II REAL ECONOMY AND LOAN QUALITY

CREDIT PORTFOLIO OF BANKS

At the end of September 2010, the financing portfolio of banks totalled 252 billion kroons, which was 6.6% less than a year previously. The stock of loans and leases granted to companies and households has decreased by 9% and 4% respectively.

The structure of the loan portfolio has changed considerably because the different loan segments have different amortisation rates. The share of housing loans has grown by 1.7 percentage points from a year ago, mainly as a consequence of the high percentage of long-term loan contracts (see Figure 1).

Changes in the structure of corporate loans differ by sector, both in loan contracts and in the demand for credit. Viewed by sector, corporate lending has shrunk most in the real estate and construction sectors, while in manufacturing and trade the demand for credit is picking up. As with housing loans, the corporate credit portfolio has a high percentage of real estate loans because of the larger share of long-term loan contracts.

The autumn 2010 forecast by Eesti Pank is more pessimistic about loan growth than the forecast was in spring 2010. The role of domestic loan money in stimulating economic growth has been weaker than expected, and credit growth is likely to remain modest in the coming years too. The forecast presumes that domestic demand will recover later than export revenues, and that this will affect the growth and structure of banks' financing portfolios over the next few years (see Figure 2).

In the near future the loan stock will be boosted mainly by external-demand oriented business areas, but banks' risk positions will nevertheless include a large share of loans issued to real-estate related sectors as well.

Figure 1. Structure of banks' credit portfolio as at 30/9/2010 and change y-o-y

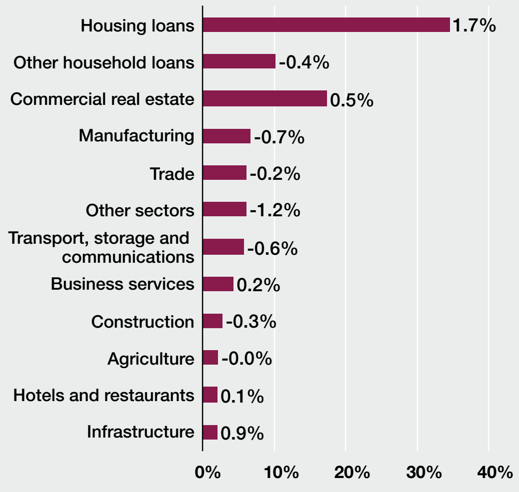
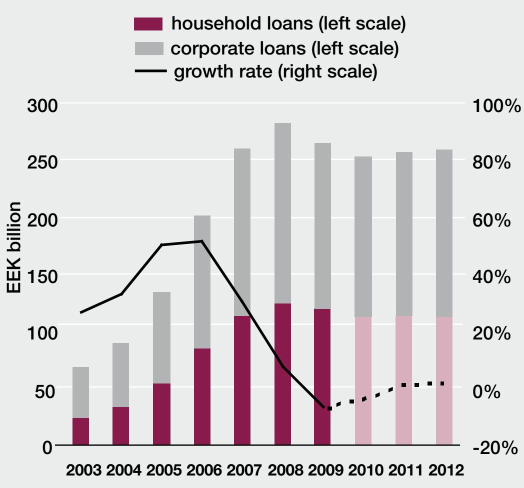


Figure 2. Value and growth rate of banks' credit portfolio and expected growth in 2010–2012



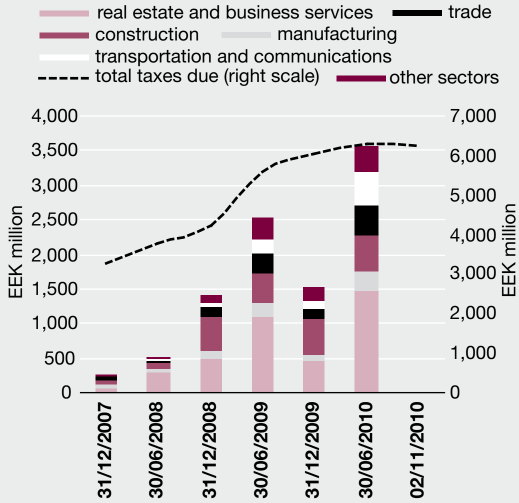
LOAN REPAYMENT ABILITY OF COMPANIES

Although the economy is recovering, the solvency problems of companies still increased in the first half of 2010, as was indicated by the growing number of payment defaults and bankruptcies, and by the quality of banks' credit portfolio. The payment default register shows that the number of reported payment defaults in the business sector had grown in all major sectors in the first half of 2010 from a year previously (see Figure 3). The situation started to improve slightly at the beginning of summer, and by the end of September the number of payment defaults[1], tax arrears and bankruptcy petitions had shrunk, which implies a moderate easing in payment difficulties.

