II BANKING SECTOR STABILITY AND RISKS

Strategic development of the banking sector

Further economic adjustment over the last six months has manifested itself also in financial intermediation through a 127% of GPD decline in banks' credit portfolios (see Figure 1). Stock market capitalisation and investment fund assets decreased in 2008, whereas the first quarter of 2009 saw a slowdown in the decrease.

Although the different business strategies of banks have slightly changed their market shares – primarily the major players have lost some of their market share – the general market concentration has remained quite unchanged. The two largest banks comprise about two thirds of the credit market; the four major banks hold over 94% of the market.

In May 2009, a new player entered the Estonian banking market when LHV Group, who used to be engaged only in asset management, started to operate also as a commercial bank. In total, there are seven companies licensed as credit institutions, eleven branches of foreign credit institutions and around 250 cross-border banking service providers operating in Estonia.

Larger banking groups[1]

In the second half of 2008, several financial groups operating in Estonia witnessed the materialisation of credit risk owing to their positions in other credit institutions and unfavourable developments on the capital markets, which reduced groups' profitability. In the last two quarters, however, profitability was more affected by the provisions on loans issued to the non-financial sector (see Figure 2).

Although banks have increased loan margins, in the first quarter aggregate net interest margins decreased due to higher funding costs. Unlike in the second half of 2008, this year profitability has been supported by trading revenues. Groups have started to cut down on costs to cope with the difficult market situation, but so far this has not supported profitability sufficiently. Extensive write-downs of goodwill[2] and fees of participation in national support programmes have rather increased the operating costs of some groups.

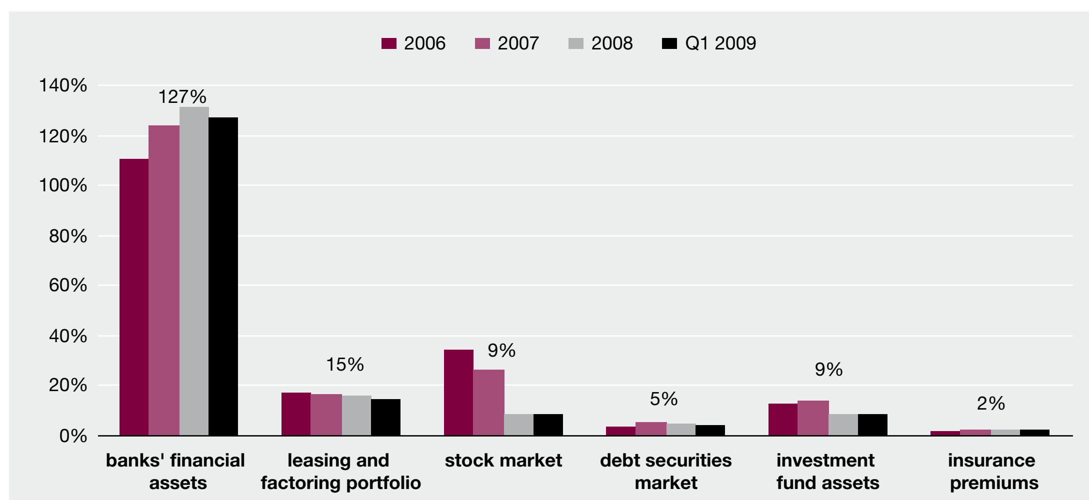

Figure 1. Structure of financial intermediation (% of GDP)

[1] The overview is based on the groups' public quarterly statements and concerns four major financial groups in Estonia on the consolidated basis of the entire group. In other words, the calculations include groups' activities in the Baltic States as well as other countries.
[2] Write-offs of goodwill are reflected in an increase in operating costs.

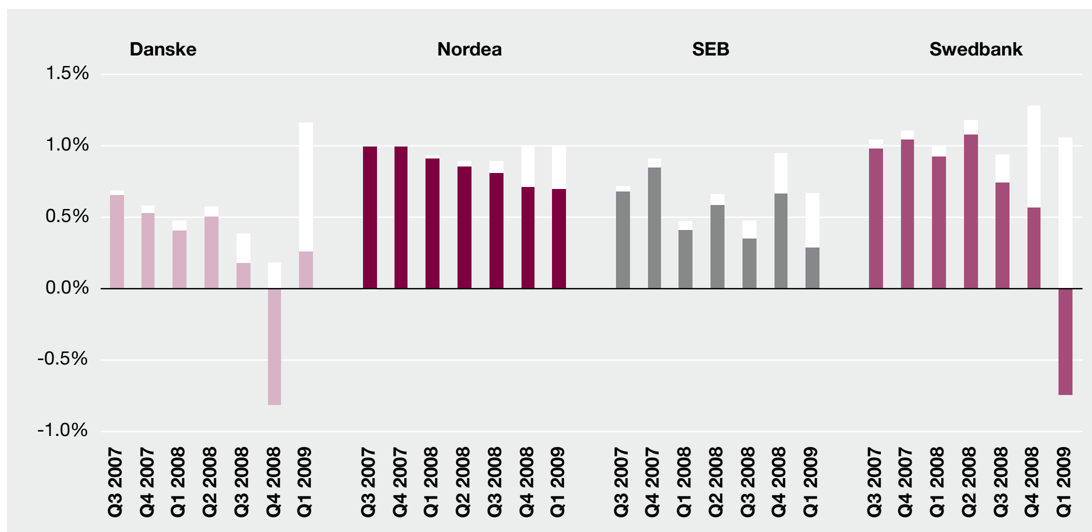

Figure 2. Real profitability of banking groups and potential profitability with loan provisions excluded

As the members of banking groups are closely integrated with each other, the cost of funds depends on fund providers' assessments of the risk level of the entire group. Several rating agencies and market players have considerably increased their risk assessments of some groups after the reporting of negative results. Although groups' risk profiles are quite similar, they have implemented different provisioning strategies, which means that the lower level of provisions of some periods need not necessarily mean that the assets of certain groups are of significantly higher quality, but rather points to differences in the financial accounting practices of different groups. Therefore, some market players who have reported (higher) operating profits may need to make bigger adjustments to the value of assets in the future.

Although the market situation is complicated, groups have been able to attract additional funds through deposits as well as other instruments. Guarantees provided by national support program-mes have been of help. In order to increase the level of capitalisation, the payment of dividends has been postponed or the ratio of profits to be paid out as dividends has been lowered. In addition, groups have issued new shares and taken subordinated loans.

Considering the future economic outlook in the operating region of the financial groups present in Estonia, several groups might report a loss in the near term. Strong capital buffers have so far helped the groups cope with the complicated market situation, but further unfavourable developments might force them to reduce the amount of outstanding assets or acquire additional capital.

FUNDING OF PARENT BANKS

The structure of funds acquired by Nordic banking groups differs by groups and, thus, the financial crisis has also affected banks' funding to a different extent. Nordea and SEB have a higher share of **deposits** and are relatively less dependent on market funding.

The Swedish government has raised the guarantee on bank deposits to 500,000 Swedish kronas and the Danish government has reported that all deposits are guaranteed in full. These measures have been taken to support the stability of that source of funding. However, in the past two quarters the share of deposits in banks' total balance sheets has changed (see Figure 3).

Tight competition has increased the cost of acquiring deposits for banks. Funding costs have also increased due to the increase in the share of time deposits.

The cost and availability of market funds is affected, among other things, by the rating given to a credit institution. Rating agencies have assessed the risk levels of the groups operating in Estonia differently (see Table 1).

Changes in **credit default swap** spreads have been similar: higher risk premiums have been asked for Swedbank and SEB.[3]

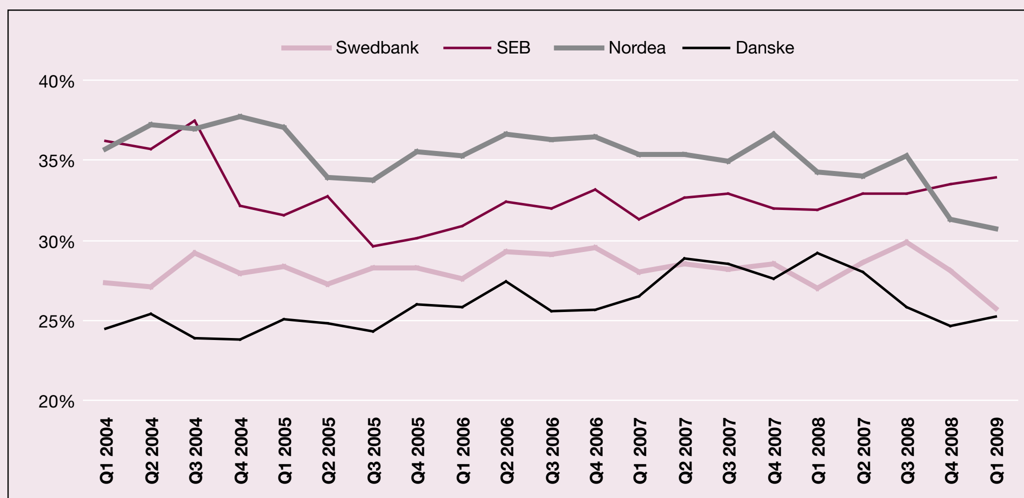

Figure 3. Share of deposits in total balance sheets

Source: public reports of banks

Table 1. Ratings of Nordic banks

	Standard & Poor's		Moody's			Fitch	
	Long-term	Change*	Long-term	Change*	Financial strength	Long-term	Change*
Nordea	AA–	-	Aa1	-	B	AA–	-
Svenska Handels-banken	AA–	-	Aa1	-	B	AA–	-
DnB NOR	AA–	-	Aa1	-	B–	A+	-
Danske	A+	↓	Aa3	↓↓	C	A+	↓
SEB	A	↓	A1	↓↓	C–	A+	-
Swedbank	A	-	A1	↓	C–	A	↓

* Change since last *Financial Stability Review* (autumn 2008). "-" no change, "↓" ratings downgraded by one notch, "↓↓" ratings downgraded by two notches.

Source: rating agencies

[3] However, the market might be quite thin and illiquid for single institutions, which is why this indicator should be treated with some reservation.

