V
FINANCIAL SECTOR

Processes taking place in the financial sector in early 2001 are characterised by different trends: the volume of banking and leasing increased due to slightly inhibited demand somewhat less than in previous quarters, issue of bonds and growth of investment funds gained pace. These are segments of securities market in which market activity has increased. The stock market turnover has been low, prices fell and market capitalisation decreased (see Figure 5.1).

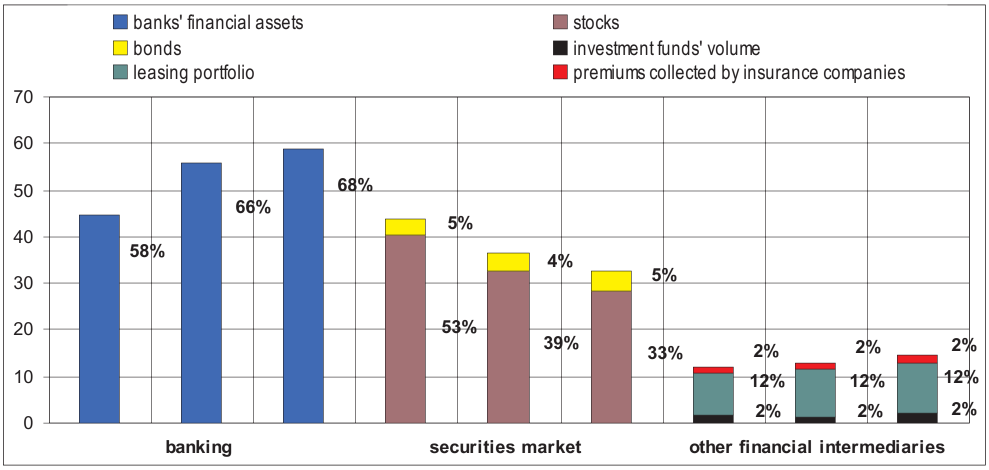

Figure 5.1. Estonian financial intermediaries (EEK billion and % of GDP)

The growth in the loan stock and turnover shrank compared to previous quarters, as did the leasing portfolio. Although the growth was mainly directed to the real estate sector, the loan stock in manufacturing and transport started to go up again. Apart from these sectors also financing of trade increased in leasing finance.

Banks' return on equity showed a slight growth earlier in the year, primarily due to decreasing loan losses. Interest margins and spread continued shrinking due to inhibited interest income. The increasing share of affiliate lending in banks' balance sheets and lower interest income earned caused this.

Banking

Banks' Assets and Their Quality

Changes in banks' assets in the first quarter of 2001 were more modest than during the previous three quarters, both by general volume and by structure. These are mostly seasonal factors as the first quarter has been less-than-regular modest by growth. **The banks' total assets reached 60.6 billion kroons by the end of the first quarter, increasing by 2.8 billion kroons over three months** (see Figure 5.2).

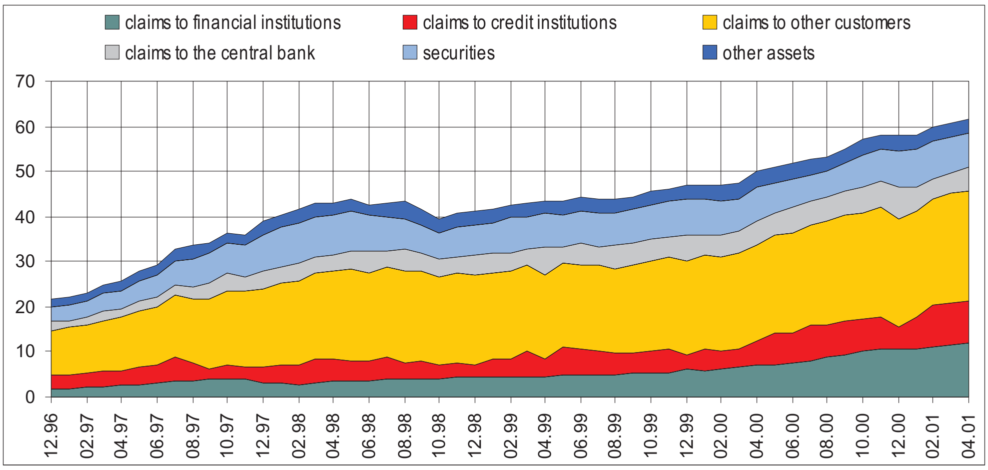

Figure 5.2. Banks' total assets (EEK billion)