The loan repayment ability of companies is stimulated by their economic performance, which has started to improve after a long period of recession. Sales revenues have not dropped any further since the end of 2009 and companies have kept their expenses under tight control, and this has resulted in rising profits (see Figure 4). The **total profit** of the business sector had been falling for nine consecutive quarters and reached its lowest level in the fourth quarter of 2009.[2] In the first two quarters of 2010, however, profits picked up.

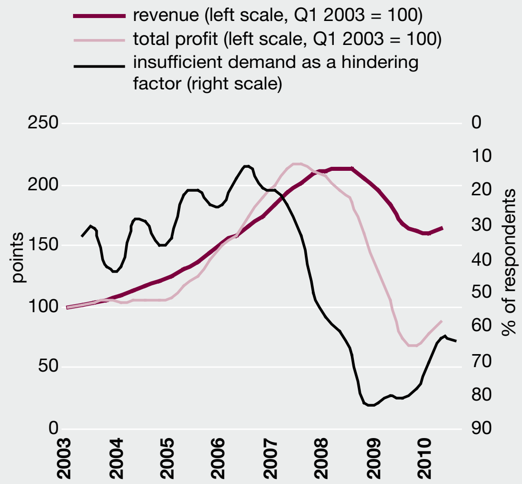
The level of total profit remains low, even in current prices, standing below the pre-boom level of 2003. This means that companies still have relatively few free funds and that they are seeking urgently to restore their profits in one way or another. Weak demand is easing as the main factor hindering business activity, which means that profits will grow in the coming quarters, as it usually takes three or four quarters for profitability to respond to changes in demand. Nevertheless, companies perceived a slight slowdown in the recovery of demand in the

Figure 3. Payment defaults by sectors and taxes due



Sources: Krediidiinfo, Estonian Tax and Customs Board, Eesti Pank

Figure 4. Corporate sector's economic results and demand for products and services



Sources: Statistics Estonia, Estonian Institute of Economic Research, Eesti Pank

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[1] Krediidiinfo states that the percentage of companies with low credit assessment in the total number of operating companies contracted from 30.7% at the beginning of 2010 to 28.0% in September.

[2] Four consecutive quarters.

third quarter of 2010, and so growth in cash flows will slow slightly in the long run.

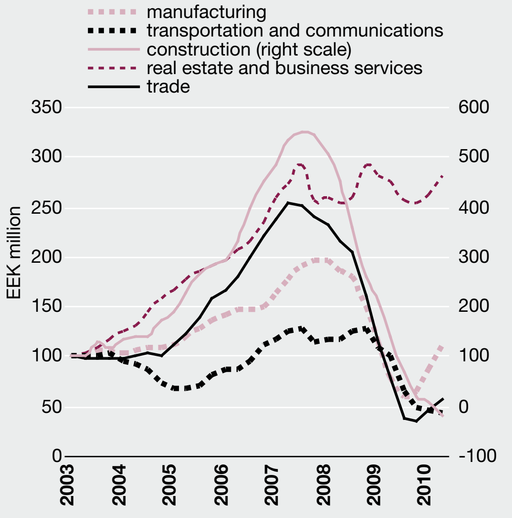
The situation varies between sectors, and several sectors, such as construction and transport and communications, still suffered declining profits at the end of the second quarter (see Figure 5). Somewhat surprisingly, trade and real estate and business services[3] have managed to increase their cash flows even with weak demand. The manufacturing sector had also increased its cash flows by the end of the second quarter, as expected, and profits for four consecutive quarters have risen to the levels of 2005. The profitability of the manufacturing sector is expected to grow more rapidly in the next few quarters as a result of substantial rises in industrial production and exports.

In the long run, however, growth will slow, as the current developments are really a recovery from the recent recession. In other, mainly domestic demand oriented, sectors the propensity to save is higher than in the pre-crisis years: growth is slower than in other sectors. As sales recover gradually, companies are trying to increase their profits, for instance by raising their margins. They may well succeed in doing so, given that competition is not tough in an economy as small as Estonia's. So in the coming quarters the profitability of domestic demand oriented sectors may recover more rapidly than could be expected on the basis of the macroeconomic conditions.