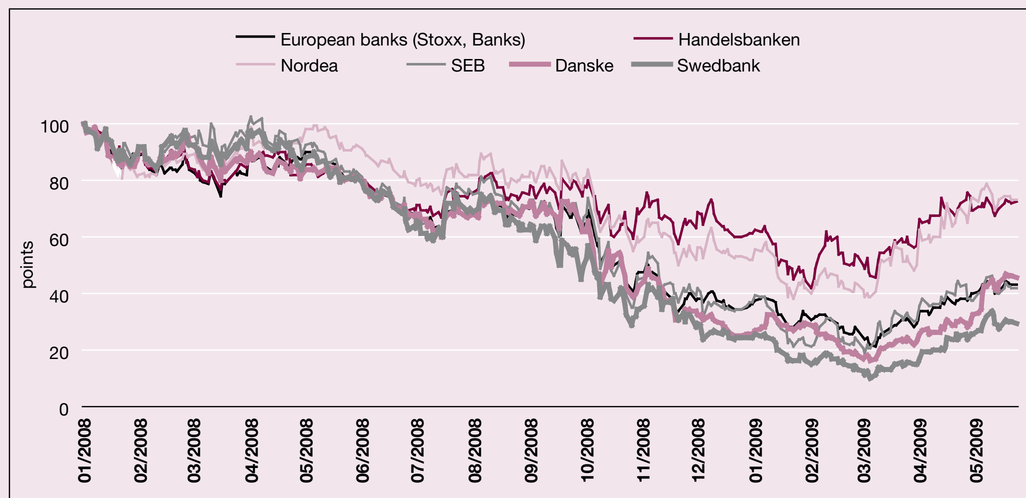

Figure 4. Stock price dynamics of Nordic banks (2/1/2008 = 100)

Moreover, investors perceive differences between Nordic banking groups to have increased also on the **stock market**. The outlook for Swedbank is regarded as the most pessimistic, whereas Nordea and Svenska Handelsbanken are regarded much more optimistically (see Figure 4).

Most of the banks' activities that are not covered with deposits are funded on **bond markets**, more particularly on the Swedish and Danish covered bond markets, as concerns the major groups also operating in Estonia. Due to financial crisis, the availability of credit (in particular long-term funds) on the markets became problematic, governments started to provide different **guarantee programmes** to banks to support functioning of the markets. Swedbank has joined Sweden's guarantee programme and is already issuing bonds under that programme. SEB reported of joining the programme in April. The cost of using Sweden's guarantee is 50 basis points plus the bank-specific risk premium. Thus, wholesale funding is still complicated and banks make active use of national support measures to raise necessary funds.

In the current market situation, the prices of **bonds** issued by banks are considerably more affected by the collateral of bonds. Market demand presists for bonds with the highest ratings. Bonds with Sweden's and Denmark's sovereign rating are also in demand, as they automatically receive the highest rating AAA. Bonds with weaker or no collateral, on the other hand, seem risky for market participants and thus demand is low.

Greater tensions on the **interbank money market** have eased and liquidity, indicated by the spread between the interest rate on the interbank money market and the expected key interest rate, has improved notably. In Sweden, this indicator reached the levels recorded at the beginning of 2008 already in mid-February, pointing to somewhat smaller tensions in the Swedish interbank money market (see Figure 5).

Central banks' alleviating measures to provide credit for banks (for instance, by loosening the criteria for acceptable collaterals) have given banks an alternative to financial markets in the turbulent times and banks intend to continue using these measures.

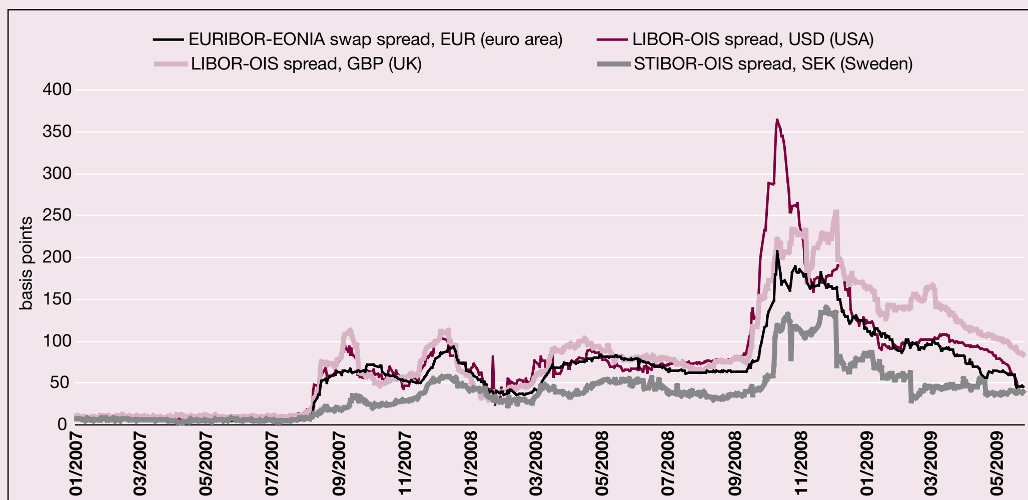

Figure 5. Liquidity in the interbank market (LIBOR-OIS spread)

Source: Bloomberg

Quality of assets

The sudden deterioration of the economic situation and outlook, rapid rise in the interest margin and tightening of credit terms led to a decrease in the **financing portfolio** of both the households and companies (see Figure 6). At the end of April, banks' loan and leasing stock totalled 276 billion kroons, having grown 1.3% year-on-year. The financing portfolios started to decrease in November 2008 and have shrunk 3.1% over the past six months. The decrease has been broad-based, concerning all types of loans.

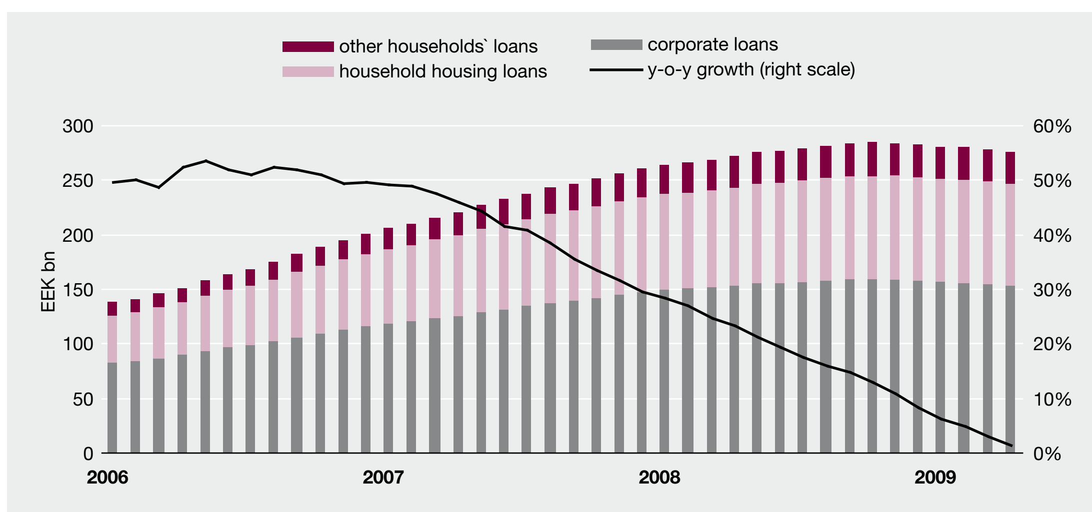

Figure 6. Stock and annual growth of real sector loan and leasing portfolio

Although the financing portfolios have diminished, the structure of the portfolios has not changed considerably over the year (see Figure 7).

Neither has the structure of **loan collaterals** changed much (see Figure 8). At the end of the first quarter of 2009, 77.3% of the loans issued to the non-financial sector were mortgage-backed (78.3% at the end of the first quarter of 2008). At the same time, loans without collateral constituted 8.4% of the total stock of loans and leases issued to the non-financial sector (6.4% at the end of the first quarter of 2008).

The sudden deterioration of the economic situation has also affected the quality of loans. At the end of April 2009, **loans overdue for more than 60 days** accounted for 5.2% of the total portfolio of non-financial sector loans (1.3% a year ago). The stock of overdue loans surged