Changes in the principle of reserve requirement have had single impact on the structure of assets, decreasing claims to the central bank (the share of the reserves deposited with the central bank was 7% at the end of March against 10–13% in 2000). On the other hand claims to credit institutions have gained in volume, their share being record high of the recent years – 16%. The loan portfolio has grown in proportion with the growth in the total assets and the loan portfolio totalled about 36 billion kroons, being 59% of total assets. The portfolio growth has been dependent on the increasing amount of liabilities and the share of banks liquidity buffers has not changed at the beginning of the year.

Similar to the year 2000 loans to financial institutions were dominant in the loan portfolio, although their growth compared to previous quarters was more modest (see Figure 5.3). Loans to private individuals continued growing, primarily housing loans (+140 million kroons) but also consumption loans (+50 million kroons). The growth in the volume of corporate lending accelerated slightly, remaining still modest. Lending to commerce and real estate development sector have increased similar to last year. Shrinking of the loan portfolio both in the industrial and transport sectors came to a halt in early-2001, displaying a slight growth in the first months of the year.

By maturity mostly long-term borrowing – 1–5 years – continued growing. During two years the share of loans with over 5 years of maturity has increased from 50% to 60%, showing a growth in the bank portfolio's interest rate risk.

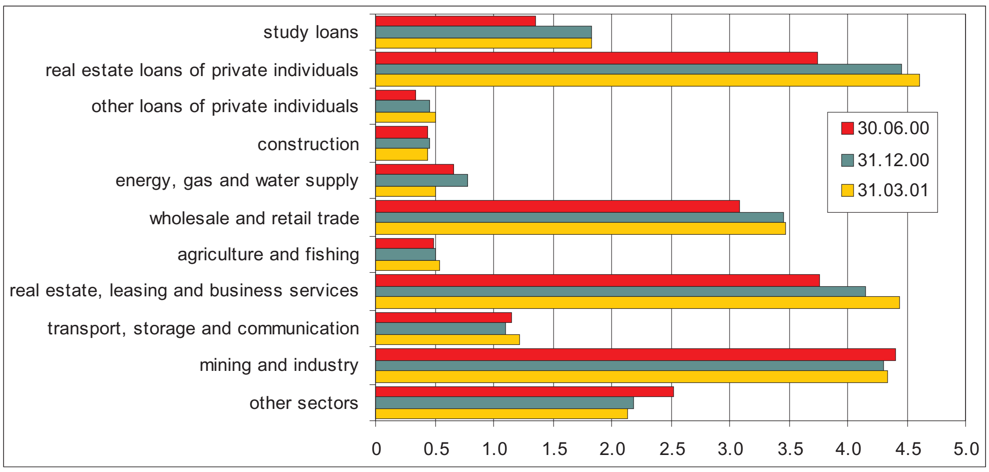

Figure 5.3. Banks' loan portfolio by sectors of economy (EEK billion)

By collateral mortgage is moving upward and pledged building downward. This change characterises developments in the ownership reform, moving to the forefront technically more stable collaterals.

Banks' claims on subsidiary and associated undertakings or holding in those increased rapidly in the 8-billion-kroon banks' securities portfolio, reaching about 3.5 billion kroons by end-March. Over the last six months the most significant shift in the securities portfolio has been the about threefold rise in the volume of subsidiary undertakings' debt securities. The volume of resident securities not associated to subsidiary undertakings has been contained at 1.8 billion kroons for a longer while already. A major change in other resident and non-resident securities took place in end-2000 when banks acquired foreign bonds due to changes in the principle of reserve requirement entering into force at the turn of the year. At the beginning of this year their share continued to grow. The volume of external bonds totalled just about 3 billion kroons by the end of the first quarter, about half of which are used to meet the reserve requirement. As banks can use foreign assets for fulfilment of reserve requirement, the foreign bond portfolio could increase even further with bond markets displaying favourable developments.