Profits have rocketed mainly in larger manufacturing companies with one hundred or more employees (see Figure 6). Larger companies, which are probably more export-oriented, have benefited more from the improved external environment. On the other hand, small manufacturers, which constitute 80% of the total sector, have not gained much from current positive developments. A number of companies, in particular those small and domestic demand oriented

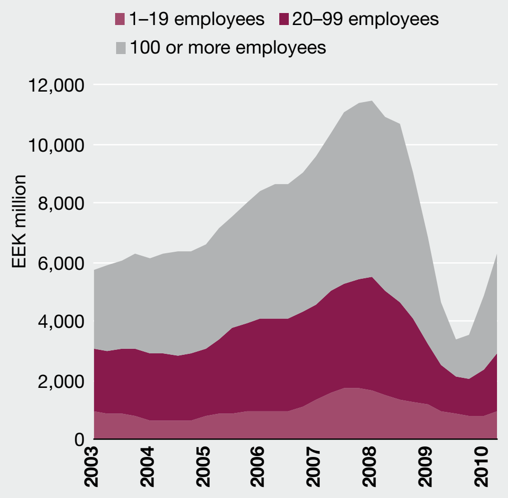
[3] Includes holding corporations.

Figure 5. Corporate sector's total profit for four consecutive quarters by sectors (Q1 2003 = 100)



Sources: Statistics Estonia, Eesti Pank

Figure 6. Total profit for four consequtive quarters of manufacturing companies by their size



Sources: Statistics Estonia, Eesti Pank

businesses which have just been coping through the downturn and waiting for the recession to end, may find that they will not survive after all. Consequently, solvency problems may still emerge in the next quarters, though they are probably not that major.

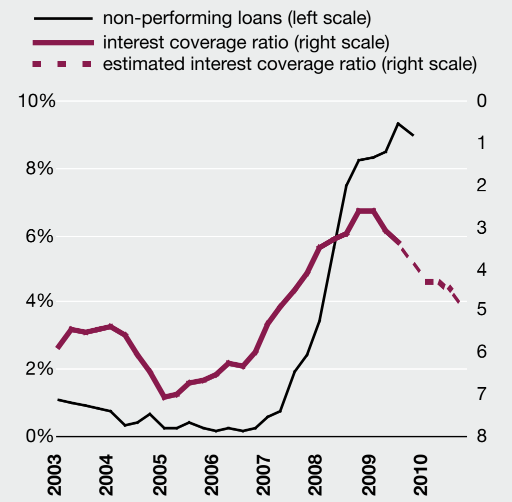
The estimated **interest expenses**[4] of companies dropped to the lowest levels of recent years in the first quarter of 2010 as a result of falls in loan liabilities and in the key interest rates. However, the interest rate on the loan stock is rising and is expected to rise further in the coming quarters. As the level of corporate debt will no longer shrink significantly, interest expenses will start to grow again after declining for five quarters. The expected growth in expenses will be much more modest than it was in the previous years, because the loan stock and key interest rates will increase only slowly.

In the first half of 2010, companies made adjustments to their balance sheets to lower their financial leverage. With lower financial leverage, a company is more likely to earn sufficient cash flows for its loan repayments after an economic shock, and is thus less vulnerable to a deteriorating economic environment.

Although interest expenses will increase, the profitability of companies will grow faster than the expected recovery of the economy, and companies' loan repayment ability will improve over the next quarters. The interest coverage ratio reached its lowest point in the fourth quarter of 2009 and has gone up since then. In the coming quarters, the solvency of the corporate sector may improve as a result of soaring profits (see Figure 7). Thus the volume of banks' new non-performing loans will probably remain low.

[4] The estimate includes the total loan liabilities of companies on the basis of the financial account, while presuming that the interest rate for the loan liabilities is equal to that for the domestic bank loans.

Figure 7. Loans overdue for more than 60 days and estimated interest coverage ratio



Sources: Statistics Estonia, Eesti Pank

LOAN REPAYMENT ABILITY OF HOUSEHOLDS

The dynamics of household incomes, which are strongly correlated with labour market movements, are a key determinant of the loan repayment ability of households. The fall in wages turned into growth in the second quarter of 2010, but the real income of households is still negative because of the rapid increase in prices. Incomes have stopped declining, but the rate of recovery will remain slow in the near future. The labour market is witnessing positive developments with the unemployment rate dropping to 15.5% and employment growing to 55.9% in the third quarter. Nevertheless, consumer sentiment about developments in the labour market over the next 12 months has deteriorated. Households perceive improvements in the labour market to be slowing, although the overall situation is better than it was a year ago.

