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FINANCIAL SECTOR DEVELOPMENT

Growth in banks' loan and leasing portfolio, the growth rate of which was 2.5 times up against the economic growth of the third quarter of 2003, sustained rapid financial deepening. Thanks to rapidly growing borrowing the growth of banks' total assets remained below the growth of loan portfolio, edging up the share of loans in asset structure. Decelerating deposit growth and contemporaneous high credit demand boosted external borrowing by banks, raising the share of institutional external financing in liabilities to 29%. As a result of such developments lending exceeded deposits by about a quarter in end-third-quarter.

Although in the third quarter banks' interest income shrank for the first time during the interest rate recession, banks' profitability remained high due to income from service charges and financial transactions as well as low provisions. Besides, the quality of the loan portfolio enabled to maintain profitability. Despite the rapid rebound of the loan and leasing portfolio, the banks' capital adequacy ratio rose from 14.7% in the second quarter to 15.4% in end-third-quarter, primarily because the second-quarter profits were included in own funds.

Out of other financial intermediaries, investment funds display the fastest growth, although there were signs of slowdown in the third quarter. At the beginning of the quarter stock market capitalisation kept growing (see Figure 5.1), sustained in thin market by a price increase accompanying foreign investors' purchase interest. In September, uncertainty-hit markets entailed a slight adjustment to share prices. Unlike other markets, shrinking volume and turnover were characteristic of bond markets.

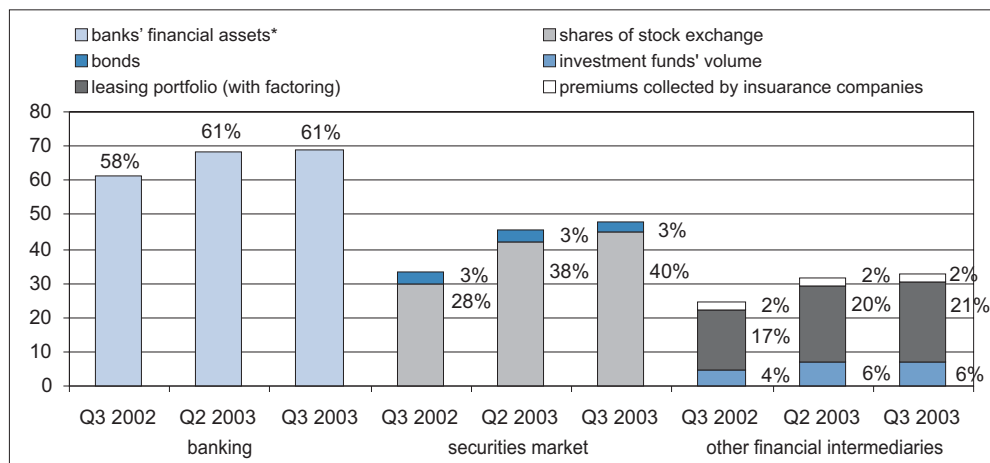


Figure 5.1. Estonian financial intermediaries (EEK billion and % of GDP)

* without loans to financial institutions

Banking

Banks' Assets and Their Quality

In the third quarter, banks' total assets grew by 1.9 billion kroons and, including the 2-billion increment in October, total assets reached 92.3 billion by end-October (see Figure

5.2). The stock of the loan and leasing portfolio increased by 3.7 billion kroons during the quarter, gaining another 1.5 billion kroons in October. The loan and leasing portfolio totalled 65.9 billion kroons by end-October. Rapidly growing lending has contained the growth of banks' total assets below the growth of the loan portfolio, whereby the share of loans in the asset structure has gone up.