The decline in the share and volume of overdue loans continuing throughout the year 2000 came to a halt in the first quarter of 2001 (see Figure 5.4). The volume of overdue loans grew in proportion with the loan portfolio in the first months of the year. In the first quarter all overdue loans were responsible for about 5% of the overall loan portfolio, loans overdue 60 days exceeded 2%. The quality of export industries' loan portfolio is improving: the share of overdue loans in the industrial, transport and construction sectors has been shrinking steadily. The share of overdue loans in commerce and real estate development sector has moved upward, possibly due to loan servicing difficulties arising from increasing competition as more shopping centres are being built.

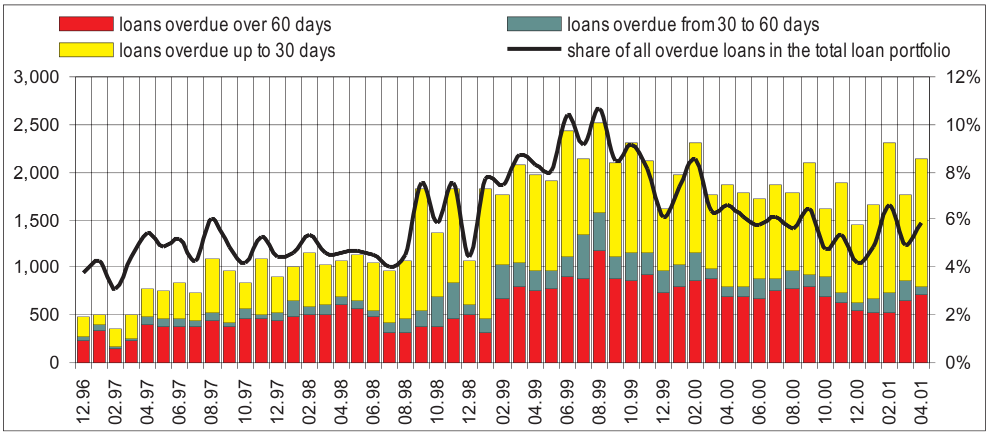

Figure 5.4. Volume of overdue loans (EEK mn, the left scale) and their share (the right scale) in banks' loan portfolio

Liabilities

Beginning from the summer of 1999 deposits of private individuals have been responsible for most of banks' liabilities. Over the last year their share has been about 29%. At the beginning of 2001 corporate depositing slowed down and their share dropped to 23%. Time deposits for up to 3 months and 6–12 months have been steadily gaining in volume. The share of time deposits for 1–3 years more actively used in the past is gradually decreasing, losing primarily to shorter maturities.

In the structure of liabilities the share of 2–5year and 6–12month resources has increased. This reflects in external borrowing the replacement of previous liabilities with new ones[1]. As the growth of the stock of this liability was modest (0.15 billion kroons over a quarter), their share is continuously shrinking (see Figure 5.5). In end-1998 they constituted about 30% of the liabilities, while this year in end-March 21%. With resident depositing growing, the share of external-borrowing-related liabilities should continue decreasing thereby reducing banks' potential vulnerability.

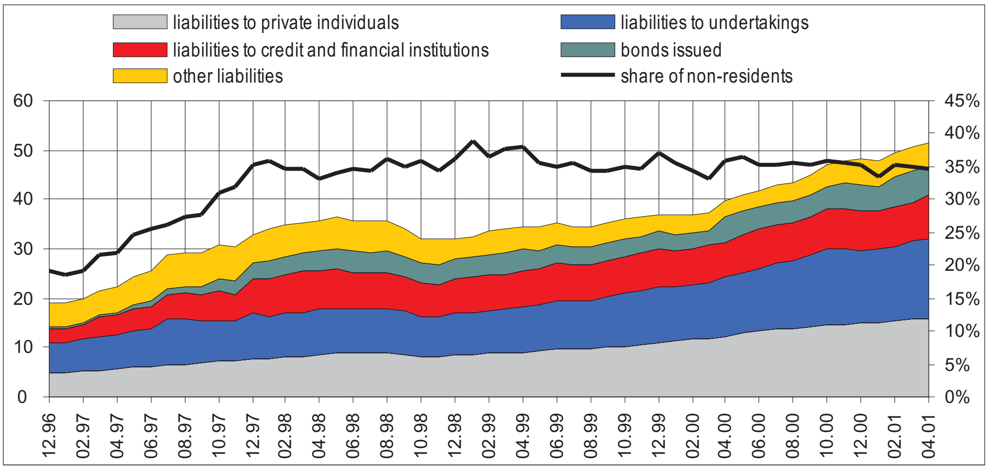

Figure 5.5. Banks' external liabilities (EEK billion, the left scale) and share of non-residents (%, the right scale)