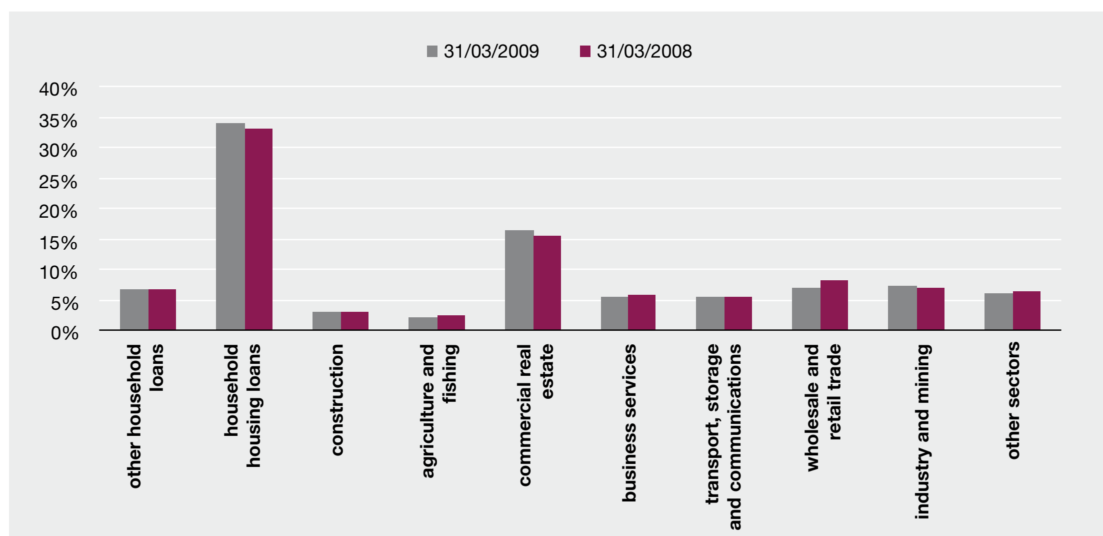

Figure 7. Structure of loan and leasing portfolio by sectors

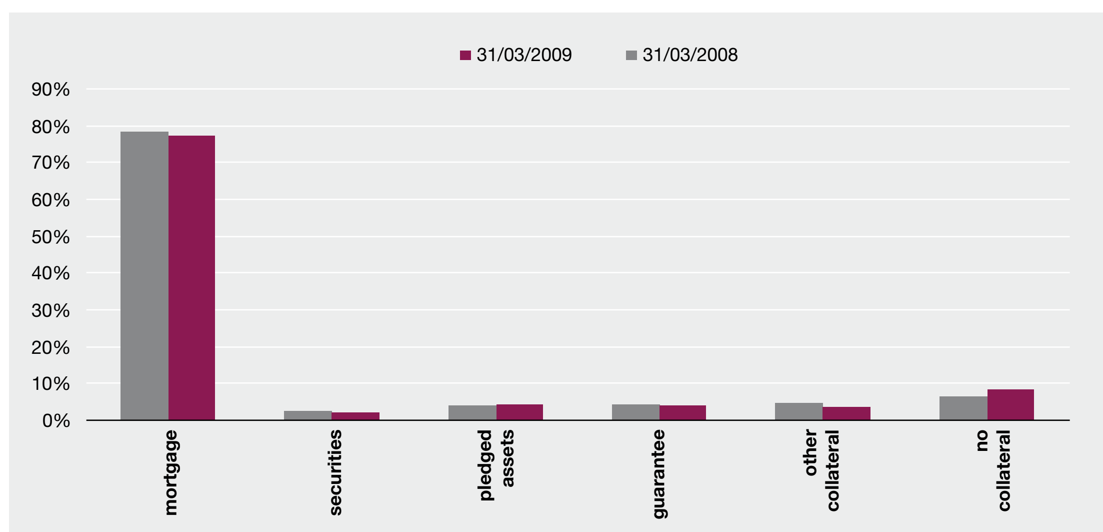

Figure 8. Loan collaterals by type

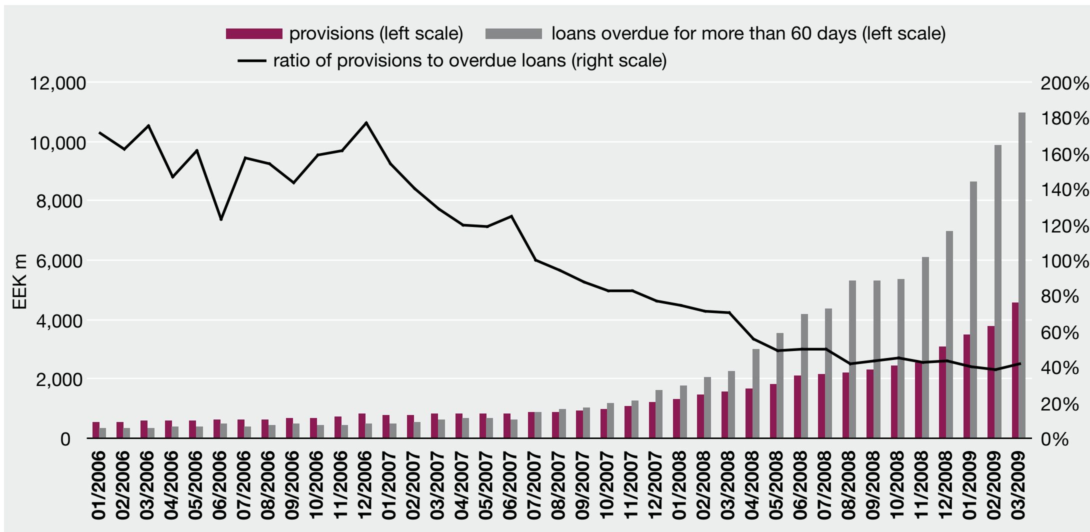

Figure 9. Overdue loans and provisions

particularly at the beginning of 2009: by over a billion kroons per month (see Figure 9).

The quality of loans granted to the business sector has deteriorated the most over the past year. At the end of April 2009, loans overdue for more than 60 days comprised 6.4% of the total corporate loan portfolio (2.4% in September 2008 and only 1.4% in April 2008). By fields of activity, the sectors of commercial real estate and construction have the most overdue loans: 18.7% and 7.9% of the total loan stock, respectively (see Figures 10-11).

The loan stock of these sectors constitutes nearly 40% of the total stock of loans issued to the corporate sector.

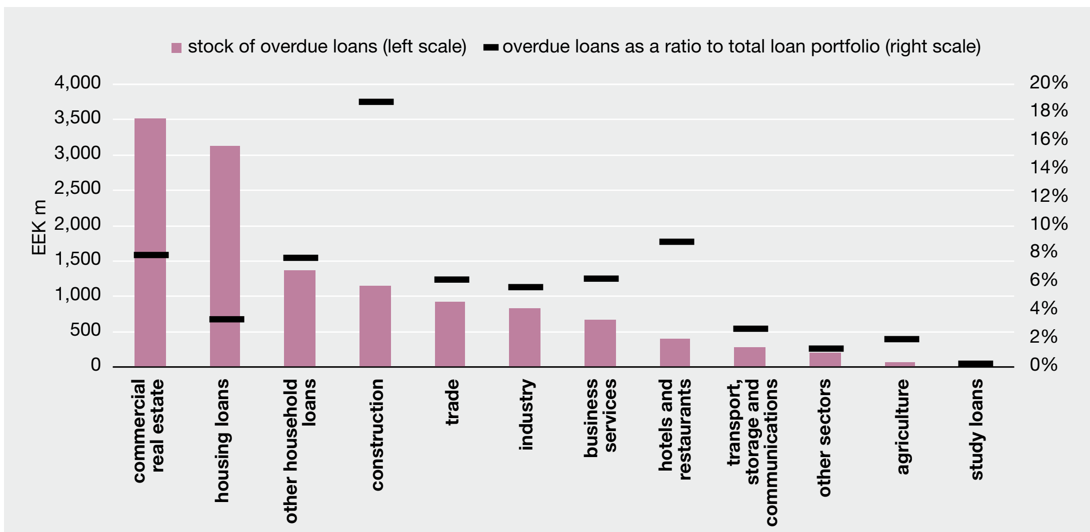

Figure 10. Stock of loans overdue for more than 60 days and ratio of such loans to sector's total loan portfolio as at 30/4/2009

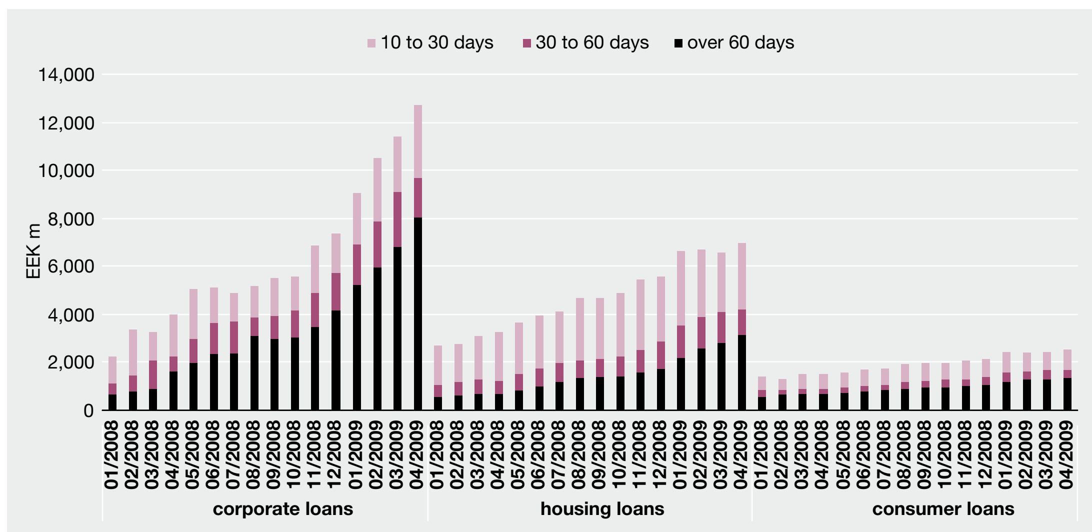

Figure 11. Overdue loans by type and length of delay

Also the quality of housing loans has deteriorated considerably. At the end of April 2009, 3.3% of total housing loans were overdue (0.7% in April 2008). However, the percentage of overdue loans is still the largest among consumer credit, reaching 7.7% at the end of April 2009 (3.9% in April 2008). Approximately 36% of the overdue consumer loans of households have been issued by one non-systemic credit institution. As regards other credit institutions, the percentage of overdue consumer and other loans is significantly smaller. Household consumer credit accounts for 9.1% of the total stock of non-financial sector loans and leases.

The cooling of the economy and the resulting low demand for the abundant new property built during the recent real estate boom has led to supply exceeding demand. The transaction activity is low and prices of both the commercial real estate and dwellings dropped rapidly in the first quarter of 2009. Consequently, more and more real estate companies are facing difficulties. According to the Land Board, the prices of two-room apartments in Tallinn have declined nearly 50% from the record highs in April 2007. Thus, the affordability of real estate (i.e. the ratio of average apartment prices and average gross wages) is approaching the level of 2004. Even though real estate is now more affordable, the recovery of the real estate market requires a considerable increase in consumer confidence.

The rapid decline in loan quality and negative future outlook has affected the ratio of loan **provisions**. At the end of April 2009, the banks operating in Estonian had made provisions in the total amount of 4.9 billion kroons (see Figure 12). Nearly two thirds of that was specific provisions (see Figure 13). General provisions constitute only 25% of total provisions made in Estonia. A considerable amount of provisions have been made in the parent banks to take into account the potential future losses in the Baltic States (see *Section Larger banking groups*). Provisions increased in the last two quarters, totalling 2.3 billion kroons. At the end of April, provisions constituted 39% of the loans overdue for more than 60 days.