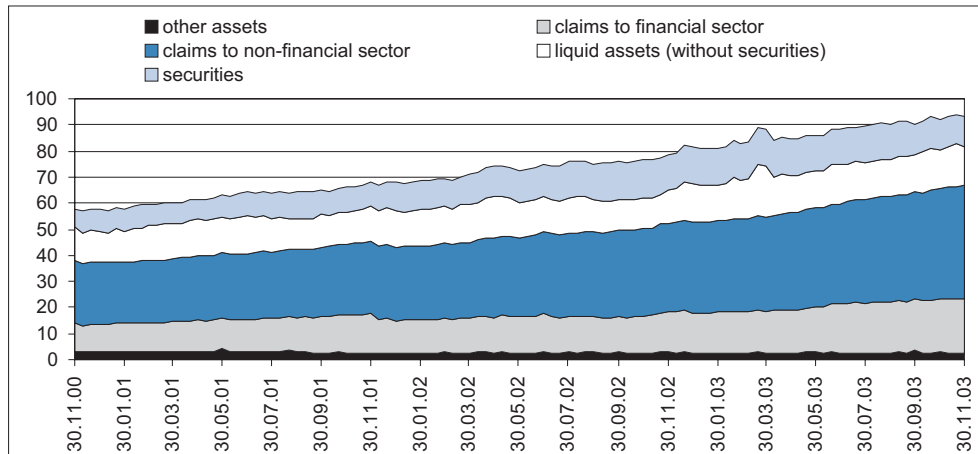


Figure 5.2. Banks' total assets (EEK billion)

Households have continued to contribute to the growth of the loan and leasing portfolio. This boosted the household loan and leasing stock by 2.2 billion kroons during the quarter (see Figure 5.3). Although the households' loan portfolio has been growing primarily at the expense of housing loans, also consumption loans added volume, particularly hire purchase facility, other small financing transactions and car leasing. In the **corporate** sector mainly commercial

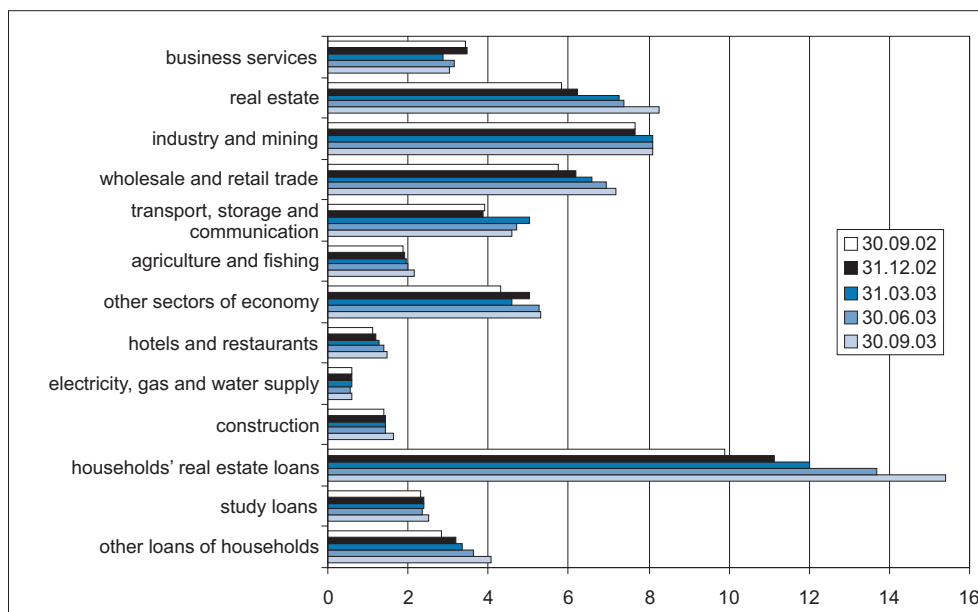


Figure 5.3. Total loan, leasing and factoring portfolio by sectors of economy and purpose of loans (EEK billion)

and real estate undertakings borrowed. Financing of transport, manufacturing and fishing shrank below previous periods.

The quality of banks' loan portfolio remained on the previous level: the stock of loans overdue more than 60 days contracted primarily because the absolute volume of overdue loans in the total loan portfolio shrank from 1.54% in June to 0.95% in end-October. The stock of loans overdue more than 60 days declined most in the real estate sector. In the third quarter and in October, only the stock of loans taken by the manufacturing sector displayed growth (see Figure 5.4).

