# SUMMARY


The credit and liquidity tensions and changes in the risk estimates of market participants that appeared in **international financial markets** in the second half of 2007 have also affected the Estonian financial sector. The changes in investors' attitudes have passed through to the Estonian market primarily via changes in financial asset prices, and caution on the interbank money markets worldwide is reflected in higher risk premiums. Meanwhile, the acceleration of inflation has complicated the implementation of monetary policy stimuli; that is, decreasing interest rates in the euro area.

As expected, the **slowdown in Estonia's economic growth** has been mainly caused by the weakening domestic economy. After a few years of robust investment and consumption growth, real economic growth has declined to considerably more modest levels. At the same time, exports have sustained growth momentum for the time being. Inflation, which rose to a double-digit level at the beginning of 2008, is putting a pressure on corporate as well as household budgets and may also affect investment and consumption decisions in the short term. According to the base scenario of Eesti Pank's spring forecast, real GDP growth will reach 2% this year, 3% in 2009 and 5% in 2010. The inflation rate is expected to reach 9.8%, 4.5% and 3.0% in 2008–2010.

### Financial behaviour of companies and households and their risks

Growth in aggregate **corporate profits** decelerated abruptly in the second half of 2007. The main reason was that in the conditions of slowing growth in sales turnover the increase in expenditures has not been managed efficiently enough so as to maintain profitability. The increase in labour costs has played an essential role in the growth of total costs. As labour costs are more inert than other costs, profitability might decrease further in the coming periods. This will entail pressure on companies' debt servicing ability and possibly a decline in loan quality.

Corporate indebtedness continued to decelerate along with slowing investment growth and weakened confidence growth. Although such a trend occurred in almost all fields of business activity, real estate companies have suffered the sharpest decline. The debt of the manufacturing sector grew at a faster pace at the beginning of 2008. Competition between banks in the corporate loan market has remained tight, which has kept the average interest margins from rising. However, as the cost of funding is increasing, banks will probably have to raise interest margins in the future.

**Household confidence** has been weakening since the middle of 2007, increasingly affecting also loan demand. As growth in housing loans has been moderating, household demand for consumer credit started to ease in the second half of 2007. The moderation in wage growth and the decreasing employment along with a high inflation rate are putting a strain on households' loan servicing capabilities. The slowing growth of deposits and other financial assets has decreased the buffers for loan servicing, although household indebtedness has been growing at a more modest pace compared to the previous years.

The activity in the **housing market** was low also in spring 2008, and average prices were dropping. As the number of dwellings up for sale is constantly growing while the number of transactions keeps decreasing, sales periods are longer now and downward price pressures persist. This means that real estate companies might face difficulties also in the coming periods. A record number of new **office spaces** are about to be completed in the near future. However, it will be more complicated to rent them out owing to the increased insecurity of market participants. On the other hand, office spaces are mainly being built by experienced real estate developers and the total volume of such loans is relatively small compared to the real estate loans related to housing development.

**Banking sector**

The worsening economic environment and deceleration in credit growth has caused an increase in the volume and share of **overdue loans** in loan portfolios in the past six months. The share of loans overdue for more than 60 days in the loan portfolio climbed from 0.35% a year ago to 0.99% in March 2008. According to Eesti Pank's spring forecast, the share of overdue loans may increase to 1.5–2.6% by end-2008 and to 2.2–3.1% in 2009.

At the end of March, the stock of **provisions** for loan losses amounted to 1.6 billion kroons and accounted for 70% of the loans overdue for more than 60 days. The ratio of provisions to overdue loans has decreased over the last six months.

At the beginning of 2008, the new framework for calculating **capital adequacy** became mandatory for all credit institutions operating in Estonia. The first months of the new framework have confirmed the validity of the quantitative impact analyses conducted earlier: the credit risk weighted assets decreased by 12.5%. The average capital adequacy ratio of the banking sector stood at 17% at the end of March; banking groups' average capital adequacy was 11.6%. A stress test conducted by the central bank showed that the banking sector will be able to meet the capital adequacy requirement, both considering the assumptions used in the base forecast scenario and those of risk scenarios.

The reserve requirement for banks, raised to 15% of banks' liabilities as of September 1, 2006, has helped to preserve the share of liquid assets in total assets. But even with the obligatory reserve requirement it is very important that market participants maintain sufficient liquidity buffers in a difficult market situation.

Meanwhile, the systemically important credit institutions operating in Estonia increasingly depend on **parent banks' liquidity management**. On the one hand, it may be presumed that the funding risk of a group operating in different markets is more diversified – funds can be reallocated among different parts of the group as needed. On the other hand, a group's ability to obtain additional funds and the cost of such funds depends on risk estimates regarding the entire group. So far, parent banks have been able to provide necessary funds to the local banking sector.

The **profitability** of banks has been influenced by an increase in funding costs, an increase in write-downs of claims accompanying the change in the current phase of the economic cycle, and developments on financial markets. As parent banks have not significantly changed the margins asked from local banks, the increase in funding costs stems mostly from general economic developments and changes in the structure of banks' liabilities. However, banks have not been able to pass the total increase in funding costs on to clients, which has diminished banks' net interest income. Profitability has been also curbed by an increase in loan write-downs, which will probably continue considering the rising share of overdue loans. The future profitability of banks depends, among other things, on their ability to respond to the decline in income by cutting down on expenses.

