II BANKING SECTOR STABILITY AND RISKS

STRATEGIC DEVELOPMENT OF THE BANKING SECTOR

Seven companies licensed as credit institutions in Estonia and branches of seven credit institutions licensed in another European Union Member State were operating in Estonia at the end of the first quarter of 2007. Four foreign credit institutions had representative offices in Estonia and over 140 foreign credit institutions provided cross-border banking services. Approximately 20 new cross-border service providers have emerged during the past half-year.

The distribution of banks' market shares has remained relatively stable despite new market participants. At the end of the first quarter, 96% of the stock of loans and leases granted in Estonia was divided among four major market participants. Two of the major participants held 74% of that.

Considering only banks and not the whole consolidated groups, the growth of the assets of banks licensed in Estonia and branches of foreign banks operating in Estonia has decelerated slightly. This has been caused by the stabilisation of the loan market and changes in the financing schemes of subsidiaries. At the end of the first quarter of 2007, the year-on-year growth of assets reached 26% (33% the year before). The assets of credit institutions controlled by branches of foreign credit institutions or non-resident financial groups comprised 98% of the total volume of banks operating in Estonia.

Operating in the markets of neighbouring countries, primarily in Latvia and Lithuania, has gained importance in the activities of local banking groups. According to Hansapank group, the group's activities outside Estonia comprised 47% of the total operations in the first quarter of 2007. For the first time, the share of loans granted in Estonia among the total volume of loans granted by Hansapank group dropped below 40%.

Quality of assets

During the past half-year, the **growth rate of credit volume** decelerated for the first time after several years of acceleration (see Figure 1). There are many reasons for the stabilisation of the loan market: the rise in interest rates, the stabilisation of the real estate market and, to some extent, the adjustment of expectations to the future economic environment. The growth rate of housing loans has decelerated the most, declining to 55% by the end of the first quarter of 2007 (67% the year before). The growth pace of corporate loans is also slowing down. Consumption credit, on the other hand, is increasing rapidly from the initial low level.

At the end of the first quarter of 2007, the **total volume of loans and leases** issued in Estonia reached 216 billion kroons. The annual growth rate of the financing portfolio decreased from 52% at the end of the third quarter of last year to 48% at the end of March 2007 (49% in March 2006). Within the two last quarters, the total volume of the financing portfolio grew by 34 billion kroons. Household loans and leases held the largest share (see Figure 2). The volume of household loans and leases increased by a total of 16.8 billion kroons, accounting for 49.5% of the total growth of the financing portfolio. Compared to the end of the third quarter last year, the share of household loans and leases in the growth has risen by 4%. Commercial real estate development and management companies had the second largest share with 22%, which is as much as at the end of the third quarter of 2006.

Banks' financing portfolios primarily consist of loans related to housing and commercial real estate, which also experienced the highest growth rates. This reflects the increasing share of mortgage used **as collateral for bank loans** (see Figure 3). At the end of the first quarter of 2007, about 78% of loans were collateralised by pledges of buildings or mortgages. The share of loans without collateral has remained relatively stable at 8%. The share of loans without collateral among consumption loans has dropped (from 46% in the first quarter of 2006