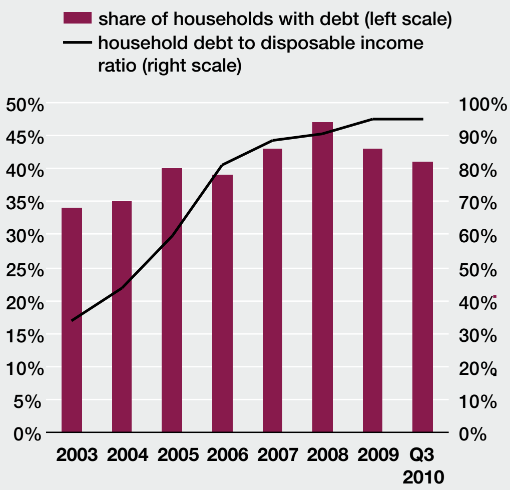
The total of loans issued to households was 4% lower in the third quarter of 2010 than it was a year previously. In addition, TNS Emor's survey on the financial behaviour of households states that the families with loan liabilities as a share of total households has decreased to 41% in the past two years. But at present there are still more families who have taken a loan than there were in 2006, and the indebtedness of households remains fairly high (see Figure 8).

TNS Emor's survey from September 2010 revealed that households believe that their economic situation will recover. Their confidence has returned, which is confirmed by a slight increase in domestic demand, as the fall in retail sales reversed in September. At the same time, households' expectations about their ability to save have improved too.

The survey also indicated that households with loans manage to save more and have recovered more rapidly from the recession. Among households with loans, there are fewer families who have no money left after their loan repayment and primary expenditure. In 2010 households with loans spent 26% of their net incomes on monthly loan repayments on average, which is more or less as much as in 2009. The percentage of families with loans whose loan liabilities constituted over 30% of their net incomes has declined from its level of a few years ago (see Figure 9).

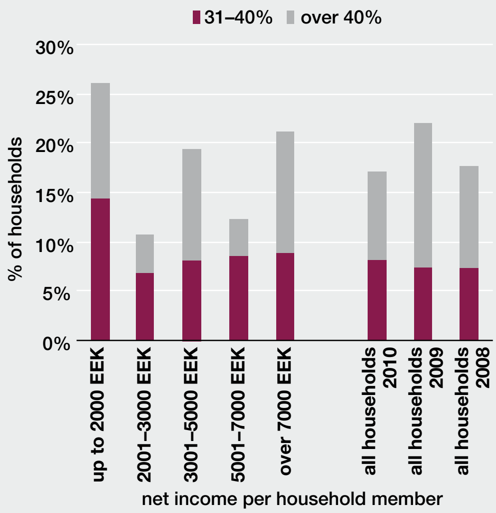
Given that 90% of household loans have floating interest rates, the drop in key interest rates has had a positive impact on many households with loans. The average interest rate on the stock of loans issued to households has fallen from 4.4% to 3.7% in a year, as a result of the Euribor dropping. Along with a drop in credit demand, the annual level of household interest payments diminished by over half a billion kroons in the past six months to 4.5 billion kroons in the third quarter of 2010, which is comparable to the level in the first half of 2007. The household interest burden or the ratio of interest expenditure to disposable income has fallen further to 3.7% in the third quarter. Based on the autumn forecast by Eesti Pank and also as a result of the small upward trend in the key interest rate, the interest

Figure 8. Household debt burden



Sources: TNS Emor, Eesti Pank

Figure 9. Households with loan liabilities higher than 30% of their total net incomes

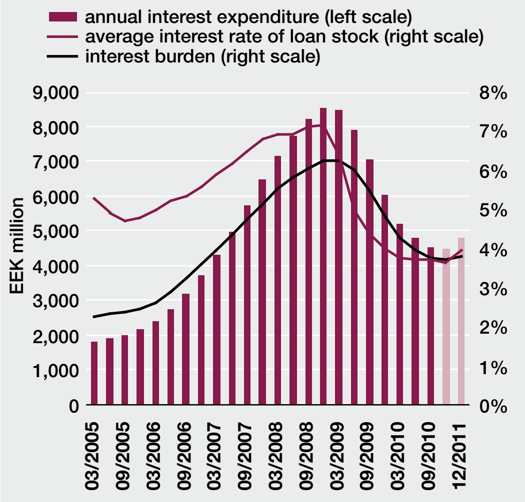


Sources: TNS Emor, Eesti Pank

burden is expected to increase slightly to around 3.8% in 2011 (see Figure 10). If the key interest rate rises more rapidly than anticipated, the interest burden will grow faster, which will have an adverse impact on loan repayment costs.

