SUMMARY

Global financial environment

The **liquidity constraints** that appeared on global financial markets last autumn **have eased by spring 2009**. This has resulted from the extensive national support programmes, which have helped banks raise capital, issue debt and restore confidence. Even though European banks are already obtaining funds from financial markets also without a state guarantee, the markets have not yet fully recovered. Without state support, the demand for long-term bonds – one of the key sources of funding for banks – is still low.

The **near-term global growth outlook** has deteriorated considerably over the past six months. The contraction of the economy and the declining solvency of borrowers have increased loan losses, which has had an adverse impact on the capitalisation of banks. Therefore, the measures taken by governments and central banks to raise capital remain crucial because of the uncertainty in the financial markets.

The **euro area money market interest rates** have dropped to extremely low levels. Compared to the peak of mid-October, the six-month Euribor had declined by over 4 percentage points by mid-May. Such a robust change in money market interest rates is unprecedented, revealing the depth of the global economic crisis. The current price environment, which is occasionally even deflationary, enables central banks to implement the policy of very low interest rates and market expectations of a new interest rate rise are therefore subdued.

Financial behaviour of companies and households and related risks

If the external environment does not improve any time soon, Estonia's GDP will contract both this year and the next, based on the spring forecast of Eesti Pank. The turning point in the economic cycle is expected this autumn, but the state as well as the private sector should be ready for over a 12% decline in 2009. The shrinking demand exerts considerable pressure on corporate and households budgets. Decreasing consumption prices and low interest rates, however, are not able to offset that pressure.

The **business sector** has tightened considerably in the past quarters. Sales and profits have plummeted, while the number of bankruptcy petitions has surged. Given that the recession is broad-based, loan repayments might pose growing difficulties for all sectors. Taking into consideration the prevailing uncertainty and low demand, less and less companies are willing to take a loan. As the lending terms are stricter now, companies are more interested in raising funds through their parent companies located abroad.

Household confidence reached a record low in March 2009. Confidence in a further price fall, fear of losing job and the resulting need to save more force the consumers to postpone purchases, which has an impact on private consumption and credit growth.

Although the net financial position of households has been deteriorating for the past year, it is expected to start improving in the near term. Household deposits have slightly grown over the last six months, whereas the stock of loans has decreased. The stock of new consumer loans has been declining especially rapidly: in April 2009 annual growth turned even negative. Households' loan repayment ability has been supported by the lower interest burden arising from the decrease in the Euribor.

Active real estate development in the past years and weak demand for new dwellings arising from the cooling economic environment has led the Estonian **real estate market** to a situation of supply heavily exceeding demand. Transaction activity is low and prices have dropped significantly in the first quarter of 2009 both as regards commercial real estate and dwellings. Based on the data of the Land Board, the prices of apartments in Tallinn have decreased by nearly a half from the peak levels in April 2007. Consequently, the affordability of apartments (the ratio of apartment prices and average gross wages) is reaching the level of 2004 in Tallinn. The strong fall in real estate prices may partly be caused by the overreaction of market players to the changes in the economic environment. Consumer confidence needs to be restored for the real estate market to regain ground.

Banking sector

In the past two quarters, the **groups of the parent banks of the banks operating in Estonia** have been more severely affected by the provisions for non-financial sector credit portfolios. The risk profiles of groups are quite similar but they have implemented different provisioning strategies. Although also forward-looking provisions have been made, several rating agencies and market players have nevertheless considerably increased their risk assessments regarding a number of groups after the reporting of negative results.

Regardless of the difficult market situation, the cross-border banking groups operating in Estonia have been able to attract additional funds through deposits as well as bond issues, supported by guarantees that the government programmes provide. As the liquidity management of the banking groups operating in Estonia has been further centralised, the local branches and subsidiaries are dependent on receiving funds from their parent banks.

Several major groups also increased their capital levels in the past quarters. Given the current market situation, the payment of dividends has been postponed or the dividend rate has been lowered.

Considering the future economic outlook in the region where the financial groups present in Estonia are operating, it cannot be ruled out that several groups may report losses also in the coming periods. Nevertheless, the capital buffers built up in good times will enable groups to run a loss for some time. In addition, the governments of groups' home countries have agreed to provide support to the groups should it be necessary.

Although the **banks operating in Estonia** have been applying different business strategies, which has changed their market share by a few per cent, the market concentration has, in general, remained more or less unchanged. The two largest banks comprise 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 the LHV Group, who used to be engaged only in asset management, started to operate also as a commercial bank.

The aggregate **capital adequacy** ratio of the banks operating in Estonia increased to 22% by the end of April, mostly as a result of implementing new risk assessment methods for the calculation of capital requirements. The capital adequacy ratio increased also due to an increase in Tier I own funds, which stemmed from including the profits from previous periods in own funds. Consequently, at the end of April banks' capital buffers for potential loan losses were more than two times bigger than the minimum capital adequacy requirement established in Estonia. The buffers are expected to increase further in 2010, when the current restrictions set for the transition period regarding the decline in risk-weighted assets will be eliminated.