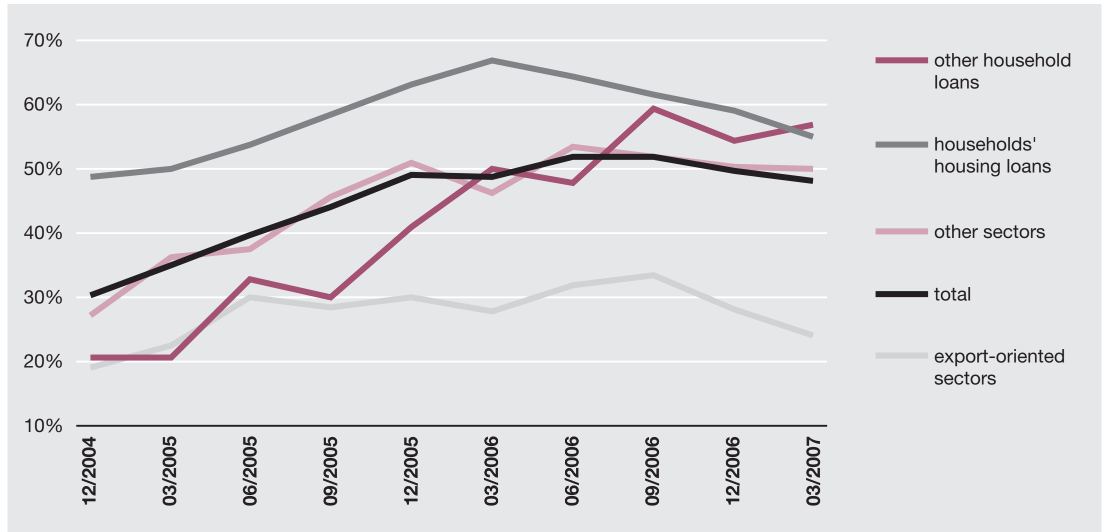


Figure 1. Loan growth by sectors

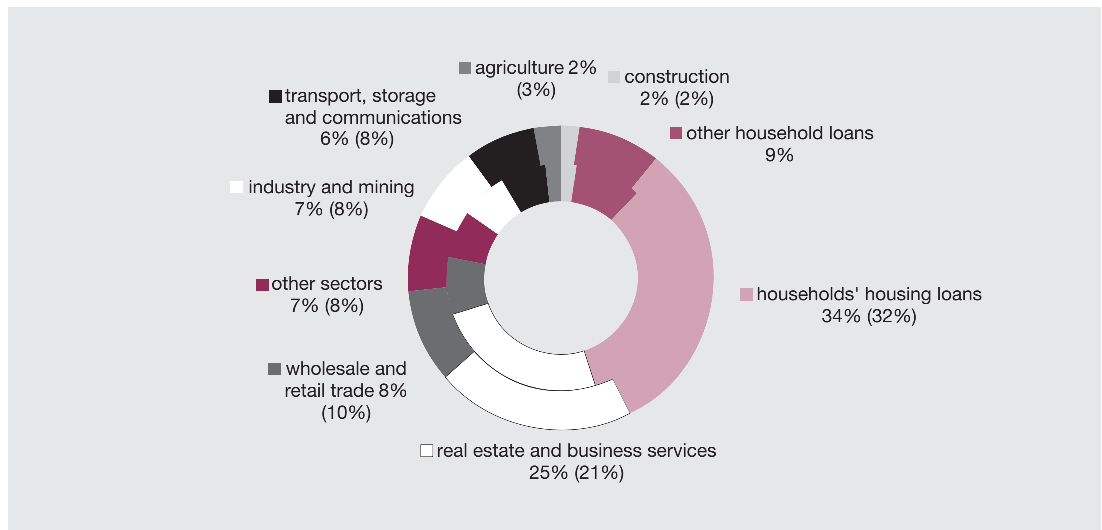


Figure 2. Financing by banks and leasing companies as at 31 March 2007 (in brackets as at 31 March 2006)

to 41% in the first quarter of 2007) and the percentage of consumption credit collateralised by real estate has risen (from 27% to 37%).

Despite the fact that customers' loan-servicing costs have increased in light of the rise in key interest rates (see Chapter I), their loan-servicing capability has remained good owing to the favourable economic environment. At the end of the first quarter, the share of **loans overdue for more than 60 days** among loans issued to the non-financial sector totalled 0.35% on an aggregate basis (see Figure 4). In international comparison, this indicator is extremely small. Although the stock of provisions for loan losses has declined slightly in recent months, at the end of the first quarter it still exceeded the volume of overdue loans by 28%. However, considering the possible further interest rate rise and the deceleration of economic growth, it is likely that the current modest share of overdue loans is about to increase during the next periods.

By **economic sectors**, the share of overdue consumer loans has increased along with the surge in the volume of consumer credit. At the end of March, the share of consumer credit overdue for more than 60 days reached nearly 2.1% on an aggregate basis. Also the share of housing loans overdue for more than 60 days has grown within the last six months, but still remained at a relatively low level of 0.25% at the end of March (0.24% at the end of the first quarter of 2006). Banks' assessments of the total loan portfolio have even turned more positive within the past six months. At the end of the first quarter, banks classified 90.3% of loans as "in order" (89.2% in the first quarter of 2006). The share of loans "subject to special monitoring" had dropped to 7.4% (8.6% in the first quarter of 2006).

Regarding banking groups, the share of write-downs in the loan portfolio has decreased even further on a consolidated basis. In the first quarter, the stock of provisions for loan losses comprised 0.67% of the aggregate portfolio of banking groups (0.72% in the first quarter of 2006). The share of loans overdue for more than 60 days in the financing portfolio of groups has remained relatively stable, accounting for approximately 0.35% of the aggregate loan portfolio at the end of the first quarter. Total write-downs of banking groups exceeded the volume of loans overdue for more than 60 days by about 1.9 times.

The small share of overdue loans may be attributed to the favourable economic environment. Although the volume of provisions for covering loan losses is satisfactory, during next periods potential developments in Latvia and Lithuania should also be taken into account.

Capital adequacy

On 1 January 2007, the new capital adequacy calculation principles entered into force[1], but due to the transition period all banks are still using the former system for calculating the adequacy ratio.

The **aggregate capital adequacy ratio** has been fluctuating around 14% for the past two quarters. Across banks, however, it varies greatly. The capital adequacy ratio of banking groups was slightly over 11% (see Figure 6).

As last year Eesti Pank increased the risk weight for housing loans to 100%, **credit risk weighted items** grew significantly in March 2006. During the past six months the structure of risk weighted items has not changed considerably. The share of credit risk weighted balance sheet items in risk assets still reaches 90%. The next in volume are credit risk weighted off-balance sheet liabilities (6.5% of risk weighted items). During the past two quarters, the share of risk adjusted trading book and foreign ex-

[1] A more risk-sensitive adequacy calculation system based on the new capital adequacy accord (Basel II).