Return on Equity

The growth in profit margin has slightly improved banks' return on equity in the first quarter of this year (see Table 5.1). Return on equity has grown as non-interest rate expenses have significantly shrunk whereas interest expenses were contained on the level of the previous period. The key factor in shrinking non-interest rate expenses was declining written-off loan loss; the administrative costs continued falling as well.

Table 5.1. Banks' profitability indicators

	Q4 1998	Q1 1999	Q2 1999	Q3 1999	Q4 1999	Q1 2000	Q2 2000	Q3 2000	Q4 2000	Q1 2001
Equity multiplier	7.08	6.25	6.35	6.31	6.37	6.27	7.01	7.34	7.72	7.85
Return on equity	-9.42%	2.04%	2.38%	2.13%	2.63%	3.24%	2.55%	2.45%	0.19%	4.08%
Return on assets	-1.33%	0.33%	0.37%	0.34%	0.41%	0.52%	0.36%	0.33%	0.02%	0.52%
Profit assets	-37.84%	10.43%	11.56%	12.12%	14.32%	18.76%	13.64%	12.28%	0.81%	17.67%
Assets utilisation	3.51%	3.13%	3.24%	2.79%	2.88%	2.75%	2.67%	2.71%	2.99%	2.94%

The asset utilisation decreased slightly in the first quarter. This was caused by preferential decrease of interest income over the growth of non-interest rate income. The reducing of average interest income of loans is due to ever-increasing loan flow into leasing companies, affiliated

[1] External institutional borrowing and bonds issued on international markets.

undertakings of the banks, as well as due to a drop in the interest rates. The growth in non-interest rate income remained below usual whereas **service charge income dropped most**.

The above reasons and shrinking interest income have pushed net interest margin and spread to historic low for banks. The interaction between decreasing non-interest rate expense and growing non-interest rate income has taken non-interest revenue to the highest ever. As anticipated financial leverage has grown slightly, continuing the trend broken in the fourth quarter of 2000, although this has had no significant impact on the return on equity.

Securities Market

Stock Market

The capitalisation of the stock market dropped from 32.7 billion kroons at the end of December 2000 to 28.2 billion kroons by end-March 2001, following the trend characteristic of the majority of the Central and East European stock markets due to the turbulence in developed countries' securities markets (see Figure 5.6). Although corporate economic outcome of the last year published at the beginning of 2001 is considered favourable, investors probably had higher expectations and no anticipated rise in stock prices took place. The passive market and leaving investors sent prices downward instead. The low average monthly turnover at Tallinn Stock Exchange, reaching barely 600 million kroons in the first quarter characterises well the passive market. Before the economic data on the first quarter was released, the market recovered again, partially because of upcoming dividend payments. Corporate financial results were well received; prices started to move upward and turnover increased. Both local and foreign institutional investors have become more active.

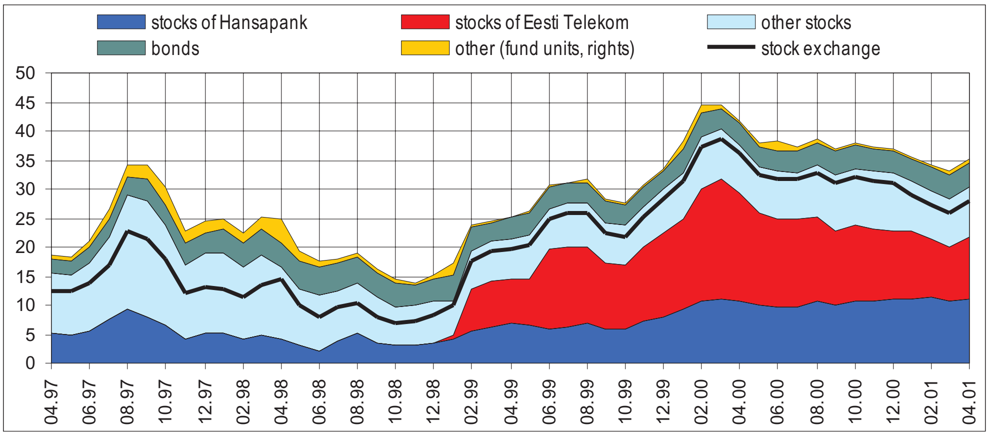

Figure 5.6. Securities market capitalisation (EEK billion)

