry C*hange in the value of assets and liabilities* yielded the best support whereas the profitability of financial transactions improved slightly, too.

Securities Market

Stock Market

The stock market capitalisation reached 33.5 billion kroons by end-October, being 1.6% above end-June (see Figure 5.6). **The growth was sustained by a 15% increase in the corporate stocks and 11% increase in banks' stock.** The prices of the service sector stocks dropped by about 10% over the quarter. The corporate stocks were successful as several undertakings (*Viisnurk, Baltika*) displayed good financial position, kindling anticipation as regards other undertakings as well. The share index of the banking sector grew due to the take-over of *Eesti Ühispank* and *Optiva Pank* and appreciation of *Hansapank*'s stocks (see Figure 5.7).

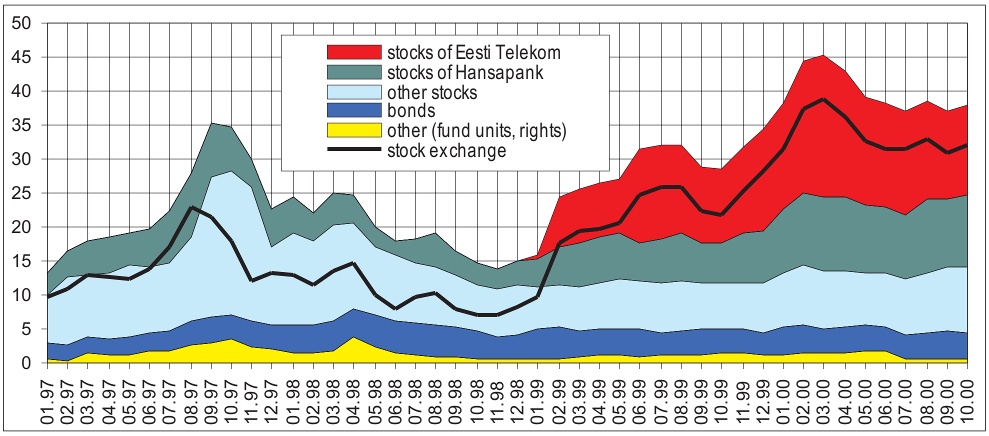

Figure 5.6. Securities market capitalisation (EEK billion)

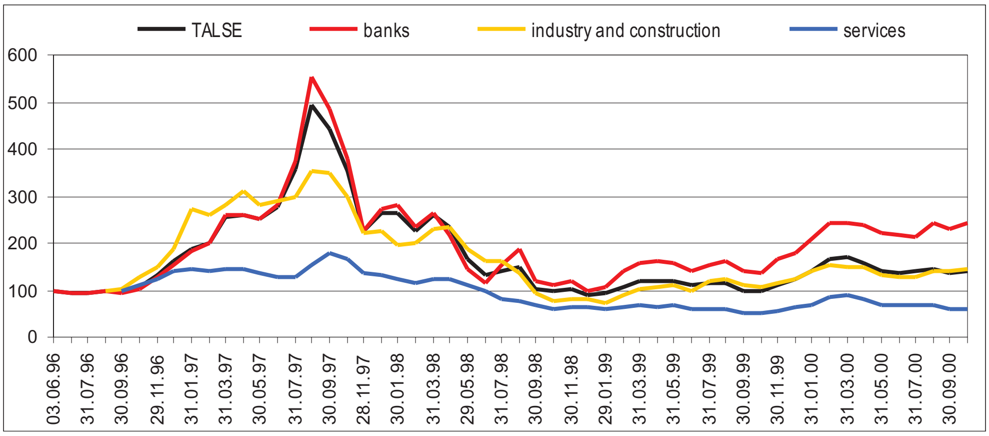

Figure 5.7. Indices of stocks traded on the Tallinn Stock Exchange by sectors of economy and TALSE (points)

The price of most-traded stocks, responsible for the majority of the turnover on the exchange, has shown modest growth as it has probably come close to the justifiable price level.

Bond Market

The capitalisation of the bond market reached 4.2 billion kroons by end-September, sinking back to below 4 billion kroons by the end of October. **During the last two quarters shorter maturities have been characteristic of issues – more than 95% of cases the maturity has**

been up to a year. In October the volume of issues grew slightly. The share of foreign undertakings in gross volume is 62%. The weighted average interest rate of kroon bonds rose to 5.7% in the third quarter (see Figure 5.8).