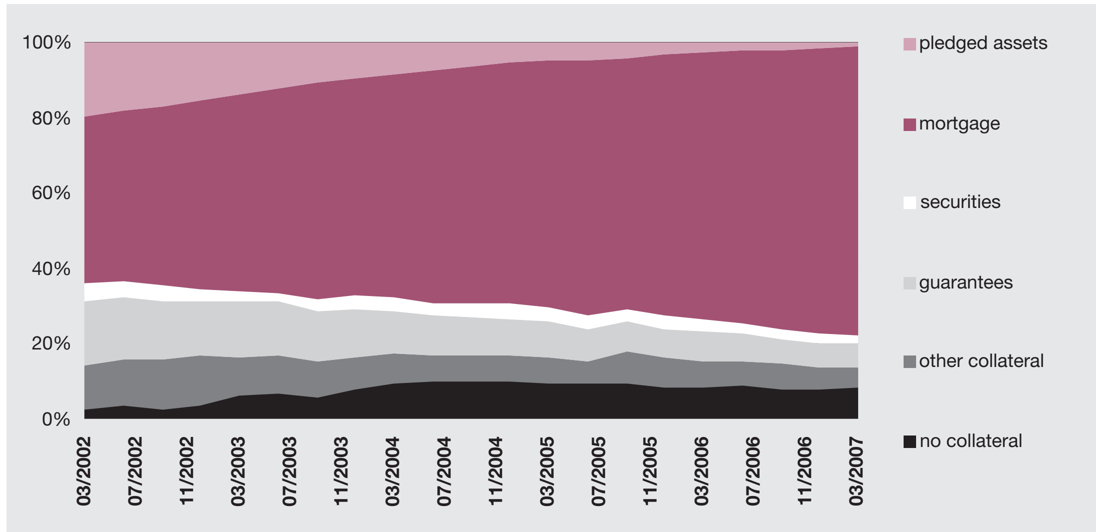


Figure 3. Loan collaterals by type

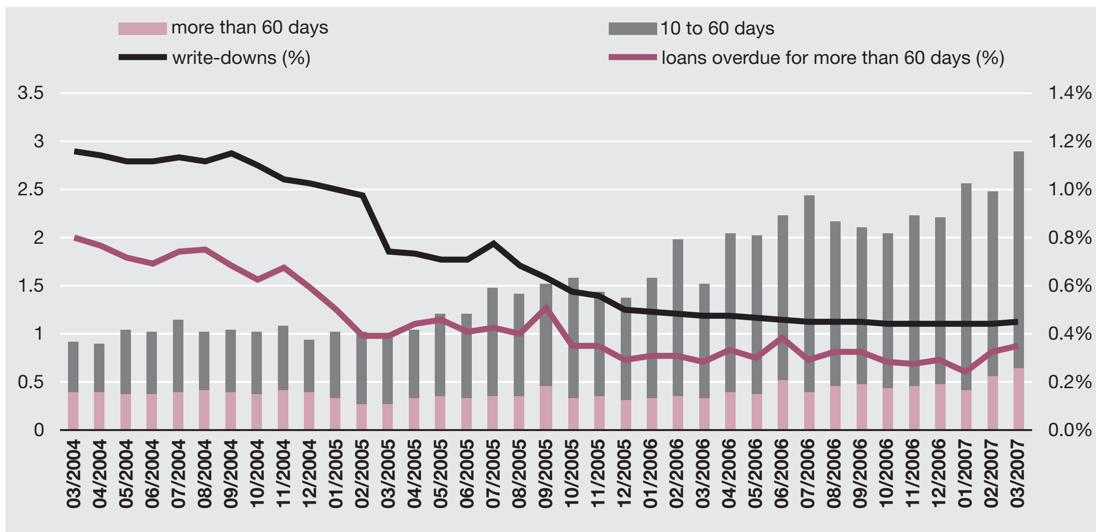


Figure 4. Volume of overdue loans (EEK bn; left scale) and share of overdue loans and write-downs in non-financial sector's loan portfolio (right scale)

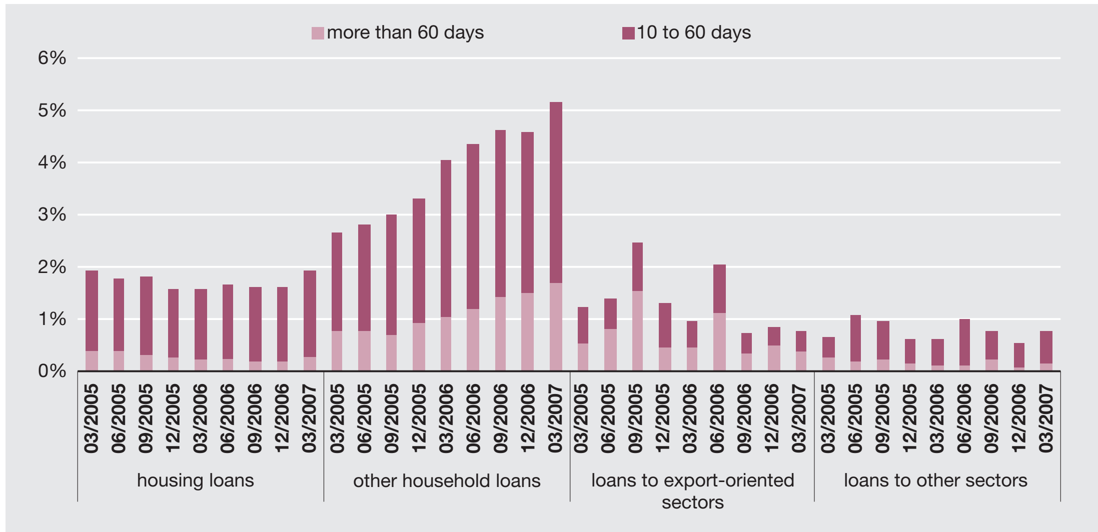


Figure 5. Overdue loans by economic sectors

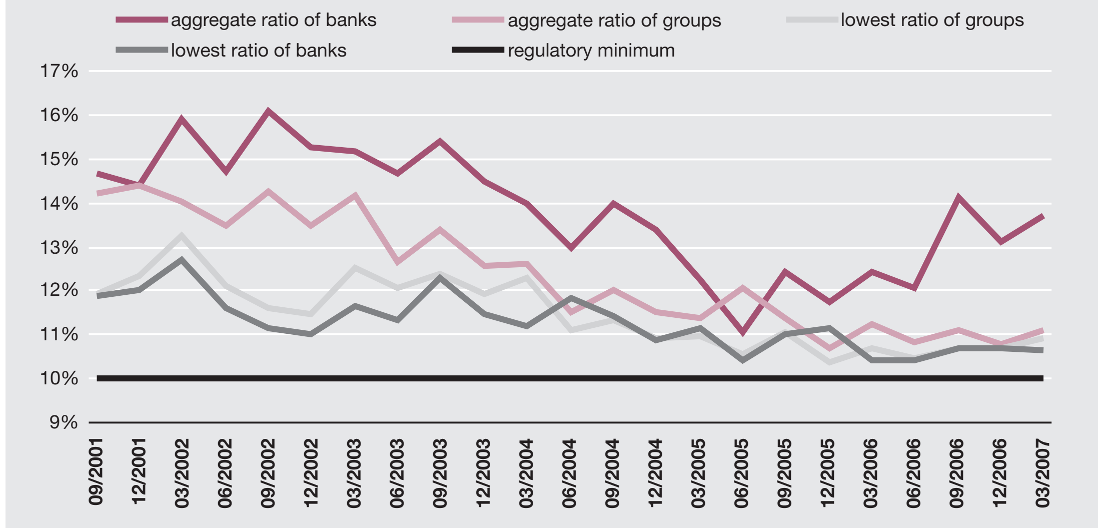


Figure 6. Capital adequacy of banks and banking groups

change positions in risk weighted items has somewhat increased (capital requirements for covering foreign exchange risks rose by 385%, year-on-year). At the end of the third quarter of 2006 they comprised 2.2% of the risk assets, whereas in this year's first quarter they formed 3.1%.