Tallinn Stock Exchange index TALSE dropped from over 140 points achieved by end-January to about 120 points by end-March but moved upward again in mid-April and exceeded 136 points by the end of the second week of May. Stocks of the services sector dropped most – by 17% – during the first quarter (see Figure 5.7). This was caused by the extended decline of Eesti Telekom stocks. Contrary to the general trend, industrial sector stocks went up by 3%.

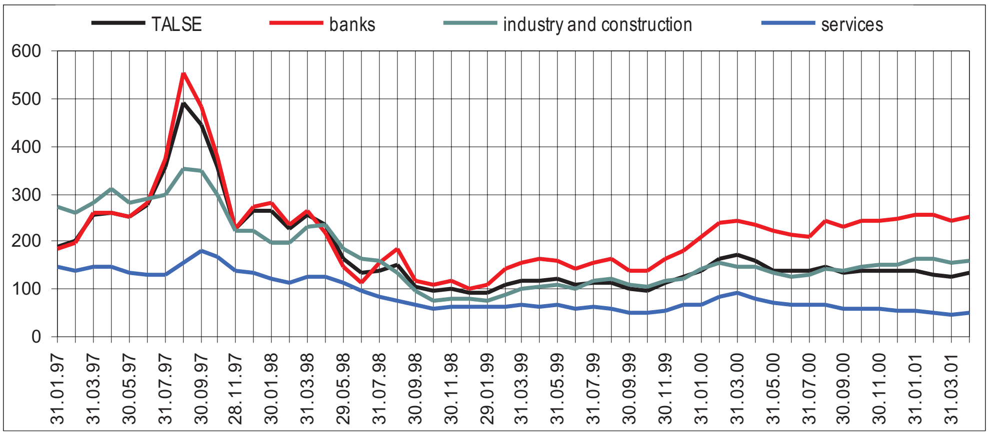

Figure 5.7. Indices of stocks traded on the Tallinn Stock Exchange by sectors of economy and TALSE (points, 3 June 1996 = 100)

Bond Market

Bond market capitalisation has started to increase as of the beginning of 2001, being continuously above 4.2 billion kroons during the last three months (even above 4.3 billion kroons in end-March). The issue volume has also expanded: new bonds were issued for 1.5 billion kroons in the first quarter. The share of Swedish and Finnish strategic owners of banks is increasing among issuers. Also local undertakings, responsible for over 30% of issues, have become more active at the beginning of the year. Maturities have slightly extended, although 90% of issues mature under a year. The average interest rate of bonds issued is just above 5 per cent (see Figure 5.8).

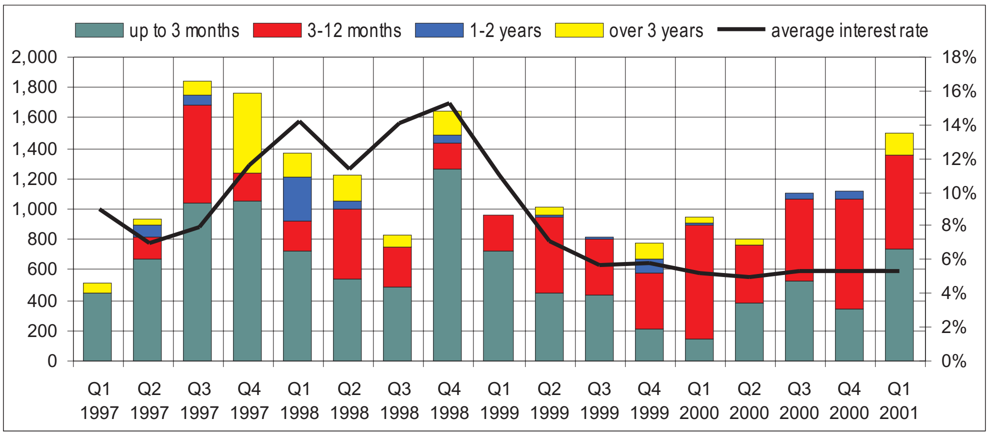

Figure 5.8. Volume of bonds issued in a quarter by maturity (EEK mn, the left scale) and average interest rate of kroon bonds (the right scale)