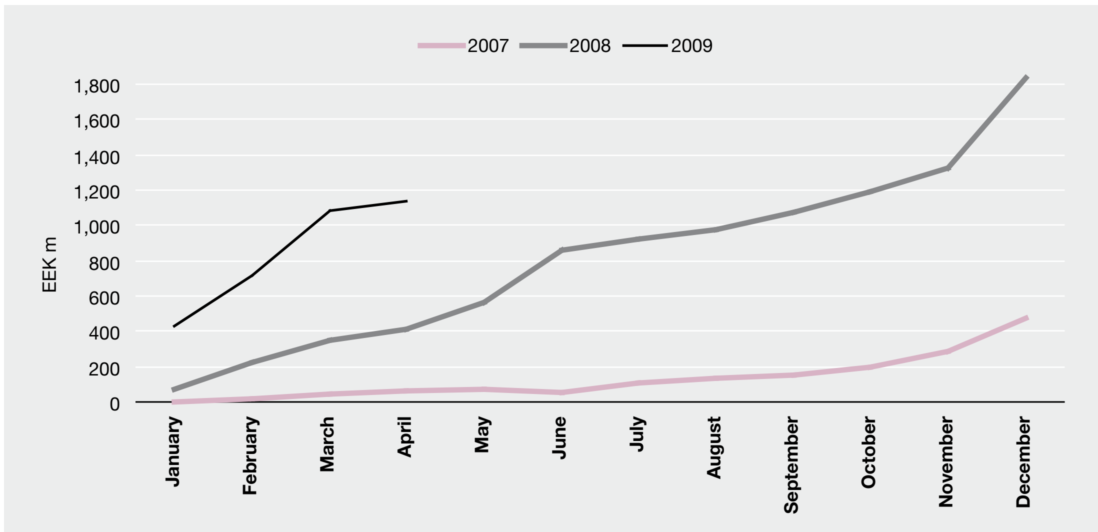

Figure 12. Cumulative loan losses (change in provisions)

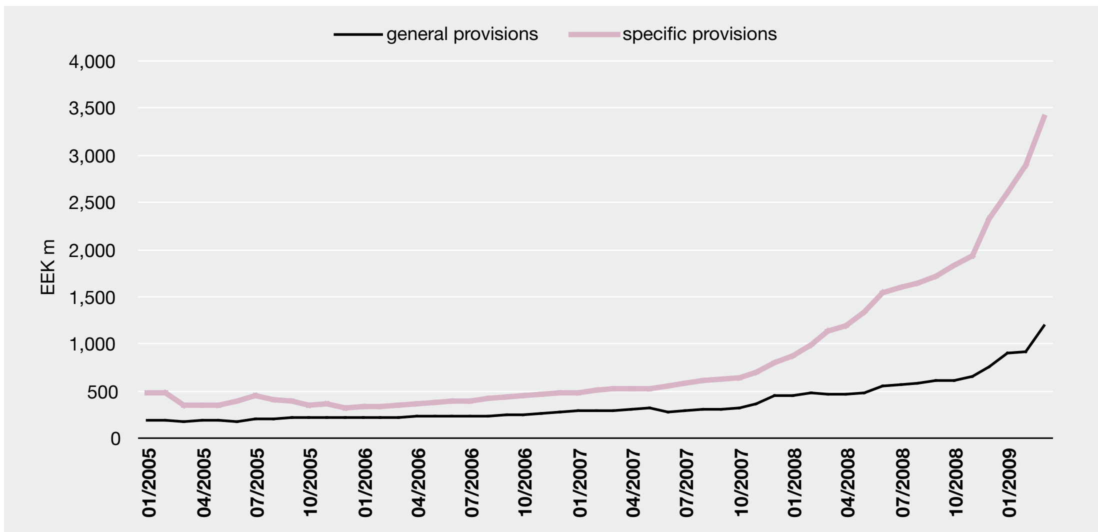

Figure 13. General and specific provisions

In 2008, the banks operating in Estonia wrote off 114 million kroons of loans and received 242 million kroons of claims previously removed from the balance sheet (see Figure 14). In the first quarter of 2009, the banks had written off 86 million kroons of loans and they collected 59 million kroons of claims previously written off.

The recession has also affected the **consolidated loan portfolio of groups** in terms of overdue loans and provisions.

The percentage of loans overdue for more than 60 days rose from 0.8% to 5.7% over the year. Nearly half of that added in the first quarter of 2009, when the stock of loans overdue for more

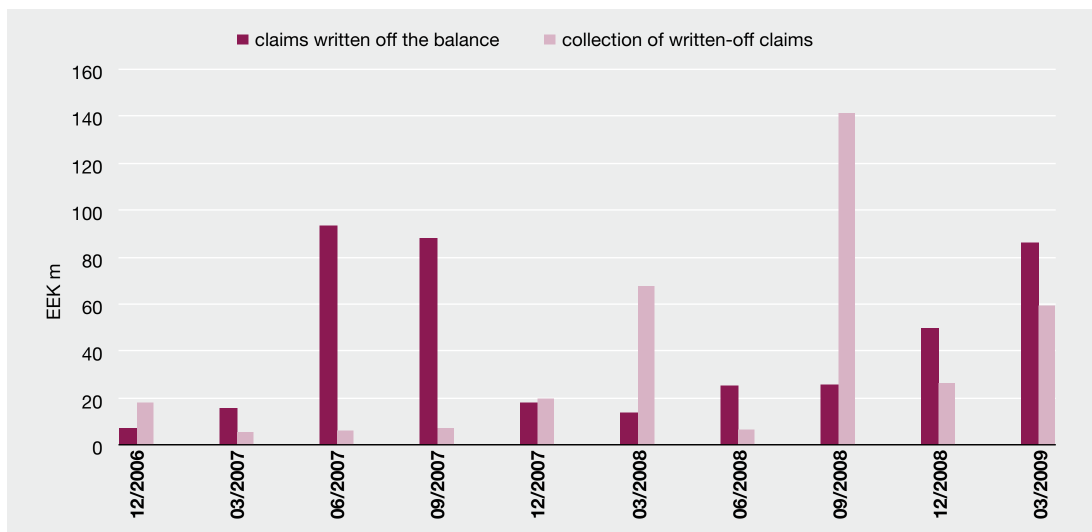

Figure 14. Claims written off the balance sheets of banks and collection of written-off claims

than 60 days increased by around 9 billion kroons in terms of banking groups. The overdue loans of Estonian residents comprised only 27% of that. Rapid growth in overdue loans and weak future outlook affected provisioning also at the group level. At end-March, provisions constituted 3% of the consolidated loan portfolio; that is about three times more than a year before. Strong growth in overdue loans has lowered the ratio of provisions to loans overdue for more than 60 days to 52.4%.

STRESS TEST OF THE BANKING SECTOR

Estonia's domestic demand started to shrink already two years ago – in spring 2007. In the second half of 2008, the external environment deteriorated suddenly and caused a rapid decline of the Estonian economy. The baseline scenario of Eesti Pank's spring forecast expects a 12.3% contraction in 2009. If the external environment does not improve any time soon, the decrease will continue also in 2010. A new growth cycle is anticipated in 2011.

Investment, which was in previous years boosted by a favourable financing environment and optimistic future outlook, usually responds to changes in economic conditions relatively sharply. Given that the economic situation has changed drastically, the banks operating in Estonia have become more cautious in terms of lending, despite the high level of capitalisation in international comparison.

Macroeconomic assumptions and future estimates of overdue loans

The loan losses of the Estonian banking sector are likely to grow considerably in the coming years. However, the forecast relies on the assumption that parent banks are continuously interested in the Estonian market and therefore will not change their current financing strategy. The baseline scenario of Eesti Pank's **forecast**

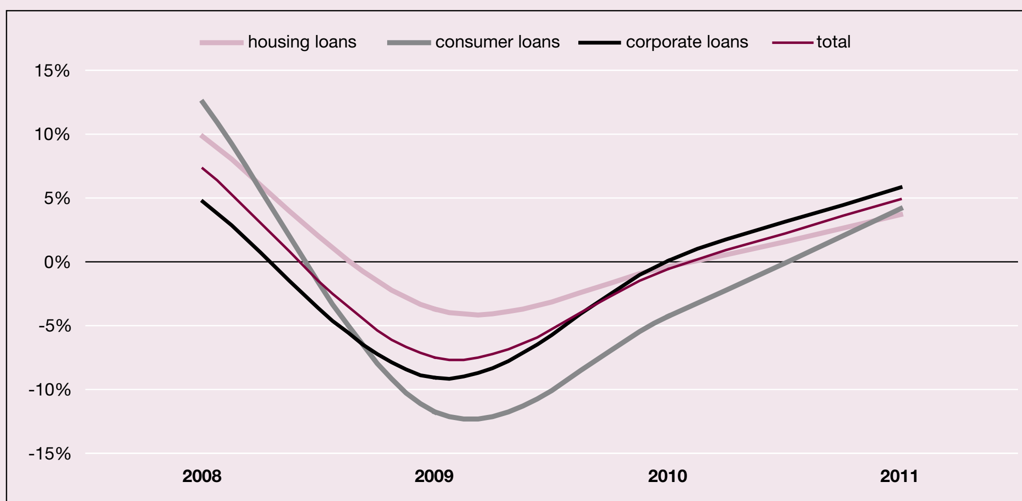

Figure 15. Credit growth based on the forecast baseline scenario

expects negative credit growth for 2009 as well as 2010: –7.5% and –0.5%, respectively (see Figure 15). Growth will be positive again in 2011 (4%). The percentage of overdue loans in the total loan portfolio will peak in 2009 at 9%. The share of overdue consumer credit will reach a record high of 23% in 2010 (see Figure 16).

Based on the risk scenario of Eesti Pank's spring forecast, global economic problems will lead to a longer recession. If the global economic decline continues for a longer period, it will entail a very weak external demand for Estonia. Besides modest exports, the business sector will be facing more difficulties in including foreign capital, which will, in turn, inhibit the necessary structural reforms. The risk scenario anticipates a 15.3% and 4.6% contraction in 2009 and 2010 in real terms, and a 1.9% growth in 2011. Nominal growth in non-financial sector loans will be –8.8%, –6.5% and –4.3%, respectively. Overdue loans will account for 10.5% of the total loan portfolio at the end of 2009 and will start to decrease after that.