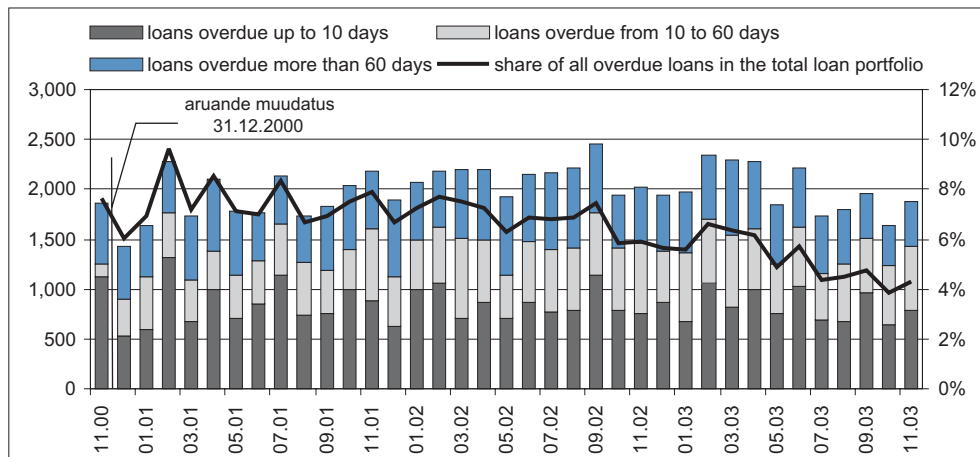


Figure 5.4. Volume of overdue loans (EEK m, the left scale) and the share in banks' loan portfolio (the right scale)

Liabilities

External borrowing has facilitated the growth in the credit volume as depositing has decelerated. Institutional external borrowing grew by 2.1 billion kroons in the third quarter, its share accounting for 29% in end-quarter. The loan-deposit ratio increased from the second-quarter 1.16 to 1.25 at the end of the third quarter (see Figure 5.5).

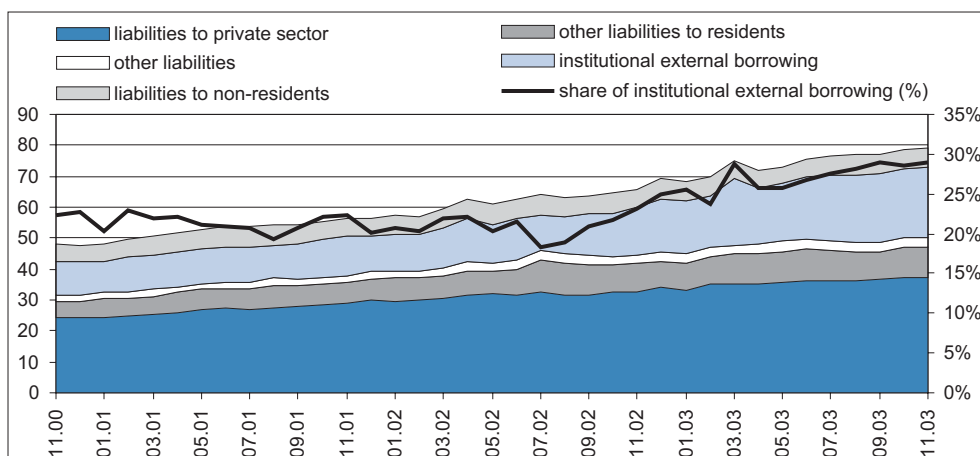


Figure 5.5. Banks' liabilities (EEK billion; the left scale) and share of institutional external borrowing (the right scale)

Despite growing risk assets, banks' capital adequacy ratio rose from 14.7% in the second quarter to 15.4% in end-third quarter, reflecting primarily the inclusion of second-quarter profits in own funds. However, the loan portfolio and resultant growth in risk assets brought the capital adequacy down to 15.1% by end-October.

Return on Equity

Banks earned 1.03 billion kroons of profit over three quarters, up by a fifth year-on-year.

In early-third quarter the growth of consolidated profitability decelerated, although as a result of nine months the net profit – 2.08 billion kroons – exceeded by about a fifth the year-ago level and the net return on equity has remained high (20%).

In the third quarter, unlike the first half of the year, inhibited interest income characterised banks' profit formation both on solo and consolidated basis. Service charge and financial transaction income as well as smaller provisions set this impact off. Interest income decline was linked to inhibited income from the loan portfolio. Thereby the price spread fell to 3.23% in the third quarter from 3.47% a quarter earlier.

Contrary to interest income, service charge income has sustained growth. Apart from loan issue and transformation charges that account for about a third of the service charges, also income from e-banking service charges was supportive. Administrative costs have remained stable.