The cooling economy has significantly affected also the stock of overdue loans. The percentage of **loans overdue for more than 60 days** in the total portfolio of non-financial sector loans has been growing rapidly for the past two quarters, reaching 5% in April. Overdue loans have increased among household as well as corporate loans. As usual, households mostly fail to repay consumer loans by due date. As regards the corporate sector, commercial real estate and construction firms as well as accommodation and catering companies, which are suffering from the low number of tourists, have the highest share of overdue loans.

Given the worsening economic environment and the growing number of overdue loans, banks have been relatively conservative and have considerably increased the stock of **loan provisions**. Since August 2008, provisions have accounted for around 40% of the loans overdue for more than 60 days. In addition, general provisions for the Baltic States have been made at the group level.

Based on the spring forecast of Eesti Pank, the stock of loans overdue for more than 60 days will constitute 9% of the total portfolio of banks at the end of 2009. Loan losses will amount to approximately 6 billion kroons. However, banks should cope with the expected high loan losses thanks to the capital buffers built up in good times.

The **funding and liquidity** of the banks operating in Estonia is supported by the relatively stable level of deposits and improved funding opportunities for parent banks. The amount of customer deposits has been sufficient in the past quarters to meet the lower demand for credit. As a result, banks' liabilities to foreign banks have decreased on an aggregate basis. Customers' price sensitivity and risk aversion have facilitated growth in time deposits in banks' resources, which in turn has increased the cost of funding for banks.

The **profitability** of banks has been mainly curbed by the need to adjust the value of loan portfolios but also due to a decrease in net interest incomes as well as fee and commission incomes. The reduction of key interest rates decreases net interest incomes, as the advantage of lower funding costs diminishes in the case of loan portfolios with floating interest rates. Moreover, the cost of funding has gone up also owing to an increase in time deposits. Thus, net interest incomes might decline also in the near future. The decrease in fee and commission incomes has been primarily caused by the lower number and value of payments, which has resulted from subdued economic activity.

Banks have started to cut down on costs, but the cuts have not been as extensive as the decrease in incomes. As the opportunities for income generation have diminished, banks are likely to make further cuts to operating costs. However, the cuts are unlikely to keep up pace with the rapid decline in incomes and growth in provisions, and the effect of cuts will probably be revealed over a longer period of time.

Therefore, 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.

Other financial markets

The Estonian **money market** interest rates have remained at relatively high levels mostly owing to the increased demand of foreign companies for the Baltic currencies, as they wish to hedge the foreign exchange risk for operating in the region. As most Estonian credit institutions manage liquidity in euros and via parent banks' groups, temporary growth in the turnover of short-term kroon loans at the beginning of 2009 can be explained by the fact that a few banks have been covering their foreign exchange positions via the Estonian kroon money market.

The otherwise passive primary **bond market** was stimulated by relatively large issues by local governments in the past six months. It is noteworthy because the last time the general government issued bonds was over five years ago and also the value of that issue was lower then. Bond market capitalisation has decreased nearly 20% to 11.3 billion kroons over the last six months.

Global **stock prices** went up again in March after a period of record low levels caused by the global financial crisis and negative economic outlook. As weak demand does not give hope for an improvement in corporate financial indicators in the near term, the upward trend of stock prices rather reflects decreasing uncertainty and growing confidence in the general economic outlook. The rise in stock prices is welcome for both the investors and financial intermediaries, since it contributes to restoring productivity, which has suffered heavily since the outburst of the crisis.

Compared to other Central and East European stock indices, the **Tallinn Stock Exchange** index OMXT has gone down more sharply from the pre-crisis levels. However, since the beginning of 2009 it has also been growing relatively faster than the euro area average and other indices of higher-risk markets. The liquidity of the Tallinn Stock Exchange dropped to a historical low. Stock capitalisation plummeted to the level recorded ten years ago and remained there until end-March.

The financial crisis has had a considerable impact on **investment and pension funds**. All funds (except for the money market fund) suffered from historical lows in terms of average annual yield. The share of foreign assets in total fund assets has been gradually decreasing and investment strategies are focused on the more stable markets of advanced EU economies. By the end of the first quarter of 2009, the value of investment fund assets had declined to the level of 2005. As payments to the compulsory pension funds have been stopped, growth in pension funds is expected to slow significantly over the next six months.

The future outlook for the **insurance market** is generally negative because of the adverse economic situation and low confidence of the society. The volume of insurance premiums collected by life insurers has decreased to pre-boom levels and the market witnessed huge losses in 2008 due to the loss from investment activities. The non-life insurance market has also suffered from lower sales, although the financial crisis has not hit that segment so hard.