Despite the first positive signs in the macroeconomy suggesting that the loan repayment ability of households is improving, the related risks are still there. A survey of the financial behaviour of households revealed that 24% of respondents admitted having temporary difficulties in repaying their loans. Although the earnings of households have increased somewhat, the risks caused by the tense labour market situation and rising interest rates still persist.

Figure 10. Annual interest expenditure and interest burden of households



Real estate market

The real estate and construction market in Estonia is recovering along with our improving macroeconomic growth outlook. The housing market is slowly picking up again and confidence in the market is on the rise, as is shown by the fact that households are again purchasing apartments in houses that are still under construction. The commercial real estate market has also witnessed various transactions in the past months, but in general the market is stabilising.

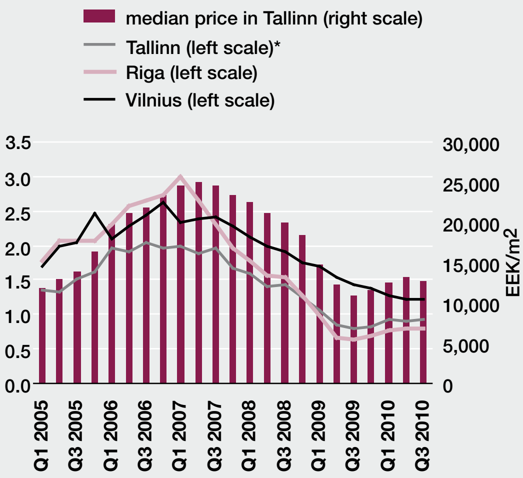
Housing market

The recovery of consumer confidence and banks' increasing interest in financing have together improved activity on the sales market. The sales periods of real estate, which extended considerably after the recession, are contracting again. A year ago, the average sales period of an apartment in Tallinn was 100 days, while in October 2010 apartments were sold in about 60 days. Although the current level of activity is similar to what it was at the beginning of 2004, in the third quarter of 2010 the number of apartment transactions in Tallinn was 7% higher than it had been a year previously. The number of building permits issued for housing construction has tripled during this time, indicating that sales activity is likely to increase further in the near future.

Real estate supply has increased as a consequence of the revival in the housing market, thus inhibiting a surge in prices. The median price for apartment transactions in Tallinn has risen by 20% from a year ago owing to a low comparison base, but the general price level has remained close to 13,000 EEK/m^2 for quite a while (see Figure 11). The average transaction value has remained close to 800,000 EEK, which is comparable to the situation five years ago. International experience suggests that after a 36% fall caused by the economic decline, real estate prices will recover fully in about five years.

As tight competition in the real estate market has kept prices low, the purchasing power of households with sufficient incomes continues to be good. The square metre price for apartments in Tallinn has been below the average gross monthly wage for over a year by now. In the third quarter of 2010, the affordability indicator for real estate stood at 0.94. Comparison of the three Baltic states shows that real estate is most affordable in Riga, because prices there have shrunk much more than elsewhere. In the third quarter, the average price for a square metre of an apartment in Riga was 581 euros. The price was the highest in Vilnius at 821 euros, which makes the real estate purchasing power of Lithuanian households the weakest in the Baltic states.

Figure 11. Affordability of real estate with average wages in Tallinn, Riga and Vilnius, and median price for an apartment in Tallinn



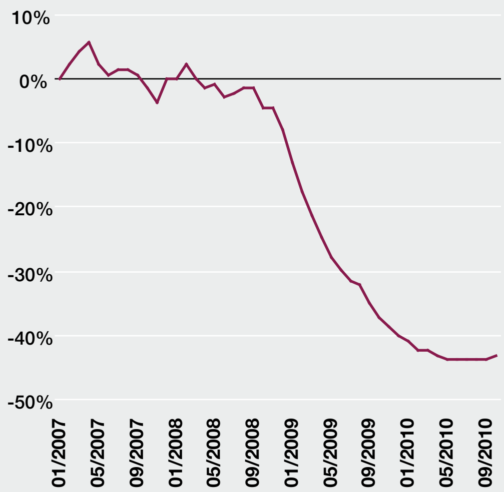
Sources: Estonian Land Board, Statistics Estonia, Latvian central bank and statistical office, Lithuanian central bank and statistical office, Eesti Pank

* The ratio of median square metre price for an apartment in Tallinn to average gross wages.