Securities Market

Stock Market

Share prices in Tallinn Stock Exchange sustained a rise also in the third quarter, peaking prior to the EU accession referendum in mid-September (306,44 points). However, it was not the main listed shares but rather other industry, construction and service sector shares, which sustained the growth. The peak was followed by a short adjustment period, which returned the stock index close to the peak by end-year.

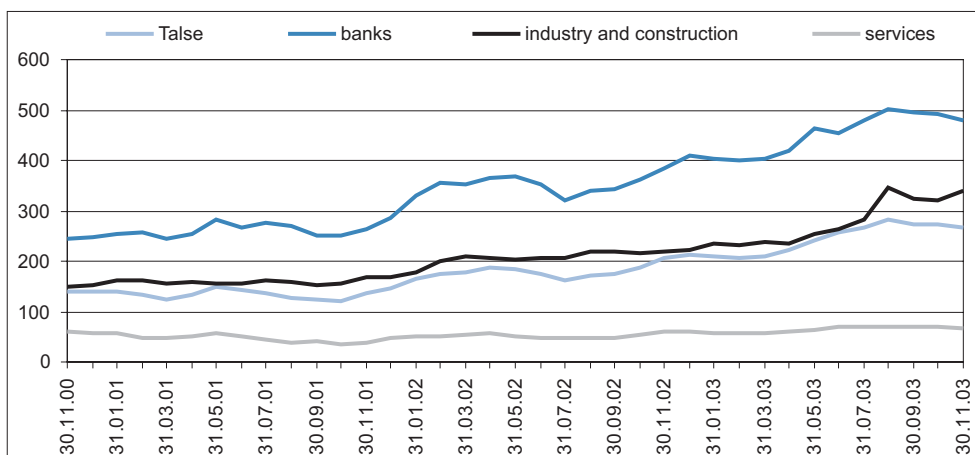


Figure 5.6. Taise and indices of stocks traded on the Tallinn Stock Exchange by sectors of economy (points)

Although the turnover remained seasonally low in the third quarter, Tallinn Stock Exchange recovered in September and October. The daily average turnover reached 27 million kroons in the third quarter (see Figure 5.6).

Bond Market

The contraction in the primary bond market deepened in the third quarter. During each of the first two quarters of the year bonds were issued for about 900 million kroons, the volume of the bonds issued in the third quarter reached 580 million kroons. Resident companies were among major issuers in the third quarter. Similarly to the first half-year, banks issued about half of the bond volume. The turnover of bonds shrank similar to the volume of issue, reaching 135 million kroons as quarterly average (see Figure 5.7).

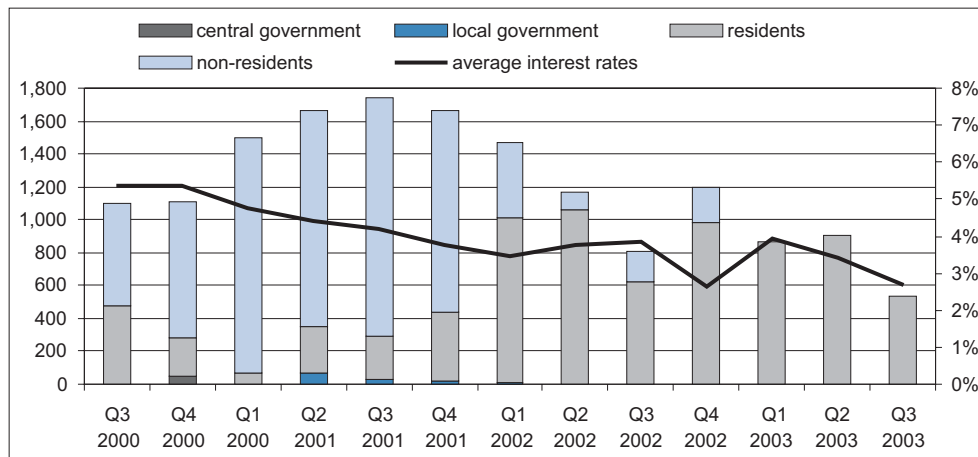


Figure 5.7. Volume of bonds issued in a quarter by issuers (EEK m, the left scale) and average interest rate of kroon bonds (the right scale)

Other Financial Intermediaries

Investment Funds

The volume of investment funds was volatile in the third quarter, although the growth decelerated over three months. Money market, interest rate and stock funds added merely 40 million kroons during the quarter – totalling 6.9 billion kroons. Most of the growth is attributable to the volume of stock funds – up by 80 million kroons. Money market funds ranked second growing by 61 million kroons. Interest rate funds have been shredding volume since June: by 240 million kroons in the third quarter and October. **One of the underlying causes in the decrease of interest rate fund volume could be shrinking productivity, as the annual yield of money market and interest rate funds fell by 2.3 and 3.5%, respectively, on the average in the third quarter.** Due to a recovery of major stock markets and sustained growth of share prices on Baltic stock exchanges in the third quarter, the annual yield of supplementary pension funds and of riskier second-pillar pension funds has significantly gone up (see Figure 5.8).