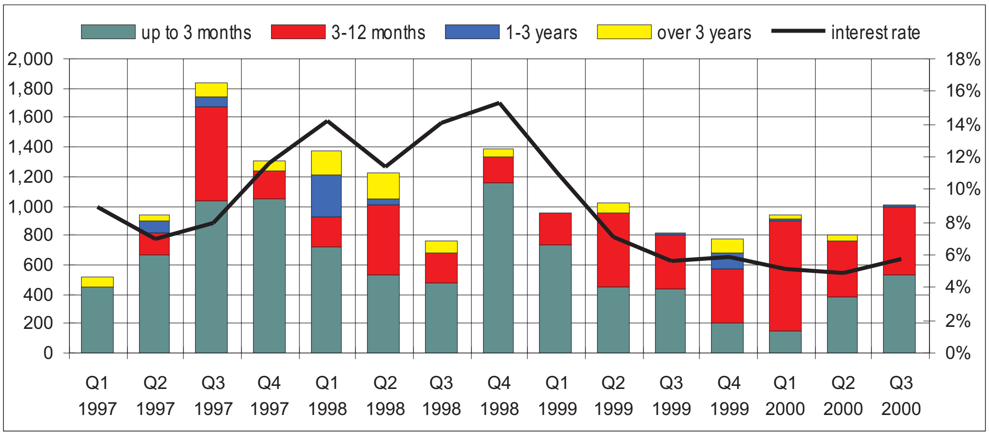

Figure 5.8. Volume of bonds issued in a quarter by maturity (EEK mn, the left scale) and average interest rate of kroon bonds (the right scale)

In November SEB, the owner of *Ühispank*, made market appearance as a new issuer, issuing short-term bonds for 240 million kroons. By the stock of unredeemed bonds *Swedbank* and *MeritaNordbanken* are still the largest issuers on Estonia's bond market.

Other Financial Intermediaries

Insurance

Non-life insurance companies collected 918 million kroons of premiums during three quarters, exceeding by 12% the same period in 1999 (see Figure 5.9). **The growth was primarily fed by insurance of private property and compulsory motor TPL insurance of legal persons' motor vehicles.** As of end-June the balance of the non-life insurance companies was equal to the previous year's level – 1.3 billion kroons. In assets structure the share of bonds and stocks continued increasing and that of deposits decreasing. On liabilities side the share of reinvestment allocations has increased. Non-life insurance companies earned 33 million kroons of profits in the first half of 2000. Technical results were prevailingly positive whereas operating costs were managed to be financed from the difference of premiums and disbursed indemnities at the consolidated level.

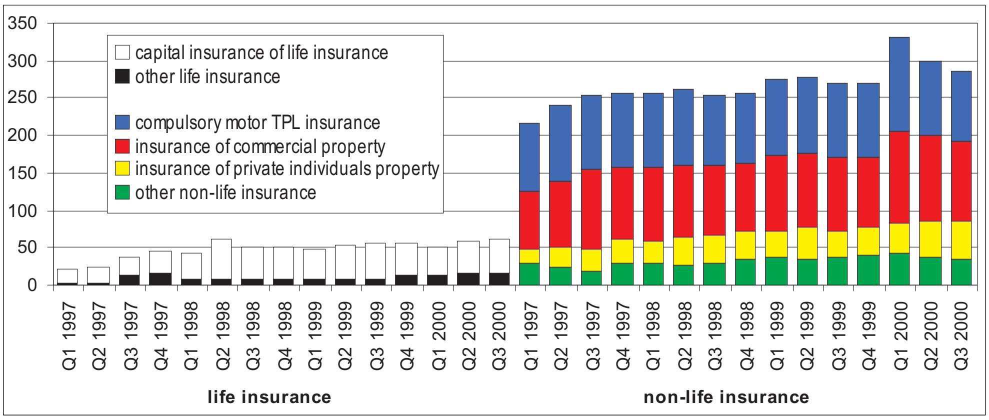

Figure 5.9. Gross premiums collected by insurance companies (EEK mn)

The volume of premiums collected by **life insurance companies** showed a modest growth of 8%, reaching 171 million kroons. **Similar to previous periods pension insurance continued as the main source of growth, its volume increasing by 240% during the first nine months of the year against the same period in 1999.** Total life insurance assets reached 520 million kroons by the end of the second quarter, being 15% above the end of the first quarter. On assets side the share of investments continues moving up and that of tangible fixed assets moving down. Life insurance companies suffered a 46,000kroon loss at the end of the first half-year. The companies could cover their operating costs from the difference of premiums and indemnities if they did not sustain losses from taking over portfolios of bankrupt companies in 1999.