Other Financial Intermediaries

Insurance

Non-life insurance companies collected premiums for 353 million kroons in the first quarter of the year, 6% above the year-ago period (see Figure 5.9). The growth is largely seasonal as about half of the premiums (mostly compulsory motor TPL insurance and insurance of commercial property) were collected in January and later their volume shrank. The compulsory

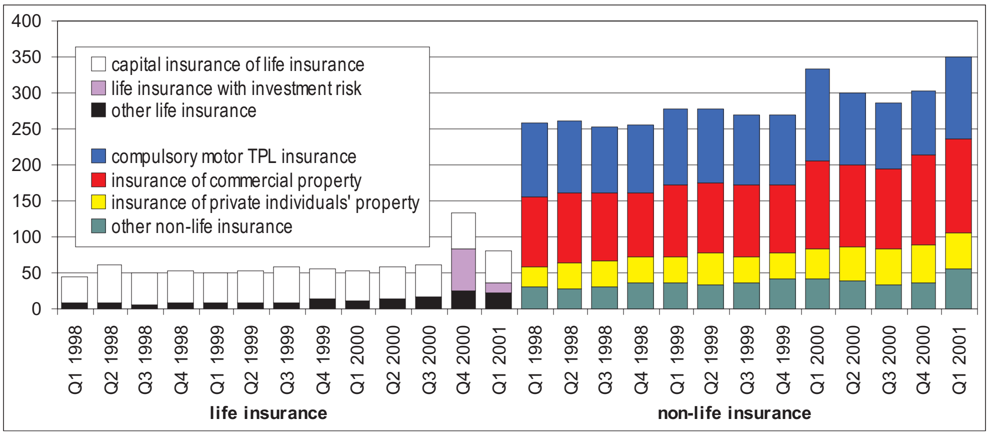

Figure 5.9. Gross premiums collected by insurance companies (EEK mn)

motor TPL insurance (32%), legal person's motor vehicle insurance (27%) and insurance of commercial and private individuals' property (10% each) have the largest share.

In the first quarter life-insurance companies collected 80 million kroons of premiums, 50% above the same period in 2000, nevertheless remaining below the volume of the fourth quarter of 2000. In the last quarter of 2000 the volume of life insurance premiums increased substantially because in 2001 an amendment of the Income Tax Act entered into force, extending the minimum maturity of income-tax-exempt life insurance policies from eight to twelve years. Among insurance categories life insurance with investment risk gained most in volume, being responsible for 17% of life insurance premiums. Pension insurance continues stable growth as well. 18% of all premiums go to pension insurance.

Leasing

In the first quarter the growth in the leasing portfolio slowed down slightly: the 821-million-kroon growth in the fourth quarter of 2000 was followed by the growth of 449 million kroons in the first quarter of 2001. The leasing portfolio totalled more than 9.7 billion kroons. Sale by instalments, which started to increase in previous periods, maintained its growth in share by shrinking capital lease (see Figure 5.10). The sale by instalments is already responsible for over a quarter of the leasing portfolio. The share of consumer factoring has slightly decreased; this has probably lost in importance due to expanding sale by instalments.