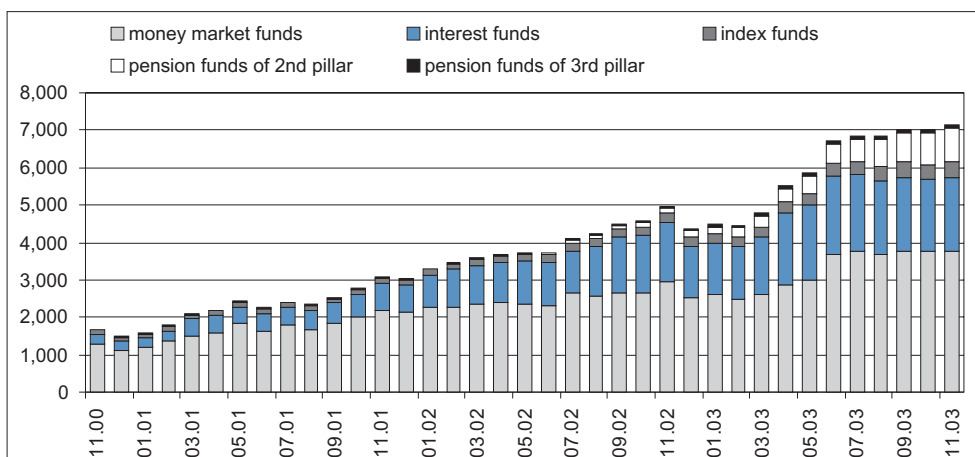


Figure 5.8. Volume of investment funds (EEK m)

Insurance

During the third quarter of 2003, **life insurance companies** collected premiums for 147 million kroons, about 44% more than a year ago. The preferential growth of life insurance against other types of insurance derived fully from supplementary funded pension scheme, ie the third pillar of pension insurance, as the conclusion of insurance contracts has become more active.

Non-life insurance companies collected gross premiums for 510 million kroons in the third quarter, 33% up from the year-ago level. In the third quarter, the compulsory motor TPL insurance as well as voluntary private motor vehicle and property insurance sustained the highest growth (see Figure 5.9).

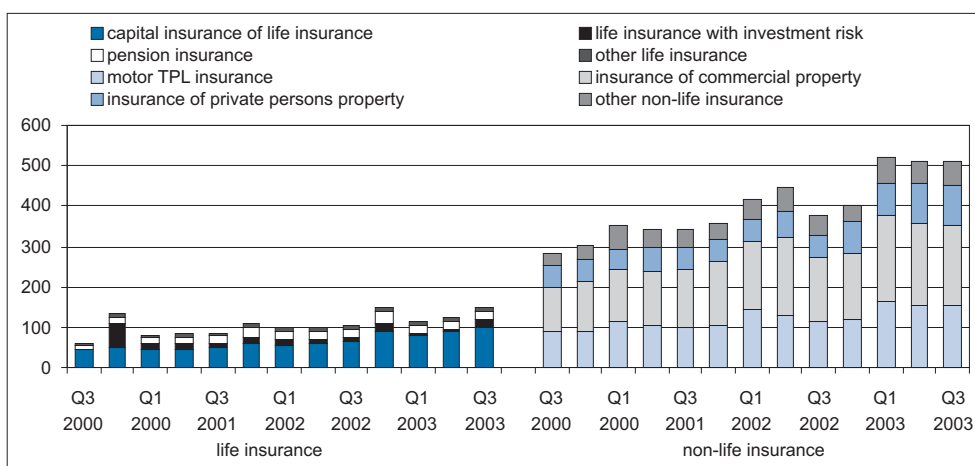


Figure 5.9. Gross premiums collected by insurance companies (EEK m)