Leasing

In the third quarter the growth of the leasing portfolio slowed down. The total portfolio reached 8.4 billion kroons (9.1 billion kroons together with factoring), the annual growth being 40% (see Figure 5.10). **Capital lease, operating lease and purchase and sale by instalments grew by 150 million kroons each. Recently consumer factoring has revealed significant growth.** The market share of non-residents-owned leasing companies contracted to 11%.

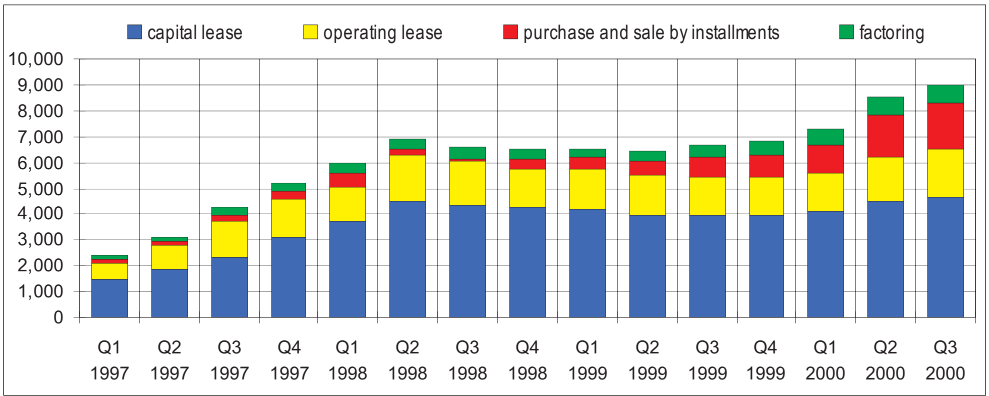

Figure 5.10. Volume and structure of leasing companies' portfolios (EEK mn)

Leasing of cars, especially representation vehicles increased most (see Figure 5.11). In the second quarter the source of concern, the stock of the real estate portfolio grew to 1.9 billion kroons during three months and its share in the leasing portfolio to 23%. In the real estate leasing all categories have contributed to the stock, in new sales (the quarterly turnover of leased assets) the share of commercial buildings has shrank whereas that of office buildings

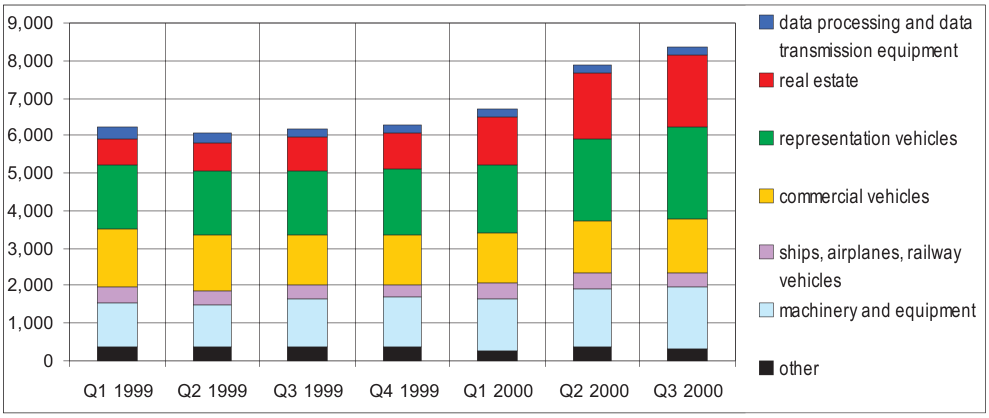

Figure 5.11. Volume of leasing portfolio by leasing objects (EEK mn)

and apartments has increased. Apart from vehicles and real estate the stock of machinery and equipment has also gone up, the portfolio stock of other leasing objects down. The stock of the factoring portfolio expanded by 100 million kroons, reaching 700 million kroons.

Investment Funds

In the wake of low end-July, the volume of investment funds reached 1.6 billion kroons by the end of September (see Figure 5.12). **Interest rate funds were responsible for most of the growth through growing bond interest rates.** The volume of stock and money market funds has remained unchanged. As regards asset structure, bonds are preferred over deposits and stocks. The volume of pension funds exceeds 8 million kroons and constitutes 0.5% of gross funds' volume. In November another bank-owned pension fund was launched to the market.