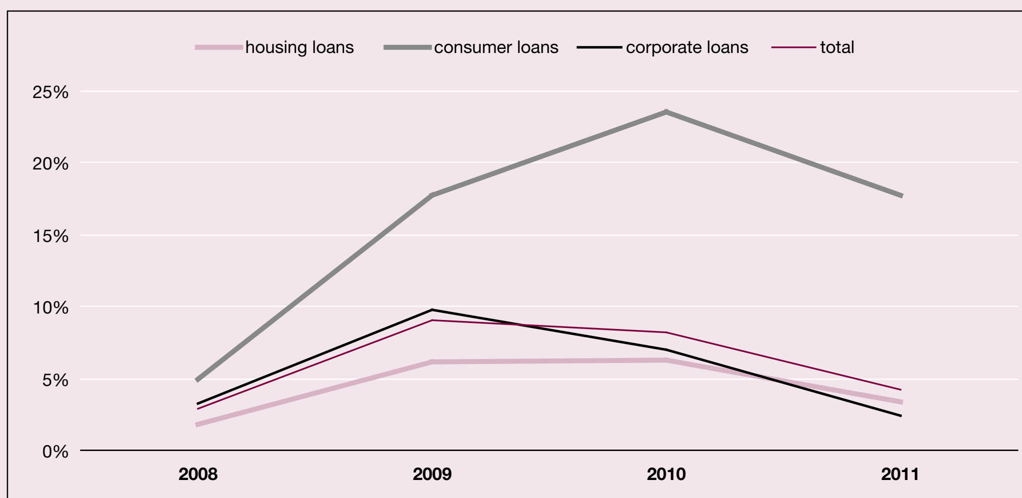

Figure 16. Changes in overdue loans based on the forecast baseline scenario

Available capital buffers

Considering the capital buffers of the Estonian banking sector, banks could have written off over 9 billion kroons of loans (6% of total portfolio) as at end-March 2009 and still comply with the 10% capital adequacy requirement on an aggregate basis (see Table 2).[4] However, writing off 26 billion kroons, i.e. 15.9% of the loan portfolio, would bring the capital adequacy ratio to 0%. In fact, banks are holding even larger buffers for coping with difficult times – in addition to the capital buffers included in the present analysis there are also the provisions made by parent banks to cover the risks.

Aggregate stress test

The aggregate stress test is based on the spring forecast of Eesti Pank and the model for the stress test of the banking sector. This model enables to analyse the developments of overdue loans and loan losses in terms of banks and loan types. Besides the inputs used for the model, the aggregate stress test takes into account a few additional assumptions regarding banks' profitability and rate of loan losses.

According to the aggregate stress test, **profitability** is lower in 2009 compared to previous years. Based on the baseline scenario of the spring forecast, the banking sector will earn 3 bil lion kroons of pre-loss profits in 2009 in total.

The risk scenario foresees that the income of banks will suffice only for covering the current expenditure, and there will not be any pre-loss profits.

Table 2. Available capital buffers

	Buffers (EEK bn))	Share in portfolio (%)
10% capital adequacy	9.6	5.8
8% capital adequacy	13.0	7.8
4% capital adequacy	19.7	11.9
0% capital adequacy	26.4	15.9

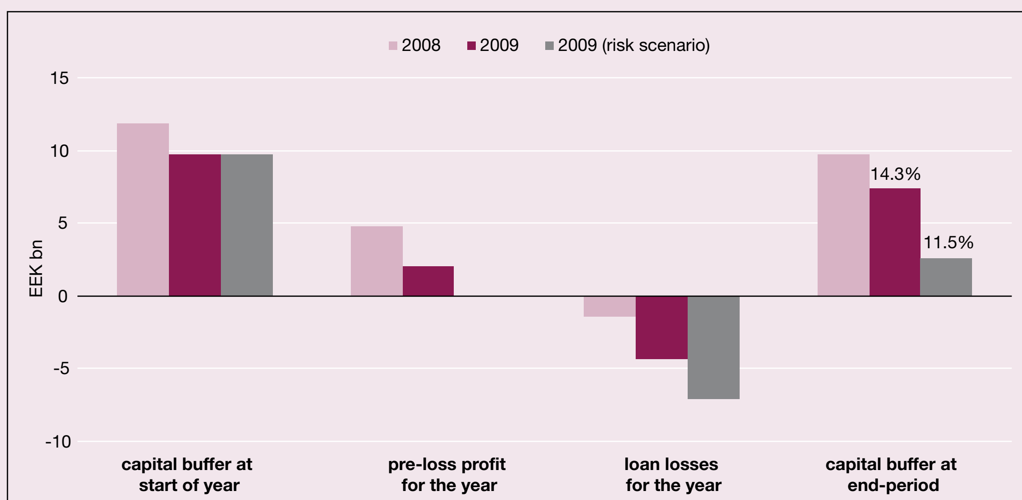

Figure 17. Factors shaping capital buffers

[4] The aggregate indicator includes only a part of Swedbank's capital for covering risks in the Baltic States so as to reflect only the risks taken in Estonia.

Considering the more conservative assumptions used in the stress test, the baseline scenario has applied a 45% LGD ratio for loan loss calculation. For the risk scenario, a 60% LGD ratio has been used.

Taking into consideration the above criteria, the **Estonian banking sector will meet the capital adequacy requirement on an aggregate basis in 2009** in the baseline and also in the risk scenario (see Figure 17). Loan loss provisions will constitute 2.8% and 4.6% of the total loan portfolio of banks in 2009, according to the baseline and risk scenario, respeively. Total loan loss provisions will account for 4.4% and 6.2% of the aggregate portfolio, respectively.

Capital adequacy

On 1 March 2009, Swedbank obtained authorisation from the Financial Supervision Authority to apply the new Internal Ratings Based approach (IRB) for calculating the capital requirement for credit risk within the capital adequacy framework (Basel II).

The purpose of using the **Internal Ratings Based** approach is to increase the risk sensitivity and measurement adequacy of the capital required for credit risk. Granting of the authorisation depends on meeting the minimum requirements provided by legislation, including the reliability of internal risk assessment methods and the daily implementation of good practice in credit risk management.

If a credit institution introduces IRB for calculating the capital requirement for credit risk, or AMA (Advanced Measurement Approach) for calculating the capital requirement for operational risk, the volume of risk-weighted assets may sharply decrease. Therefore, restrictions have been set for the transition period in respect of the decline in risk-weighted assets. This means that when the volume of risk-weighted assets calculated according to the new methods will be lower than 80% in 2009 compared to risk-weighted assets calculated on the basis of earlier methods, the 80% limit must be applied when calculating banks' own funds. The transition period will be over by 2010 and the volume of IRB-based risk-weighted assets is expected to decrease further, which will increase the average capital adequacy ratio of banks.

Changes in banks' own funds and risk-weighted assets are presented in Table 3.

Table 3. Changes in risk-weighted items

	June 2008	July 2008	Sept 2008	Dec 2008	Mar 2009
Tier I own funds	24.2	24.2	24.3	24.4	27.2
Tier II own funds	10.7	10.7	10.7	10.8	10.8
Deductions	0.2	0.7	0.3	0.3	0.9
Own funds in capital adequacy calculation	34.6	34.2	34.7	34.9	37.1
Credit risk	178.2	161.9	152.1	150.7	141.4
Other risks	3.3	3.7	5.8	5.1	5.4
Operational risk	8.5	7.0	7.1	7.1	7.2
Addition to risk weighted assets arising from transition period	0.0	15.1	24.4	22.1	13.3
Risk weighted items	190.1	187.7	189.4	185	167.3
Banking sector average capital adequacy	18.2%	18.2%	18.3%	18.9%	22.2%
Lowest capital adequacy indicator	14.2%	14.1%	14.9%	15.4%	16.2%

The **average capital adequacy** of the banking sector has been increasing since 2005 and reached 22% at the end of April 2009 (see Figure 18). Thus, banks' average capital adequacy is over two times higher than the 10% minimum required in Estonia. This shows that banks have strong buffers for loan losses on an aggregate basis (see also background information *Stress test of the banking sector*).

In the last quarters, the capital adequacy ratio has increased mainly owing to a decrease in risk-weighted assets and an increase in Tier I own funds.

In the first quarter of 2009, Tier I **own funds** grew by nearly 3 billion kroons. Most of that were retained earnings from previous periods included in own funds after the audits of annual reports.

Risk-weighted assets decreased primarily as a result of a decline in the capital requirements for credit risk. The capital requirements for operational and other risks did not change considerably. The capital requirement for credit risk is necessary in case the counterparty of the bank fails to meet its liabilities and the loan collateral is not sufficient to cover the claim. Credit risk is the biggest of banks' total risks and concerns nearly all loan products. In the first quarter of 2009, the capital requirements for credit risk decreased by 9.3 billion kroons in total, and by nearly 37 billion kroons over the past three quarters. The net portfolio[5] of non-financial sector loans and leases granted by banks did not change significantly during the period under observation. Risk-weighted assets declined mainly due to the adoption of more sophisticated methods for capital requirement calculation by two major banks. The current restrictions for the decline in risk-weighted assets set for the transition period will be eliminated in 2009. Consequently, the volume of risk-weighted assets will decrease further, which will, in turn, increase the average capital adequacy ratio of banks.

Considering the current phase of the economic cycle, the timing of the transition to new methods for capital adequacy calculation under Basel II is relatively suitable. By using more specific methods, banks' risk-weighted assets will decline and there will be free capital available. If this capital is used as a buffer for potential loan losses, such a countercyclical process contributes to ensuring financial stability.