On an aggregate basis, the year-on-year growth of risk weighted items was 31% in the first quarter – slower than in the previous year before changing the risk weight (33% at the end of the fourth quarter of 2005).

In order to retain the level of capitalisation upon expanding their activities, banks had two ways to react to last year's regulation amendment: curb the growth rate of risk weighted items or increase own funds. Banks have preferred to include additional own funds rather than decrease risk weighted items. At the end of the first quarter, banks' **net own funds** totalled 27.2 billion kroons, of which 70% consisted of Tier I own funds (see Figure 7).

Own funds have gained 45% within the year (16% within the last six months). Tier I own funds have increased by 19% within the year, whereas Tier II own funds have grown by 94%. Thus, the share of Tier II own funds in gross own funds has been increasing since the first quarter of last year. In the first quarter of 2006, they accounted for 25% and in the first quarter of 2007 for 34% of gross own funds (before the regulatory amendment, Tier II own funds comprised 10% of gross own funds).

During the past year, also the difference between Tier I capital adequacy (Tier I – only primary own funds) and the total capital adequacy ratio (ratio of all own funds to risk weighted items) has been growing (see Figure 8). Until the end of 2005, the respective ratios posted relatively similar results, but since the first quarter of 2006, the gap has started to widen. Consequently, while the regulation amendment has caused an increase in the capitalisation of banks, the stucture of banks' own funds has undergone some qualitative changes.

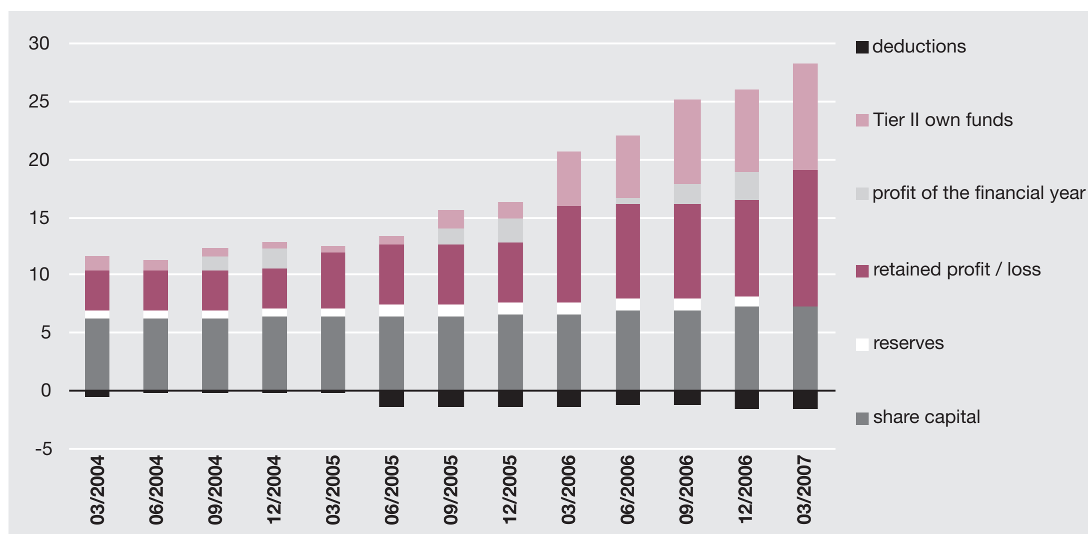


Figure 7. Structure of banks' own funds (EEK bn)

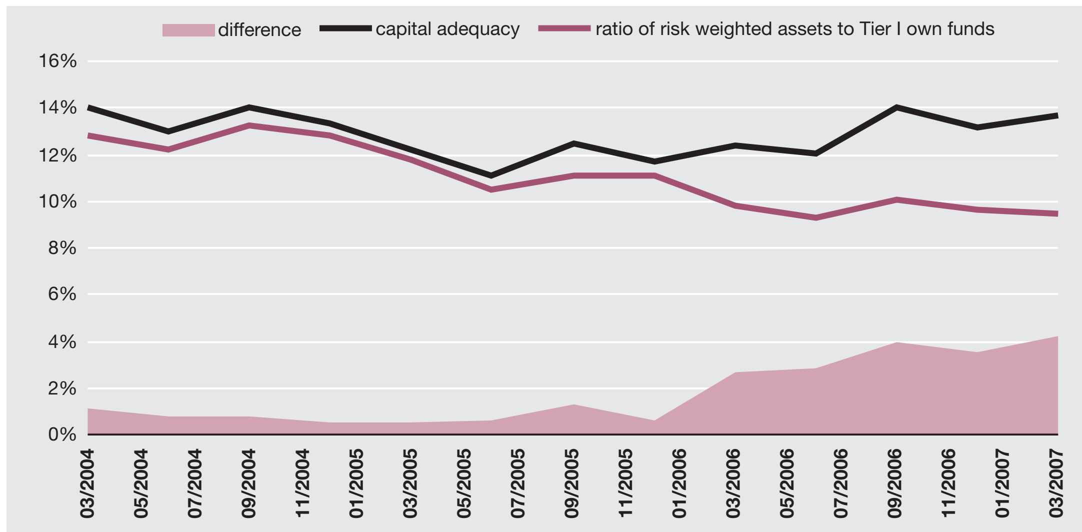


Figure 8. Tier I capital adequacy and the key indicator of capital adequacy

Liquidity

Funding

The growth of loan portfolios has been exceeding that of deposits. This has expanded the **funding gap between deposits and loans** even further. In order to fill it, more additional funds have been received mostly from parent banks.