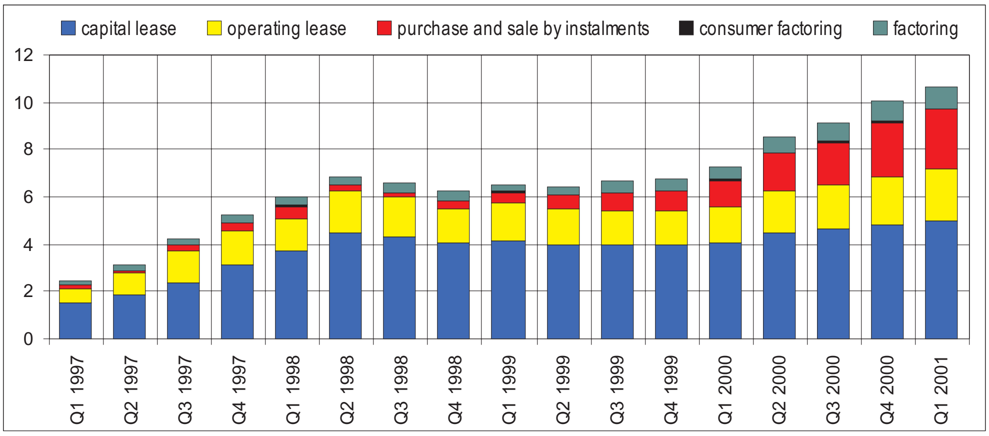

Figure 5.10. Volume and structure of leasing companies' portfolios (EEK billion)

The share of private contracts has significantly moved upward since the fourth quarter of 2000. This trend is partially due to sharply increasing sale by instalments, comprised primarily of real estate leasing and credit-card type sale-by-instalments products. In the first quarter the corporate leasing stock grew by 300 million kroons. Real estate development (304 million kroons), wholesale and retail trade (255 million kroons), transport, warehousing and communication (226 million kroons) and industry (186 million kroons; see Figure 5.11) received most of the money in the first quarter.

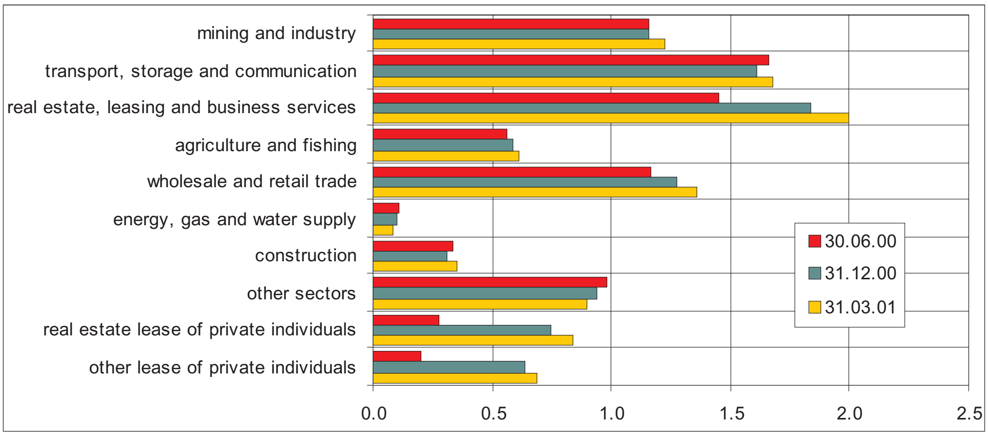

Figure 5.11. Leasing portfolio by sectors of economy (EEK billion)

The share of real estate objects in the leasing portfolio (over 25%) is continuously increasing at the expense of all other objects. This explains well the large growth in the stock of sale by instalments. On the other hand, the turnover of real estate leasing fell from about a billion kroons in the fourth quarter of 2000 to 300 million kroons in the first quarter of 2001, comparable to the early-2000 quarterly turnovers. Contracts with private individuals are responsible for 33% of total real estate leasing (840 million kroons).

Investment Funds

The volume of investment funds has started to grow significantly in 2001, increasing by 600 million kroons (40%) between end-December last year and end-April this year, exceeding 2.1 billion kroons by the end of April 2001 (see Figure 5.12). Almost all funds