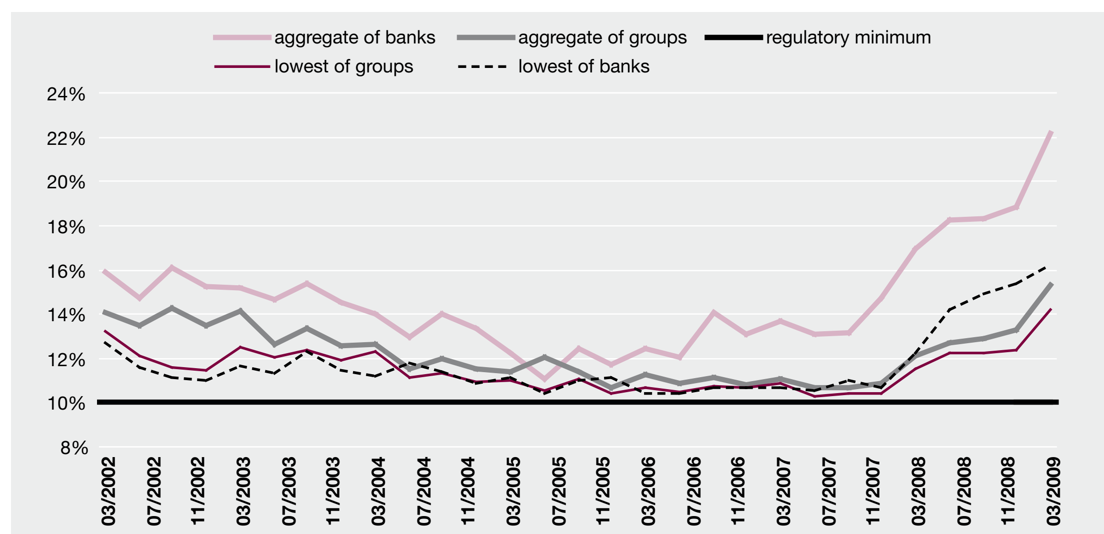

Figure 18. Capital adequacy of banks and banking groups

[5] The net portfolio of non-financial sector loans and leases = the stock of non-financial sector loans and leases – provisions for loans.

Liquidity

The amount of customer deposits has been sufficient in the past quarters to meet the lower demand for credit. Therefore, banks did not have to acquire significant amounts of additional funds from their parent banks (see Figure 19).

The slight outflow of deposits to institutions with a higher rate of guaranteed deposits that occurred in autumn 2008 subdued soon after the harmonisation of the guarantee rates.[6] In the last quarters, the deposit market has been primarily shaped by customers' price sensitivity: institutions providing higher deposit interest rates have also increased their customer base. Nevertheless, markets shares have changed by only a few percentage points, which shows that customers are relatively loyal (see Figure 20).

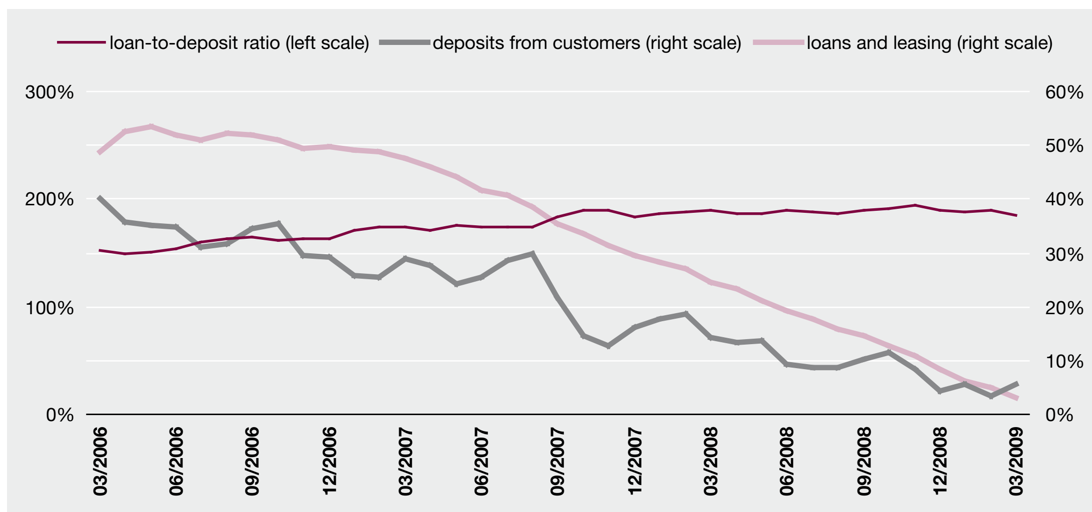

Figure 19. Loan-to-deposit ratio and year-on-year loan, leasing and deposit growth

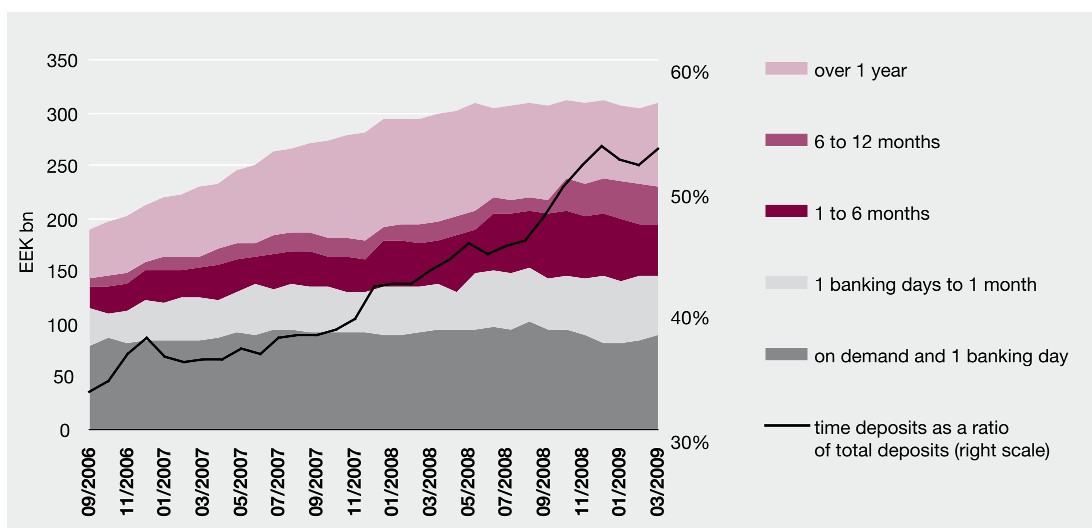

Figure 20. Banks' liabilities by remaining maturity and time deposits as a ratio of total deposits

[6] On 9 October 2008, the maximum amount of guaranteed deposits was raised to 50,000 euros (782,330 kroons) in most EU countries, including Estonia. In addition, the share of guaranteed deposits was raised from 90% to 100% within the 782,330 kroons limit.

Competition in the deposit market and customers' price sensitivity have facilitated growth in **time deposits**, which has a favourable impact on banks' liquidity positions[7] but has also increased the cost of funding for banks (see also Section *Profitability*).

The subsidiaries and branches operating in Estonia **manage liquidity** mostly centrally, **through parent banks**. As the maturities of funds received from parent banks keep shortening, local banks are increasingly more dependent on the availability of funds from parent banks (see Figure 21).

Given the higher risk sensitivity of customers in the current economic situation, the primary liquidity risk of the banking sector can be managed with the help of the requirement of liquid assets, which was increased to 15% in Estonia on 1 September 2006. However, considering that customers are entitled to require redemption of deposits on a very short notice, it is still vital that credit institutions assessed the increased risks adequately and ensured the availability of sufficient liquid funds to satisfy the potential claims.

Profitability

The profitability of banks has been affected mainly by the need to adjust the value of loan portfolios in line with the changed risk assessments. Profitability has suffered also from a decrease in interest incomes and fee and commission incomes, which has resulted from the general decline in economic activity. Banks have started to cut down on costs, but the cuts have not been as extensive as the decrease in incomes.

The credit institutions and branches of foreign banks operating in Estonia have had to make considerable adjustments to the value of assets. Consequently, most of them operated at a loss in the first quarter of 2009. Still, the total **loss of the banking sector** was only 0.4 billion kroons (see Figure 22).

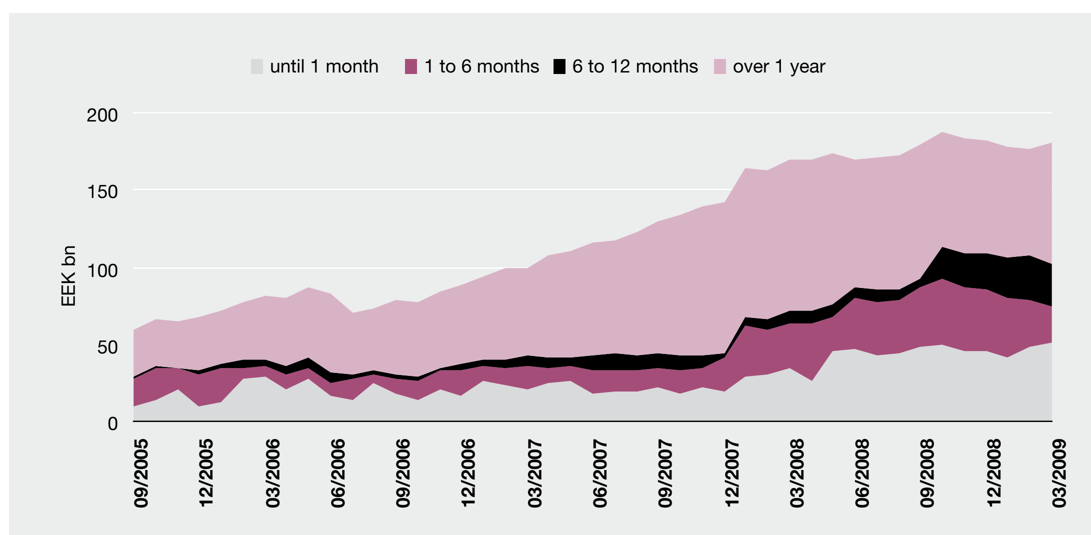

Figure 21. Banks' liabilities to external creditors by remaining maturities

[7] The terms and conditions of time deposits differ across banks. In some banks, customers can terminate the deposit contract also during the period of depositing and require early payment of the deposited funds, giving up only the accrued interest.