The growth of **deposits**, which in 2005 mainly accelerated, slowed down again in 2006 (see Figure 9). Despite the growth of deposit interest rates, the negative yield stemming from inflation does not favour depositing savings but makes savers to look for profitable investment options. The interest rates on time deposits have risen much faster (year-on-year growth over 1 percentage point) than those of demand deposits, but the share of time deposits in the deposit structure has nevertheless grown by only a few percentage points. Demand deposits still comprise approximately two-thirds of all deposits (see Figure 10).

In June and July 2006, banks' **liabilities to foreign banks** diminished owing to rearrangements in intra-group financing schemes[2]. Still, owing to the continuing increase in the difference between deposits and loans, at the end of March the share of foreign financing among the banking sector's liabilities exceeded the level of 42% again and drew near 100 billion kroons.

The structure of banks' external financing did not change much within the past six months. About three quarters of our banking sector's external financing consists of funds received from parent banks as deposits and loans. The additional 9% originates from subordinated liabilities to parent banks. The volume of funds received by banks as bonds has not changed much recently. Over two thirds of bond liabilities consist of long-term funds received during earlier periods.

Although banks' **funding costs** have risen along with the increase in key interest rates of the European

[2] In financing subsidiaries, the role of local banks as resource intermediators was reduced.

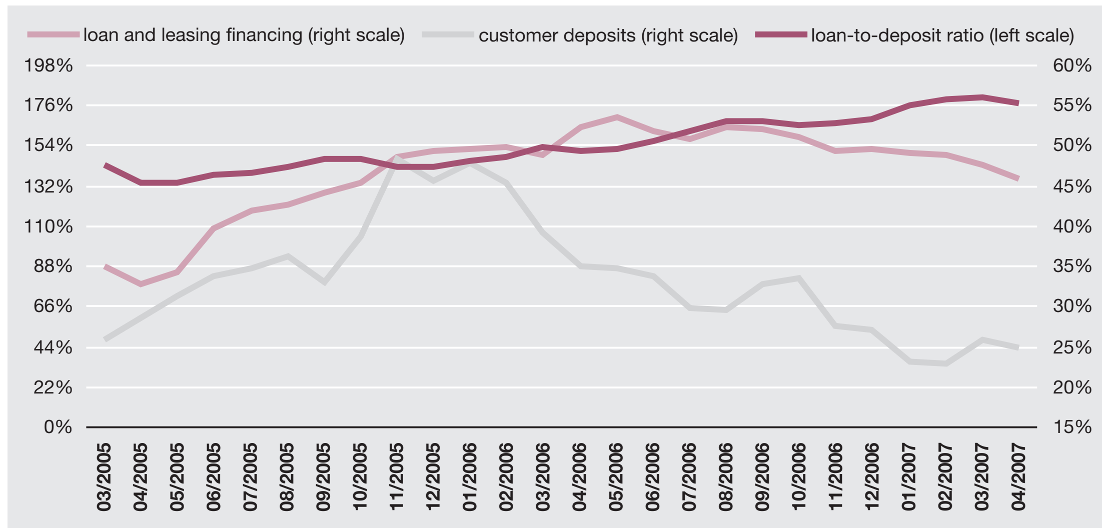


Figure 9. Annual loan and leasing growth and loan-to-deposit ratio (%)

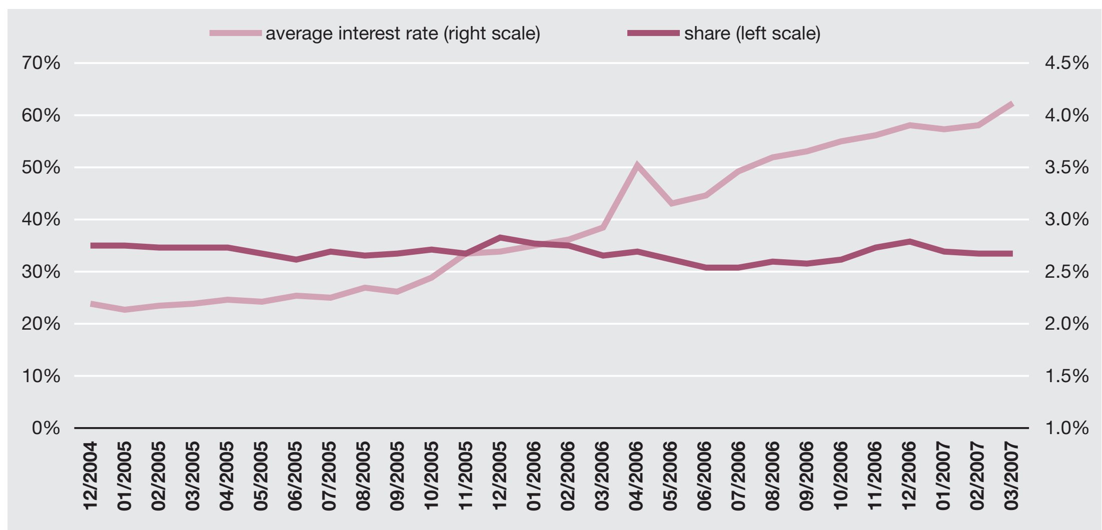


Figure 10. Average interest rate on time deposits and the share of time deposits in the deposit structure

Central Bank, they have increased less than key interest rates mainly due to the share of demand deposits. In the first quarter, demand deposits comprised 34% of all liabilities on average (see Figure 11). Also, the interest rates on time deposits have grown slower than those on external funds.

Liquid assets

After the cutback of the intermediation of funds to subsidiaries the **share of liquid assets** has remained relatively stable over the last two quarters. Also the coverage of current liabilities (with remaining maturities of up to one month) by liquid assets has remained at a below average annual level (see Figure 12).

