SUMMARY

The robust economic growth witnessed in the last years slowed down to 9.8% in the first quarter of 2007. The smooth deceleration of growth is facilitated by the better than expected economic situation in Europe. Eesti Pank estimated the economic growth for 2007 to be 8.4%, and 6.5% and 5.6% in the following two years.

The external factors affecting Estonia's financial sector were relatively favourable international liquidity environment and strong growth in Estonia's main export markets. At the same time, both the financial and non-financial sector must still take into account any further increase in the Euribor.

Corporate financial behaviour and risks

Generally, Estonia's rapid economic expansion has been reflected in good financial results of local enterprises. However, the shortage of labour and raw materials together with the resulting growth in costs has started to have a negative effect on the **profitability** of some fields of activity. The confidence indicators of the corporate sector had improved even further by the beginning of 2007 owing to strong domestic and external demand. Nevertheless, the number of bankruptcies started to rise in the second half of 2006, whereas the number of new enterprises has been declining.

The good economic performance of companies has been accompanied by high investment activity, which is why the growth rate of corporate **debt** has remained fast as well. The level of indebtedness rose to 71% of GDP by the end of March 2007. Borrowing was as active at the beginning of 2007 as in 2006 but since March 2007 the growth rate of corporate debt has been slowing down.

The majority of corporate investment was still made in **real estate**. The rapid economic expansion brought about a strong demand for retail and office spaces. Thus, real estate developers are now also focusing on the office space market in addition to the housing market. In the coming years, the number of new spaces is expected to grow which means that vacancies are to increase, particularly in case the economic environment should change.

Financial behaviour of households and related risks

The rapid rise in net wages and employment rate improved the **economic situation** of households and shaped their future expectations. Although the growth of household financial assets and deposits remained fast, the borrowing activity has been even higher and the net financial position has considerably deteriorated. Consequently, households' shock-absorbing ability has diminished. Household **credit growth** has remained fast, even though the housing market has been cooling down and the number of housing loan customers has started to decrease. Rapid wage growth has boosted the volume of consumer credit.

While in recent years the terms and conditions of loans issued to households have been gradually loosened, by the beginning of 2007 this process had come to an end and the credit environment has become stricter. This is clearly expressed in the rise of average loan interest rates, which keeps adding to the interest burden of households. However, the rapid growth of net incomes has largely offset the impact of rising interest costs on households' financial situation. The growing share of fixed-rate housing loans shows that acknowledging the increase in interest rates has made households to be more risk-conscious. Nevertheless, this does not affect the total loan stock much. Households' loan portfolio is still exposed to interest rate risks, as loans with floating interest rate continue to hold the largest share in the total loan stock.

Since **real estate prices** are high, the number of potential borrowers has fallen. This has resulted in a decrease in the number of real estate transactions, a slowdown in price growth and an increase in supply. As the demand for older apartments is higher owing to their price advantage and fixed supply, then the main risks are related to the market of new dwellings. The poor sale and the possible price correction entail less resources for real estate developers to service the existing liabilities and finance new projects which depends on their financial leverage and liquidity buffers.

Banking market

Competition in the banking market has remained tough and the number of market participants has increased. The most important change is the transfer of the ownership of Sampo Pank – as from 1 February 2007, the bank belongs to the Denmark's largest banking group, the Danske Bank Group. The assets of branches of foreign credit institutions and credit institutions controlled by non-resident financial groups comprised 98% of the total assets of banks operating in Estonia.

The **quality of assets** has remained good during the past two quarters both in case of banks as well as banking groups. At the same time, given the further possible interest rate rise and a slowdown in economic growth the small share of loans overdue is likely to start growing in the near future.

As regards the regulatory amendments made in 2006, the commercial banks responded by including additional own funds, continuing their operations on quite the same scale as before. Since additional own funds predominantly consisted of subordinated liabilities (received from parent banks), the share of Tier II own funds grew significantly. Differences in the **capitalisation** of banks have increased as well. Some banks have started to keep their share of own funds close to the regulatory minimum requirement, i.e. 10% of risk weighted items. At the same time, the regulatory requirements valid in Estonia are more conservative than the minimum rates established for commercial banks in the EU. In Estonia, the capital adequacy ratio is 10% and the risk weighting on housing loans is 100%, whereas in Europe the respective figures are 8% and 50%. This ensures an additional capital buffer of approximately 3% compared to the EU minimum required rates. Therefore, it can be said that owing to the stricter regulatory requirements, banks have sufficient capital buffers to withstand the risks in the changing economic environment.