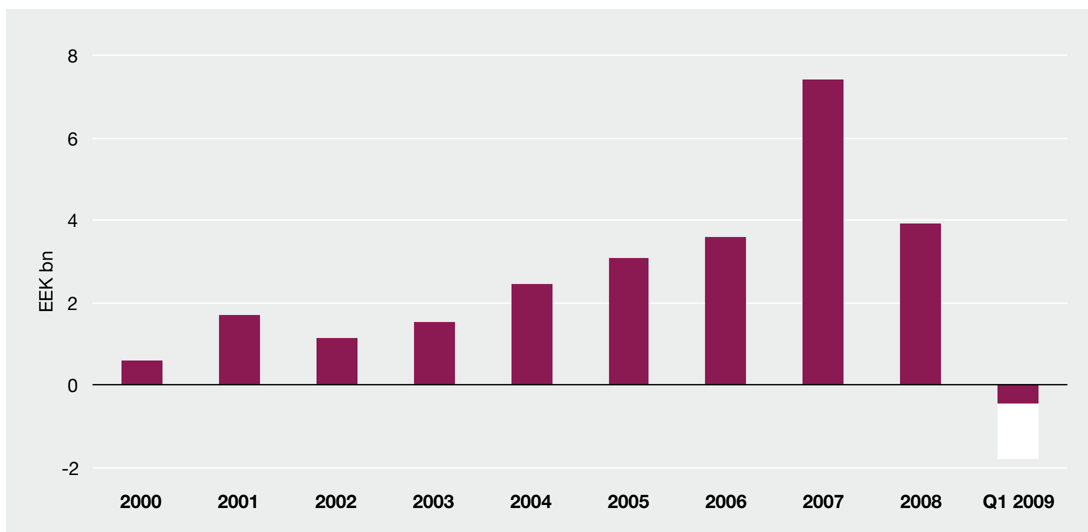

Figure 22. Banks' annual profit and Q1 2009 results (y-o-y)

As regards the total of **banking groups**,[8] the first-quarter loss stood at 1.4 billion kroons. Considering the relatively strong profitability in previous periods, the **return on equity** for the last four quarters still remained over 8.7% in the case of banks and 8.8% in the case of groups (see Tables 4-5). Although the fall in profits has been rapid and broad-based, the average profitability of the previous periods has been even over 30%, which has enabled banks to build up reserves for difficult times.

Since the economic situation has deteriorated, also credit risk is currently more likely to materialise. Given that a growing number of customers are facing difficulties with loan repayments, banks have started to make more **downward adjustments** to the value of loan portfolios. In total, the value of loans issued in Estonia was written down by 1.6 billion kroons in terms of banks and by 3.7 billion kroons in terms of groups in the first quarter (see Figure 23).

Table 4. Profitability of banks

	31/12/ 2007	31/03/ 2008	30/06/ 2008	30/09/ 2008	31/12/ 2008	31/03/ 2009
Average return on assets in the past four quarters	2.6%	2.4%	1.7%	1.6%	1.2%	0.8%
Return on assets in a quarter (x 4)	1.8%	1.1%	2.0%	1.4%	0.3%	-0.5%
Average return on equity in the past four quarters	30.2%	27.0%	18.4%	17.2%	13.6%	8.7%
Return on equity in a quarter (x 4)	21.1%	13.2%	20.7%	14.5%	3.5%	-5.3%
Net profit in the past four quarters (EEK bn)	7.4	7.1	5.2	5.1	4.0	2.6
Net profit of the quarter (EEK bn)	1.4	0.9	1.6	1.2	0.2	-0.4
Net write-downs of assets in a quarter (EEK bn)	-0.3	-0.4	-0.5	-0.3	0.8	-1.5

[8] Includes only the data of banks and groups licensed in Estonia, whereas the data of branches of foreign banks have been excluded. The comparative data on groups does not include Danske Group who has been operating as a branch in Estonia since the second quarter of 2008.

Table 5. Profitability of banking groups

	31/12/ 2007	31/03/ 2008	30/06/ 2008	30/09/ 2008	31/12/ 2008	31/03/ 2009
Average return on assets in the past four quarters	2.3%	2.1%	2.0%	1.9%	1.4%	0.8%
Return on assets in a quarter (x 4)	2.3%	1.6%	1.9%	1.7%	0.5%	-1.1%
Average return on equity in the past four quarters	29.3%	26.9%	25.0%	22.6%	16.8%	8.8%
Return on equity in a quarter (x 4)	29.2%	19.7%	22.6%	19.2%	5.6%	-12.2%
Net profit in the past four quarters (EEK bn)*	9.9	9.7	9.6	9.2	7.1	3.8
Net profit of the quarter (EEK bn)*	2.7	1.9	2.4	2.1	0.6	-1.4
Net write-downs of assets in a quarter (EEK bn) *	-0.4	-0.7	-0.8	-0.7	-1.7	-3.7

* Excluding data of Danske Group.

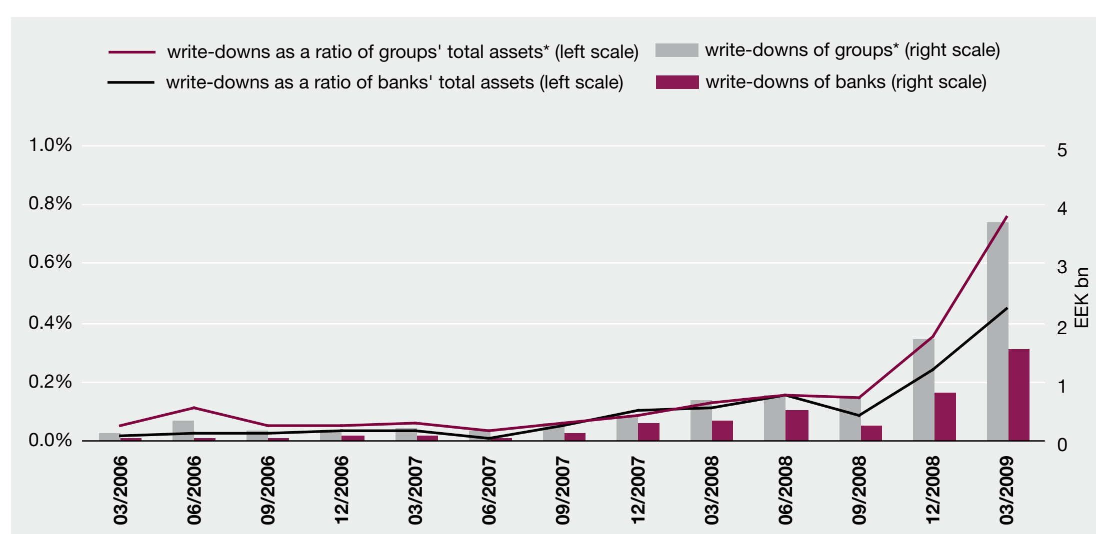

Figure 23. Write-downs of assets of banks and banking groups at the beginning of period

* Data of groups does not include Danske Bank.

The provisioning practices vary greatly by banks. However, the extensive asset write-downs of some credit institutions need not necessarily indicate substantial differences in their loan quality compared to other groups. It rather points to differences in the financial accounting practices of different groups. In some cases, part of the provisions made for covering the credit risk of loans issued in the Baltic States has been recorded in the group's parent bank in Sweden and do not appear in local statements.

Although the asset write-downs have been the most volatile component of banks' profitability of the previous quarters, in the first quarter of 2009 the **operating profits before write-downs** were 12% lower in the case of banks and nearly 15% lower in the case of groups, year-on-year.

The extensive interest rate cuts by central banks have entailed a **decline in the net interest margin** for banks (see Figures 24-25). The difference between the prices of assets and liabilities is affected, among other things, by the percentage demand deposits in the total liabilities, as the interest rate on these deposits is lower. Thus, if key interest rates are reduced, the advantage of quite low funding costs dimin-

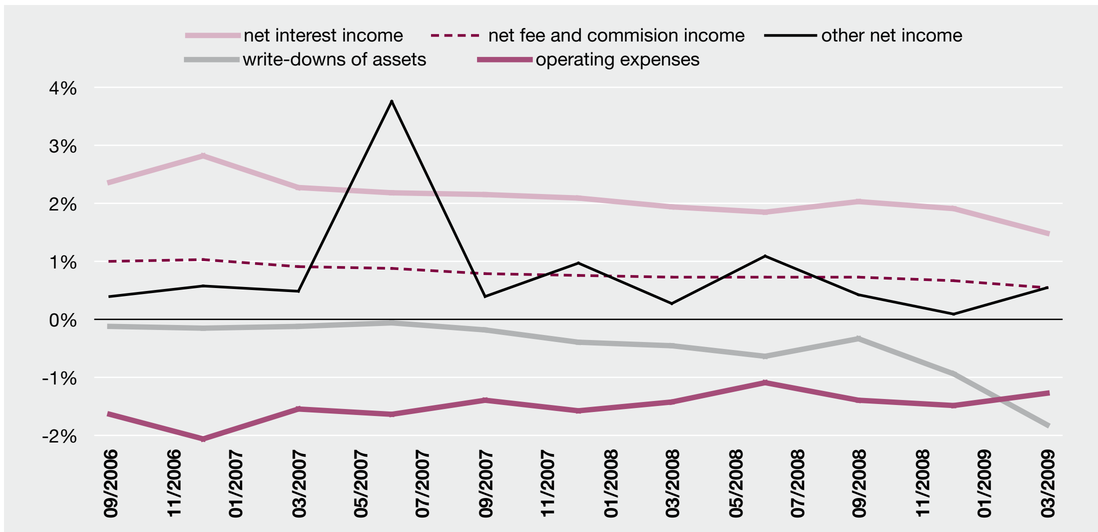

Figure 24. Income and expense items of banks (% of average assets per quarter x 4)