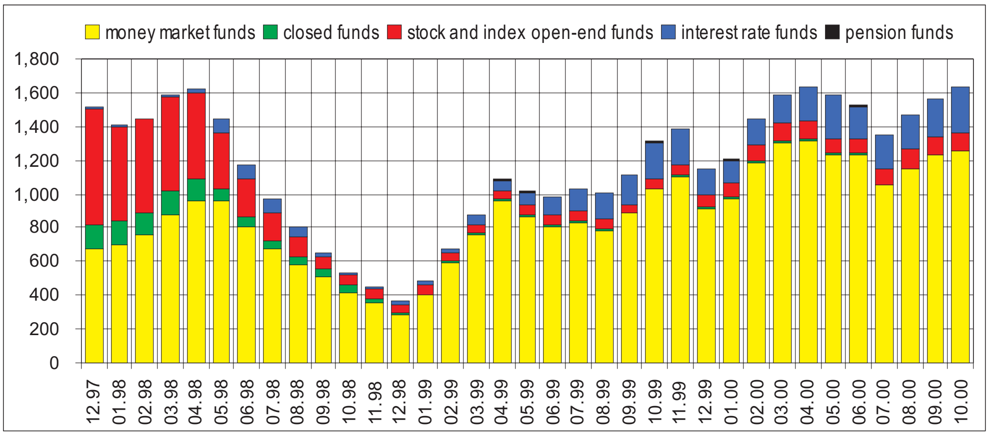

Figure 5.12. Volume of investment funds (EEK mn)

Payment System

Against the same period in 1999 the number of payments has increased by 34% in the third quarter, exceeding four million transactions per month. The payment turnover grew by 23%. **A major change took place in domestic payments, the turnover increasing by about 34%.** The payment of outgoing external payments increased by 2% whereas that of the incoming external payments dropped significantly – by 11 % (see Figure 5.13).

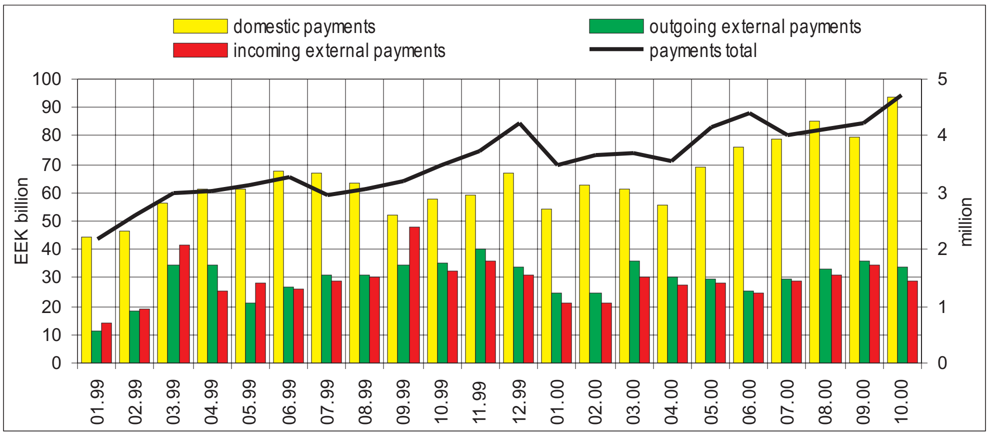

Figure 5.13. Turnover of payments by types (EEK billion, the left scale) and total number of payments (million, the right scale)

The share of paper-based payment orders is continuously decreasing. Against the share of 18% in the third quarter of 1999, it has dropped to 9% in the same period of 2000. **The shares of Internet banking and card payments in the electronic payment mode have grown the most (from 11% to 16% and from 24% to about 29%, respectively).**

In electronic channels the share of payment orders in telebanking shrank, mostly because undertakings target cheaper and more flexible service modes, eg Internet banking. The application of Internet banking has expanded even further: several banks offer communication with the Tax Board via Internet.

Recently the introduction of new non-cash payment instruments has gained pace. Banks have launched new products on favourable conditions, eg a revolving credit card and an instalment card, and improved also terms of current credit cards.

Competition introduced differentiation of bank charges. *Hansapank* raised service charges or started charging for services, which had been free of charge, whereas neither *Eesti Ühispank* nor *Optiva Pank* has followed the example. Each wants to increase its client base. Currently it is hard to say to what extent the above factor is going to influence customers' decision-making in choosing a bank.