The share of **liquid assets** in the banking sector's total assets has not changed much over the last half-year. The higher reserve requirement valid from 1 September 2006 has contributed to the increasing share of highly liquid assets in banks' total assets. But since the growth rate of deposits has been lower than that of loans, the domestic banking sector has become even more dependent on financing by parent banks.

The **profitability** of banks has been supported by the rise in key interest rates. The increase in banks' interest expenses has been slower than the growth of interest income, as deposits are less affected by changes in the interest cycle while loan portfolios in Estonia mostly consist of floating rate loans. Low loan losses have also contributed to the profitability. However, income growth has been accompanied by an increase in operating expenses. The future profitability of banks depends, among other things, on the efficiency of their cost management.

Securities market and other financial intermediaries

The primary **bond market** and capitalisation grew in volume owing to the increase in the volume of issues by resident non-financial sector companies. The most significant events on the **Tallinn Stock Exchange** in the past half-year included the robust increase in stock prices, the following correction at the beginning of 2007, and the listing of shares of AS Ekspress Grupp on the stock exchange. Although the Tallinn Stock Exchange index OMXT reached a record level in February, by the end of May its annual growth had decreased to 49% owing to the falling stock prices.

Given the developments in the stock market, the growth of **investment fund** assets slowed down. The majority of new capital in investment funds was invested in stock funds, most of it being channelled to the EU stock markets. The growth of investment fund assets was boosted by the addition of five new funds in the list of funds registered in Estonia. The most popular investment region of the new funds is the Central and Eastern European market.

Pension funds have continued robust growth: the volume of second pillar pension funds has increased to 8.3 billion kroons and that of third pillar funds to 0.9 billion kroons. Growth stemmed primarily from the new capital invested in pension funds; the return on pension funds accounted for approximately a fifth of last year's growth in volume. Third pillar pension funds mainly comprise pension insurance; the share of pension funds in the third pillar accounted for about a third.

Both the **life and non-life insurance market** experienced balanced growth last year. The annual growth of collected gross premiums stood at 18% and 20%, respectively, which is comparable to last year's nominal GDP growth. Developments in the non-life insurance market are still driven by the favourable economic environment and credit growth. The life insurance market has been quite volatile. Growth has been primarily driven by unit-linked life insurance products.

Payment and settlement systems

According to the overseer, failures in the payment and settlement systems of Eesti Pank did not endanger the sustainable operation of the payment and settlement systems or the financial sector. Moreover, the overseer gave a positive assessment to the new service developed by the Estonian Central Register of Securities, which enables Delivery versus Payment (DvP) settlement for securities transactions in real time. The service is provided through the Real-Time Gross Settlement System of Eesti Pank (EP RTGS). One of the advantages of the new real-time service is that it helps reduce settlement risks.

The **connecting of the EP RTGS system with TARGET**, the payment system of the euro area, on 20 November 2006 extended the functionality of both the EP RTGS and the Settlement System of Ordinary Payments (ESTA). With longer operating time of the settlement system also customers' settlement opportunities increased. Moreover, the EP RTGS became a cross-border and multi-currency payment channel.

Conclusion and financial stability risks

According to the assessment of Eesti Pank, **risks to Estonia's financial stability are low**. The credit growth indicators for April and May signal a slightly more cautious credit behaviour of both borrowers and lenders. This means that risks to the functioning of the financial system, stemming from fast credit growth, are also diminishing. The recent strong investment activity has gained momentum from the rapidly increased borrowing by enterprises and households. The Estonian banking sector experienced even closer integration with Nordic banking groups, which ensures that our banks have sufficient capitalisation and liquidity, thus also contributing to the above development.

Meanwhile, the inflation pressures might start to weaken the competitiveness of enterprises. The real estate sector can be considered the most at risk, because its indebtedness is high and the strength of demand may have been overestimated during the period of rapid growth. The loan-servicing capability of households has remained good owing to the robust growth of wage income, but the risk of an abrupt decline in income growth has become more serious.

Owing to the more conservative attitude of banks and their owners, as well as to the stricter regulations that entered into force in 2006, the risk tolerance of the Estonian financial sector has improved. At the turning point of the economic and credit cycle, it is especially important to follow conservative credit standards and to be more careful when considering the borrowing ability and risk level of customers.

From the point of view of the further development of the financial sector, it is important whether banks' cost management is sufficiently flexible in order to maintain profitability in the changing environment.

According to Eesti Pank's assessment, financial stability is most threatened by the following risks: the growth of loan servicing costs and real estate prices exceeds income growth and earning ability; the real estate sector has overestimated the number of customers; a possible deterioration in the quality of banks' loan portfolio; slower growth of the income base. The materialisation of these risks may alter Eesti Pank's assessment in respect of financial stability.