Owing to the rising share of funds from parent banks, during the past half-year the percentage of current liabilities in the structure of banks' liabilities has somewhat decreased (liabilities with remaining maturities of up to one month now comprise less than 50% of all liabilities).

In autumn 2006, Eesti Pank raised the **reserve requirement** of banks operating in Estonia from 13% to 15%. This means that instead of 13%, banks are obliged to deposit 15% of their reserve requirement base in the central bank or own highly liquid securities. This step has also helped ensure the larger share of highly liquid assets.

Efficiency and profitability

Banks' profit growth has been supported by the continuous expansion of loan portfolios and the rise in key interest rates. As most of the loans in Estonia have been granted with a floating interest rate, banks' interest income on interest-earning assets has increased by 1 percentage point, year-on-year, to 4.9% on an aggregate basis. The interest paid on interest-bearing liabilities has increased by only 0.7 percentage points to 2.7%. The impact of the changes in key interest rates, however, has been reduced by the decreased share of deposits (as it is a cheaper resource than external financing) in banks' funding (see Figure 13).

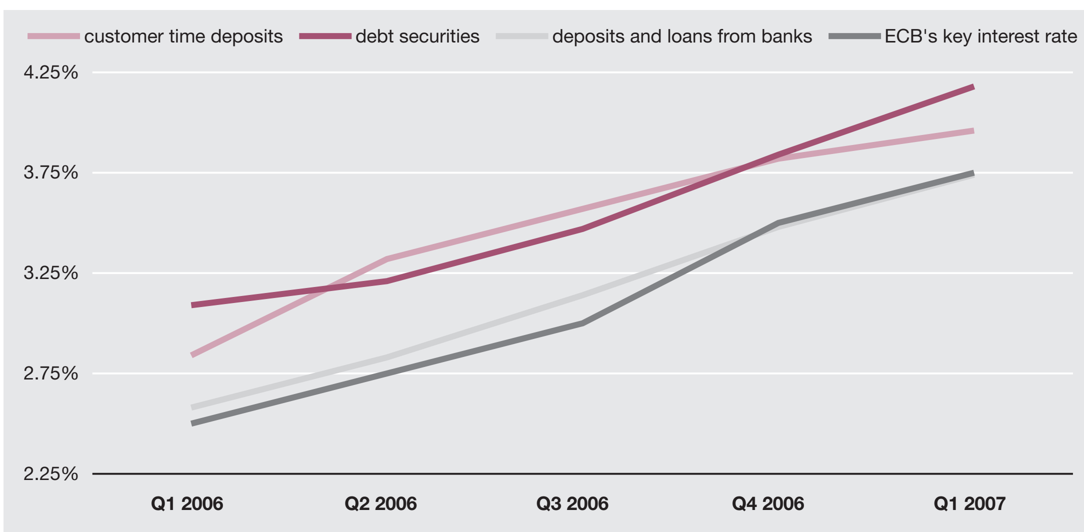


Figure 11. Average intrest rate on funds raised and ECB's key interest rate

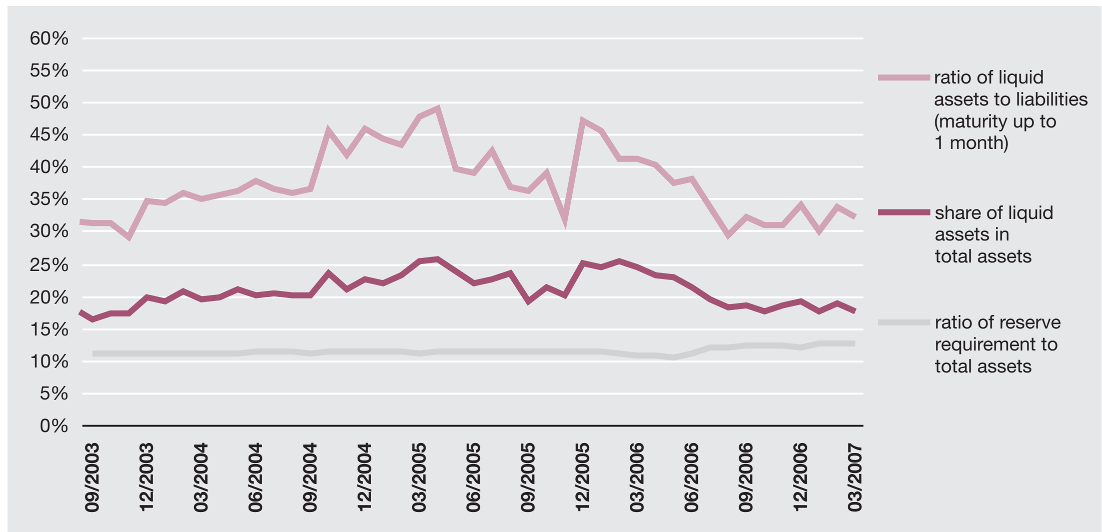


Figure 12. Liquid assets of the banking sector

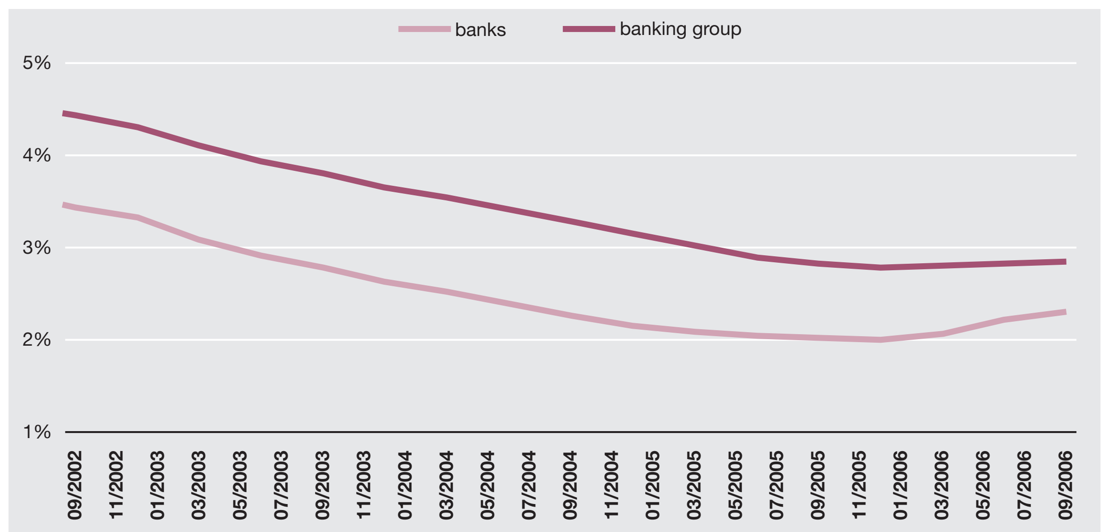


Figure 13. Aggregate net interest margin of banks and banking groups

Hence, during the past two quarters the share of net interest income in the banking sector's income structure has continued to grow. As regards banks, the ratio of net interest income to assets has grown by an average of 0.3 percentage points and that of banking groups by 0.04 percentage points compared to the third quarter of 2006[3] (see Figure 14).

In domestic operations, banks have been able to increase fee and commission income nearly as fast as the assets they manage. As regards banking groups, on the other hand, the ratio of the net fee and commission income to assets has kept on shrinking towards the aggregate indicator of banks' domestic results (see Figure 15).[4]

As for other income, the growth in recent profits has also been stimulated by higher income from trading. In the last two years subsidiaries have not contributed much to banks' profit in dividends because groups have been compelled to include profits in subsidiaries' own funds owing to the rapid growth of loan portfolios.

Besides the enhanced incomes the profitability of the banking sector has also been fostered by the so far relatively low risk costs. Although the share and volume of the net write-downs of claims has continued to increase, banks' total net write-downs of claims did not exceed 0.1% of assets as an annual average. In case of banking groups the share of write-downs is somewhat higher (0.26%).