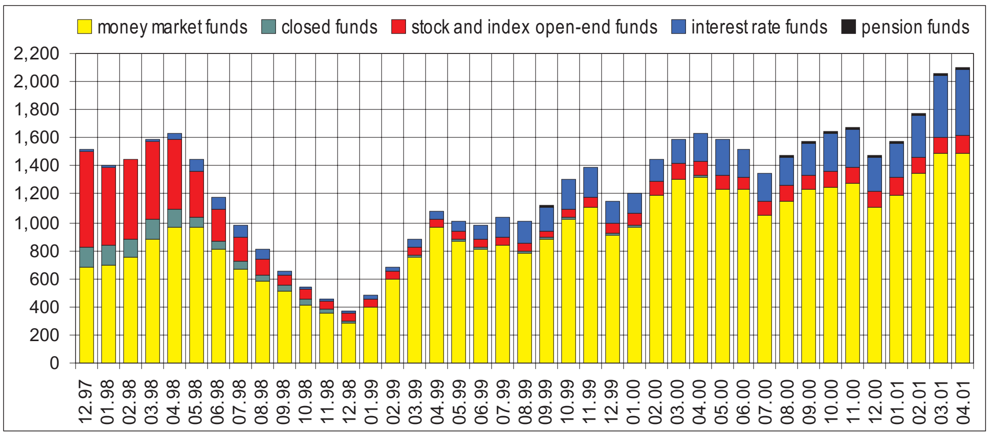

Figure 5.12. Volume of investment funds (EEK mn)

have increased their volume (except growth funds), with interest rate funds growing most. The structure of fund assets has remained unchanged whereas the share of cash has significantly grown, as rapidly added amounts have not yet allowed time to invest in interest-bearing assets. The resources are likely to be used for purchasing fixed income bonds. To a lesser extent they will be deposited, dependent on the investment strategy of interest rate and money market funds.

Payment System

The turnover and number of payments maintained their rapid growth. In the first quarter of 2001 the number of payments was about 42% above the year-ago period – five million transactions a month. The turnover of transactions increased meanwhile by about 23% (see Figure 5.13). Traditionally the turnover of domestic payments grew most – by close to 25%. The turnover of outgoing external payments increased by 20% and incoming external payments by 27%.

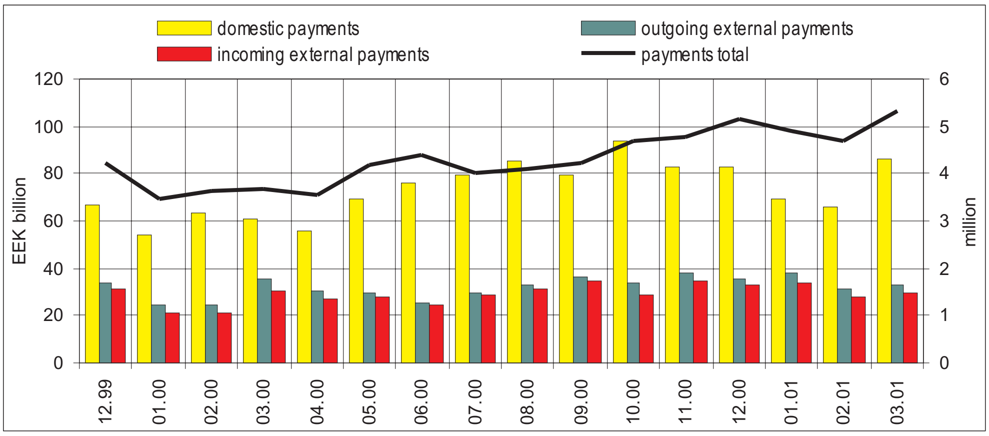

Figure 5.13. Turnover of payments by types (EEK billion, the left scale) and total number of payments (million, the right scale)

The use of conventional paper-based payment orders kept decreasing. In the first quarter of 2000 their share was about 18%, shrinking to 11% a year later. Unlike other electronic instruments, the share of telephone banking diminished from 3.9% to 2.3%. The share of direct debit increased from 4.7% to 7.3% over the year. Out of electronic payment modes Internet banking and card payments have grown the most, from 21% to 31% and 26% to 33%, respectively. Economic participants prefer cheaper and more flexible services.

Banks' persistent marketing campaigns have raised the number of bank cards by 15% in the first quarter of 2001 against the year-ago period, reaching 895,000 of which 93% are debit cards and 7% credit cards. The number of credit cards increased threefold (from 22,300 to 60,000) in the first quarter of 2001 against the same period last year. The number of ATMs has grown by 32: reaching 636 by the end of the first quarter of 2001. The number of points of sale has meanwhile increased from 3,575 to 4,608.