**Securities market and other financial intermediaries**

The Estonian **bond market** was very active in the fourth quarter of 2007 and the first quarter of 2008, and capitalisation grew faster too. This was primarily supported by three-fold growth in non-residents' bond issues. **Stock markets**, however, experienced a reverse development. At the end of April, the Tallinn Stock Exchange index OMXT was nearly 40% down from the summer's peak, causing a sudden decline in stock market capitalisation. The structure of investors of listed companies has not changed: at the end of the first quarter of 2008 foreign investors comprised 49% of total investors.

The Estonian stock market witnessed the merger of OMX AB, the majority shareholder of the Tallinn Stock Exchange, with NASDAQ Stock Market, Inc., a US stock market company. This strategic event will provide better access for the Estonian securities market stakeholders to global securities markets.

The yield of **investment funds** was shaped by the key interest rates moving in opposite directions as well as uncertainty in global financial markets. As a result, the total assets of investment funds started to decrease at the beginning of 2008. Nearly a third of the decrease stemmed from the declining yield. The decrease was somewhat offset by the emergence of new market entrants: two stock funds, the first hedge fund and the first real estate fund. **Growth in pension fund assets** slowed considerably. A large share of the assets of pension funds registered in Estonia has been invested in other funds to hedge risks better.

Although the **life insurance market** witnessed strong growth at the beginning of 2007, the total annual profit of insurance companies decreased noticeably. This arose from a robust increase in costs and a decrease in investment profitability. The **non-life insurance market** is supported by the continuing, though somewhat eased credit growth. Meanwhile, the profitability of insurance companies has declined, mainly because of tight competition.

### Payment and settlement systems

**There were no such incidents in the operation of the Estonian payment and settlement systems** that would have threatened the stability of these systems or Estonia's financial sector. The number and turnover of payments settled through the payment and settlement systems managed by Eesti Pank increased. The activity of the RTGS system was boosted by the growing number of payments initiated by bank customers; the number, turnover and average value of payments settled through the ESTA increased too.

Since May 19, Eesti Pank is managing three interbank payment and settlement systems instead of two: the Settlement System of Ordinary Payments (ESTA), the Real-Time Gross Settlement System (EP RTGS) and the new **cross-border settlement system TARGET2-Eesti.** The latter is a subsystem of TARGET2 operating on a single shared platform. All major Estonian credit institutions have joined the new payment and settlement system. This means that most bank customers now have an alternative to settle express payments in euro. Moreover, TARGET2 allows credit institutions to lower the charges for cross-border express euro payments.

### Conclusion and financial stability risks

Estonia's financial stability is primarily affected by credit risk, which arises from Estonia's macroeconomic environment, and liquidity risk, which depends on the risk appetite and strategy of international markets. Compared to the end of last year, liquidity risk has remained generally unchanged, whereas the likelihood of the materialisation of credit risk has grown. Nonetheless, **risks to the financial system as a whole may still be considered low**, as the capital and liquidity buffers of the banking sector are sufficient to alleviate possible setbacks.

Estonia's further macroeconomic development has become slightly clearer over the last six months. Although the first signs of an adjustment of strong economic growth appeared already last summer, this spring clearly showed that domestic demand has eased more than expected. The beginning of a new growth cycle may be delayed because of weaker global growth outlook. This means that credit risk is more likely to materialise in the coming years, compared to the estimates given in the last Financial Stability Review.

The shrinking demand, easing wage pressures and increased costs are some of the factors that put a strain on corporate budgets. Moreover, potential problems will also affect households. Therefore, given the tensions in the labour market, it is crucial to maintain sufficient loan servicing buffers. Household deposits have grown slightly faster this year compared to earlier periods but to preserve the solvency of borrowers, saving should continue to increase at a sufficient rate.

Although the volume of new loans issued has so far been nearly 40% smaller than last year, the low growth rate does not really arise from possible supply-side restrictions to finance new projects. Banks have been willing to finance good projects and competition among banks in the corporate loan market has remained strong. Avoiding a "grinding halt" in the credit market, however, is essential to support a new upward cycle of the economy. Recent developments confirm the stabilisation of loan growth at 10% this year, which can be considered sustainable for our economic environment.

The real estate sector which has been enjoying high profit margins in the last few years is today facing the downside of over-investment. Banks have become considerably more cautious in financing housing development projects and more conservative in assessing the risk level of ongoing projects. Namely, in the current economic cycle, the majority of loan losses are incurred by the real estate sector.

The confidence crisis that is spreading in global financial markets has not abated notably in the past six months. Changes in the external environment pass through to the Estonian banking sector via parent banks, mainly through an increase in the cost of funding. Local banks have been able to maintain their liquidity buffers. Nevertheless, as regards **liquidity risk**, it is still important that parent banks are able to obtain and provide funds to local subsidiaries and branches.

Weaker macroeconomic environment may bring along increasing loan losses and higher cost of funding may curb banks' net interest income. All in all, this causes a decrease in profitability but the extent of the decrease depends on the banking sector's ability and willingness to adjust their costs according to the economic cycle. The capitalisation of banks is still good and, according to stress tests, they are strong enough to cope, should the more negative scenarios of Eesti Pank's economic forecast materialise. The banking sector has maintained a high level of capitalisation by including earlier profits in own funds. As loan losses might increase further, it is crucial that banks retain sufficient capital buffers to maintain solvency also in the future.