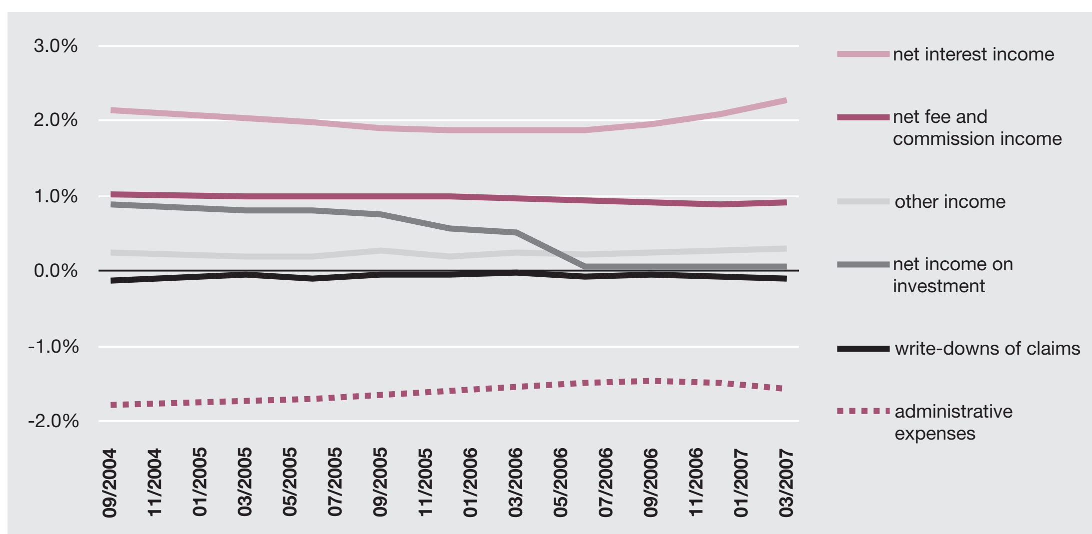
Administrative expenses have risen along with banks' income growth. This partly derives from the policy of associating the remuneration of employees with the profit earned. The ratio of total costs to assets has increased by nearly 0.2 percentage points compared to September (as for groups, however, the ratio has shrunk). Nevertheless, the faster increase in incomes compared to expenses has brought about a further decrease in the cost-income ratio. As mentioned in the previous issues of the Financial Stability Review, comparison with Nordic countries gives reason to assume that the Estonian banking sector's cost-asset ratio still has room to decrease (1.6% for banks; 1.8% for banking groups). The respective ratio in Sweden and Denmark, for instance, stands at approximately 1%[5].

In the first quarter of 2007, banks' aggregate net profit of the past four months exceeded a total of 4 billion kroons. Year-on-year, the net profit increased by 44%. The indicator of the profitability of banks' own funds has risen to 21% again (see Figure 16). The net profit of banking groups of four consecutive quarters, however, has risen by a half year-on-year, reaching 7.9 billion kroons. When assessing the growth of own funds' profitability, the increase in financial leverage should also be taken into account among other factors.

As regards the **future profitability of banks**, the further rise in key interest rates would probably facilitate the continuing growth of the net interest margin. However, this would occur at a slower pace, should the growth of loan portfolios still exceed that of deposits. In that case, the share of the more expensive external funds in banks' liabilities would increase. The rise in customers' loan-servicing costs, however, may decrease loan demand and entail a slight growth in the volume of loan provisions. Banks can react to the rise in key interest rates by curbing interest margins. But in order to preserve the current profitability, a change in net

[3] As the average aggregate of the last four quarters.
[4] In part, the share of fee and commission income has diminished also because in 2006 the principle of the so-called effective interest rate was adopted for recording incomes. In this case, a significant part of loan fees and commissions are spread out over the entire loan period and reflected as interest income. As for Estonian banking groups, most of the fee and commission income originates from payment intermediation services.
[5] Source: ECB "EU Banking Sector Stability" (2006).

interest income should be offset by an increase in other types of income or a cut down on expenses[6]. As regards the latter, banks' opportunities are most probably not exhausted yet.