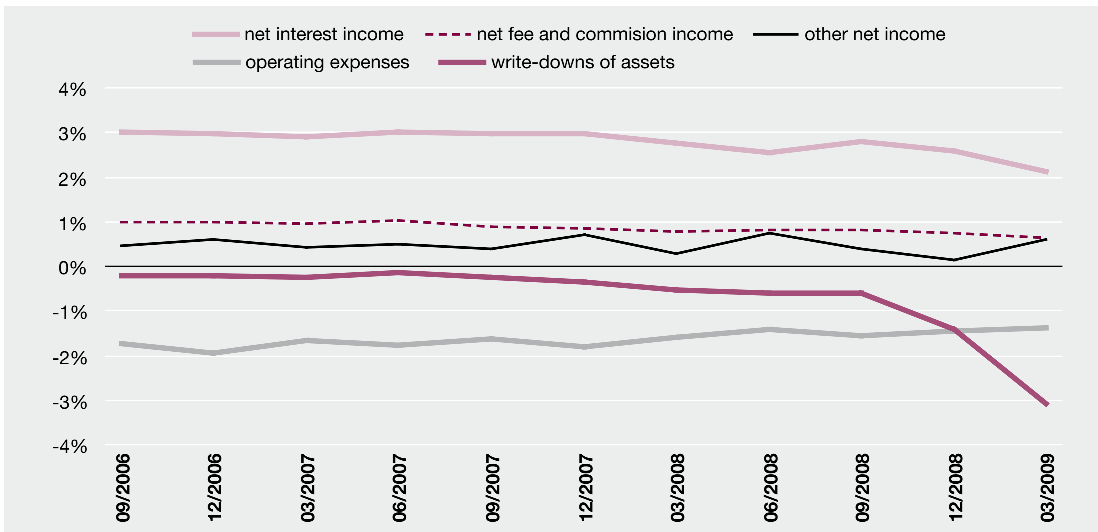

Figure 25. Income and expense items of banking groups (% of average assets per quarter x 4)

ishes if loan portfolios are mostly with floating interest rates. Moreover, the cost of funding has increased also owing to growth in the share of time deposits: from 43% in March 2008 to 53% of total deposits in March 2009.

The fear of the possible devaluation of the Estonian kroon has not prevented depositors from seeking for higher deposit interest rates – the percentage of kroon deposits, which have recently had higher interest rates than euro deposits, in total deposits has fallen by only a few percentage points. Deposit interest rate developments have varied across currencies, reflecting the differences between money market interest rates. The interest rate on euro and

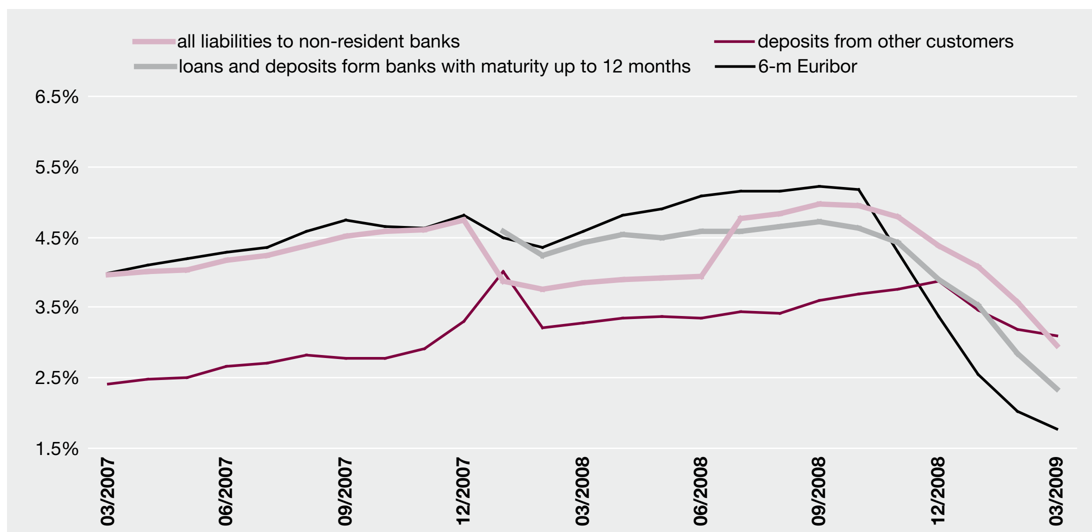

Figure 26. Average interest on banks' liabilities at month-end and 6-month Euribor

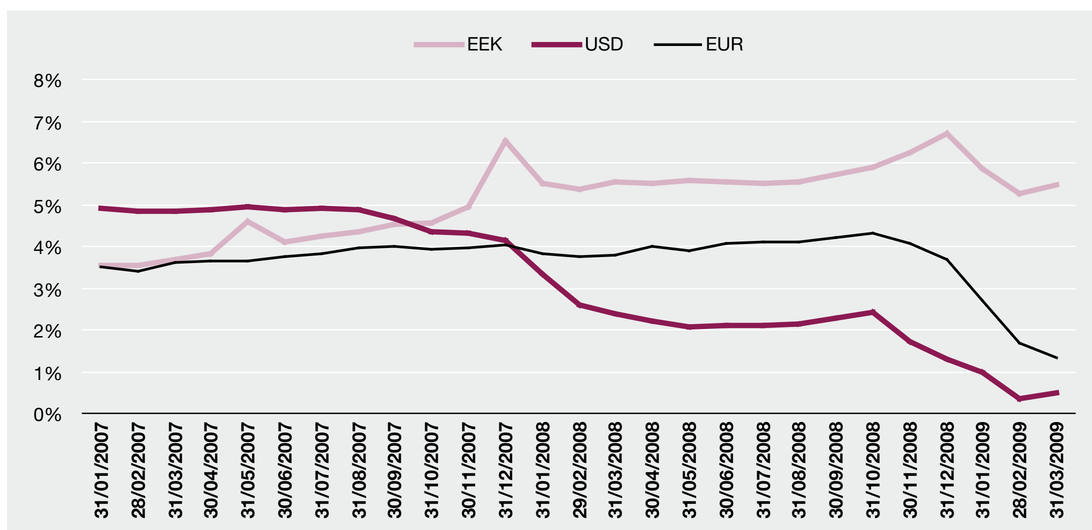

Figure 27. Average interest rate on time deposits

dollar deposits has declined considerably in the past quarter, whereas the interest rate on kroon deposits remained close to 5% (see also Figures 26-27).

As the economic situation has aggravated, risks have increased and the cost of funding has grown, banks have raised the interest margin on new loans. However, the impact of higher interest margins on net interest income is constrained by the low amount of new loans and also termination of interest calculation in the case of overdue loans (see Figure 28).

Year-on-year, total net interest income decreased nearly 24% in the case of banks and 20% in the case of groups. **Fee and commission income** shrank as well: by 20% and 14%, respectively. The decrease in fee and commission incomes has been primarily caused by the lower number

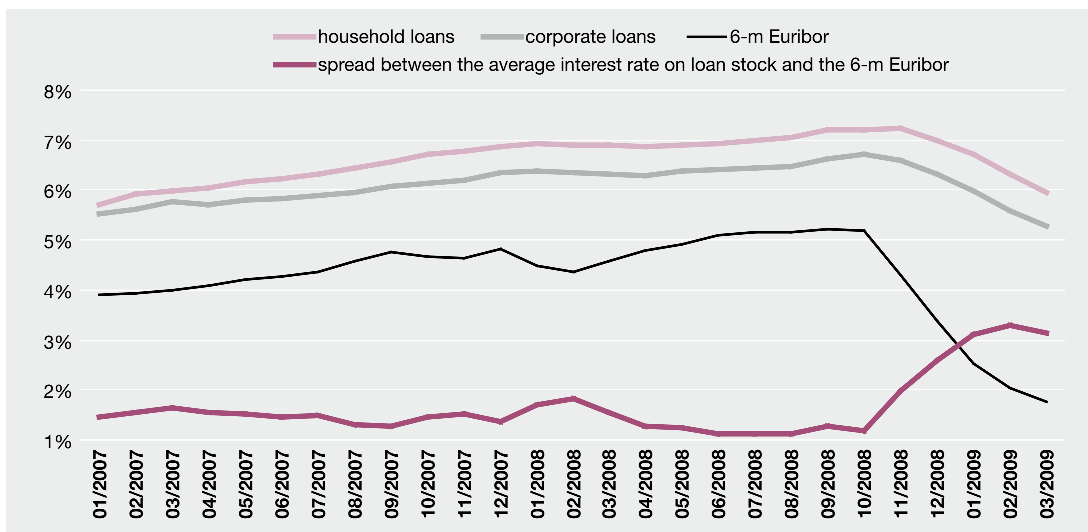

Figure 28. Average interest rates on loan stock

and value of payments, which has resulted from subdued economic activity (see also Section *Payment and Settlement Systems*).

Lower incomes and higher provisions for credit portfolios have decreased the profitability of banks to which they have responded by **cutting down even more on expenses**. For instance, bank offices have been closed and the number of employees has been curbed. However, the cuts are unlikely to keep up pace with the rapid decline in incomes and the effect of some cuts will probably be revealed over a longer period of time. By the first quater, the total staff and administration costs had decreased nearly 12% in the case of banks and 8% in the case of groups, year-on-year.

The **future profitability of the banks** will still be affected by the further materialisation of credit risk, as the economic situation is not expected to improve rapidly in the near future. Given the relatively similar structure of the credit portfolios and the business strategies of the banks operating in Estonia and other Baltic States, their ratios of loan provisions to total loans might differ also in the coming periods.

Net interest income generation will be important for banks also in the future, as it has always constituted a large part of their incomes. Higher risk estimates and lowered ratings have increased the cost of funding due to specific risk. The interest paid on deposits is influenced by growth in the share of time deposits and the differences between the interest rates on domestic and foreign currency deposits. Although the measures taken by central banks have lowered the general cost of funding, the high percentage of loans with floating interest rates reduces the favourable impact of low-cost resources on net interest margins.

To sum up, in recent quarters the profitability of banks has been largely affected by extensive loan write-downs as well as decreased interest incomes and fee and commission incomes. Even though the economic forecast allows to anticipate further growth in loan write-downs, it will affect profitability less due to the high rate of provisions already made. It is quite likely that several banks may report losses also in the coming quarters. At the same time, high profits from previous periods have enabled banks to build up buffers for difficult times.