Payment and settlement systems

The recession has manifested itself also in the payment and settlement systems: the **value of payments** processed in the Settlement System of Ordinary Payments (ESTA) declined 12%, year-on-year, to the level of mid-2007. There were no such incidents in the operation of the Estonian payment and settlement systems that would have threatened the stability of the financial sector.

Compared to several other EU countries, the Estonian payment environment is highly advanced and electronic. The **direct debit** market has already fully developed and there is potential for growth mostly for cross-border direct debit services. Besides the harmonisation of the payment and settlement environment and establishment of support infrastructures, the general integration of the financial and non-financial sectors is important in this context.

Assessment of financial stability and risks

Since last autumn the role of national and international institutions in ensuring the operation of the financial system has grown considerably all over the world. Thanks to the large-scale measures taken by governments and central banks to protect financial stability, the tensions regarding the liquidity and funding of banks have eased by this spring. National support programmes remain vital also in the next stage of the global financial crisis, as loan losses are expected to grow and sufficient capitalisation must be ensured.

The parent banks of the major banks operating on the Estonian banking market have been secured by the guarantee schemes of their home countries Sweden and Denmark. Until the end of 2008, Nordic banking groups experienced relatively small setbacks from the global crisis compared to other larger banks in Europe, and the support programmes rather served as an emotional and calming instrument. However, the recession on the global as well as the target markets of the Nordic groups has made banks more cautious about the materialisation of credit risk. Groups have sufficient buffers based on the spring estimate of the Swedish central bank, but should negative scenarios materialise, it cannot be ruled out that parent banks may have to acquire additional capital if loan losses grow.

In addition to or as an alternative to acquiring additional capital, parent banks might set restrictions to asset growth if loan losses increase. The probability of that scenario has clearly risen since autumn. As credit demand has contracted, Estonian borrowers need not perceive the effect arising from capital restrictions, at least for the time being. However at some point, the current stable funding channel – the Nordic banking groups – might be insufficient to support the beginning of a new investment cycle.

The Estonian credit market has been mainly shaped by the decreasing willingness of companies and households to consume or invest, which has been modest compared to the amortisation of banks' loan portfolios. On the other hand, banks all over the world have tightened their credit terms and conditions, thus keeping away customers with smaller solvency, collaterals and financial buffers. Banks have become more conservative in the current economic environment but are still willing to finance viable projects. However, there is no reason to hope for the loose pre-crisis credit standards. Borrowers may benefit from lower loan interest rates, resulting from key interest rate cuts, and the overall decline in prices.

The number of households and companies with temporary or permanent loan repayment problems has grown amidst the recession. Based on the baseline scenario of the spring forecast of Eesti Pank, loans overdue for more than 60 days will constitute 9% of the total loan portfolio at the end of 2009. Regardless of that, banks have enough capital to cover potential higher loan losses. In addition to the reserves from the profits of previous years, banks can also use the capital buffers built up with the support of earlier counter-cyclical measures. The decrease of the capital buffers is only natural in the current phase of the economic cycle. Nevertheless, the reserves need to be restored as soon as the new growth phase starts off.

Half a year ago, the assessment of risks to financial stability focused on global liquidity problems; at this point, the uncertainty may be increased by a sudden deterioration in the region's economy. Consequently, the confidence of Estonian households and business sector in the domestic monetary and banking system may ultimately suffer, even though in autumn the global financial turmoil could not damage the confidence considerably.

Trust in the Estonian financial system has been so far supported by the high reserve requirement (15%), which covers nearly a third of the customer deposits. In February 2009 Eesti Pank also entered into a precautionary arrangement with the Swedish central bank to help ensure liquidity in the currency board arrangement implemented in Estonia. In addition, the government has proposed legislative changes that are aimed to provide a better basis for financial crisis management.

To sum up, the risks to the Estonian financial stability have not decreased in the current uncertain economic and financial conditions but have even grown in some areas. Although funding by parent banks has stabilised with the support of government and central bank measures, expected loan losses might reduce the capital buffers of the groups of parent banks. This, in turn, might affect credit supply to Estonia.

Compared to last autumn, the future outlook of the Estonian economy has deteriorated considerably because of the worsening external environment, which is why credit risk is currently more likely to materialise. At the same time, local subsidiaries have sufficient capital buffers to cover potential loan losses, and this helps ensure the functioning of the financial system also should a more negative scenario materialise.

In the conditions of the ongoing recession and global financial crisis, Estonian households, companies, financial intermediaries as well as the state should continue making reasonable decisions with regard to their economic performance and financial behaviour. Attention should be paid to policies aimed at avoiding or reducing the implications of risks, including excessive pessimism that can easily emerge in view of negative economic indicators.