Joonis 14. Banks' income and expense items by type (% of total asstes)

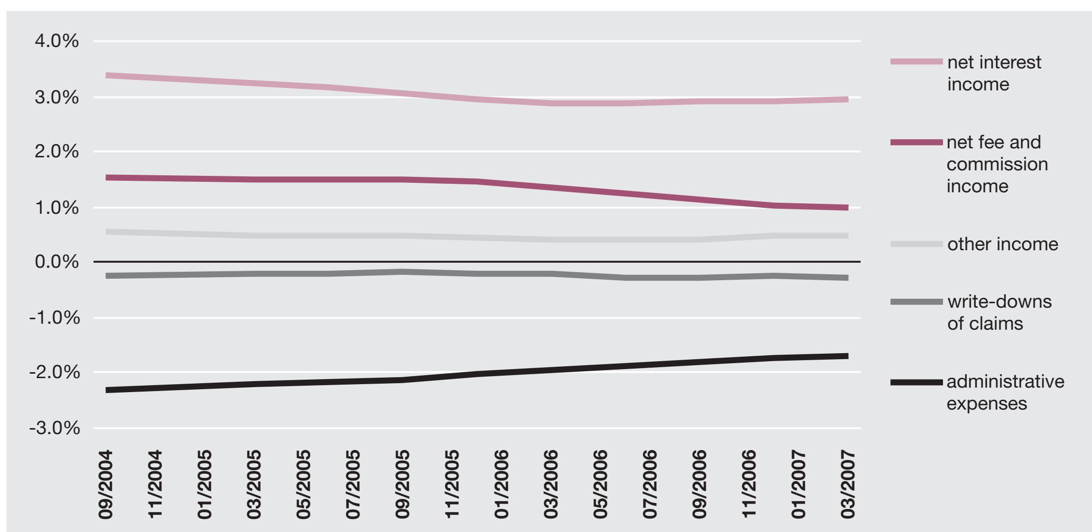


Figure 15. Banking groups' income and expense items (% of total asstes)

[6] Year-on-year, banks' net interest income increased by 1.7 billion kroons and administrative expenses by 0.8 billion kroons. The respective figures for banking groups were 3.7 and 1.4 billion kroons.

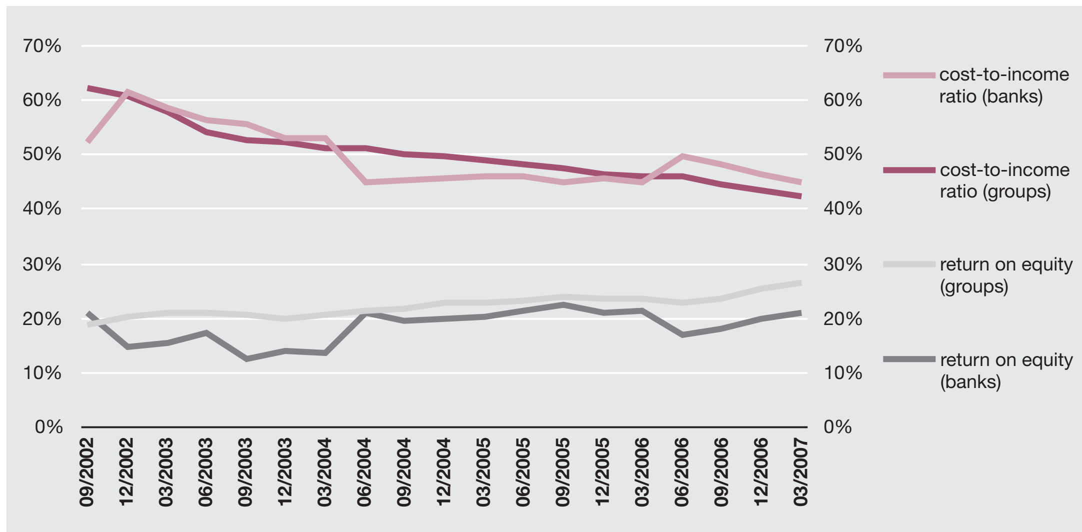


Figure 16. Profitability of banks and banking groups

Table 1. Profitability of banks

	2002	2003	2004	2005	Q3 2006	Q4 2006	Q1 2007
Return on assets	1,6%	1,7%	2,1%	2,0%	1,6%	1,7%	1,8%
Equity multiplier	7,3	7,9	8,8	9,9	10,6	10,7	10,7
Return on equity	14,7%	14,1%	20,0%	21,0%	18,0%	19,8%	21,2%
Cost-to-income ratio	61,6%	53,0%	45,8%	45,6%	48,4%	46,6%	45,1%
Net interest margin	3,6%	2,9%	2,4%	2,0%	2,1%	2,2%	2,3%
Spread	3,4%	2,8%	2,3%	1,9%	2,0%	2,1%	2,2%

Table 2. Profitability of banking groups

	2002	2003	2004	2005	Q3 2006	Q4 2006	Q1 2007
Return on assets	2,1%	2,1%	2,2%	2,1%	1,9%	2,0%	2,0%
Equity multiplier	9,2	9,2	9,7	10,7	12,0	12,4	12,7
Return on equity	20,3%	20,0%	22,8%	23,5%	23,6%	25,5%	26,5%
Cost-to-income ratio	60,9%	52,3%	49,7%	46,6%	44,6%	43,3%	42,3%
Net interest margin	4,6%	3,9%	3,4%	2,9%	2,8%	2,8%	2,9%
Spread	4,4%	3,8%	3,3%	2,8%	2,7%	2,7%	2,7%