Office and commercial premises market

Developments in commercial real estate are following the changes in the business cycle, which is why the future of the commercial real estate market depends largely on the country's economic activity. The outlook for the Estonian economy has improved from a year ago, but uncertainty has not entirely vanished. The incomes of real estate owners and investors have shrunk drastically due to the 50% drop in rental prices and the large number of vacant office premises (see Figure 12). Nevertheless, the positive economic outlook slightly softens the looming risks. Real estate prices and supply have stabilised, but in the future prices will remain below their peak and there will still be plenty of vacancies. No building permits were issued for the construction of large-scale commercial premises in the first nine months of 2010, and so no new development projects are expected to enter the market in the near future (see Figure 13).

Figure 12. Changes in rental prices for office premises in Tallinn (index = January 2007)

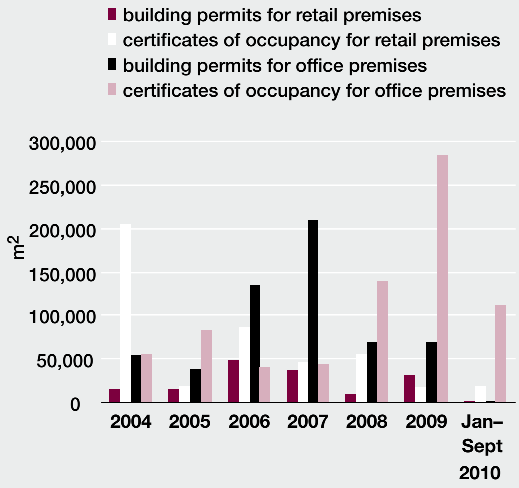


Sources: spot.city24.ee, Eesti Pank

The improved confidence of companies has boosted business activity, which is reflected in the lower number of vacant commercial premises in modern office buildings in desirable areas. Market analysts state that the vacancy of class A office premises has dropped below 15%, but difficult times continue for lower quality office premises, where the number of vacancies is not expected to fall notably in the near future. In 2010, the average rental price for office premises was 78 EEK/m², which is 24% cheaper than it was a year previously. Given that the number of vacancies has diminished, in 2011 the rental prices for high-quality premises are expected to climb slightly.

The increase in retail sales since July is a positive sign for the commercial premises market. The rental prices for commercial retail premises did not change significantly in the third quarter and there are almost no vacancies. Although the economy is slowly recovering, retail traders remain extremely cautious about their expansion plans. During the first nine months of 2010 only eight building permits were issued in Tallinn for small commercial premises. Real estate development is probably also inhibited by the fact that the retail trade area per 1,000 people in Estonia is already 300 square metres, which exceeds the average for Europe by almost 40%.

Figure 13. Retail and office premises with building and use permits in Tallinn

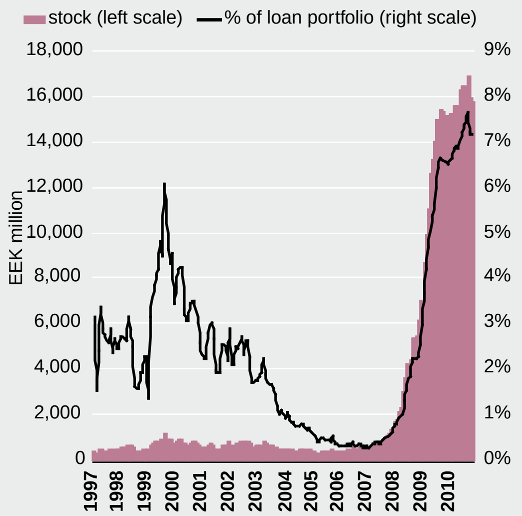


Sources: register of construction works, Eesti Pank

QUALITY OF ASSETS

Although the economy was recovering, the **quality of the loan portfolio** did not show any signs of improvement in the first quarter of 2010 because of a natural lag. The percentage of loans overdue for more than 60 days continued to grow and constituted more than 7.4% of the loan portfolio at the end of August 2010 (see Figure 14). This happened for two reasons. First, the level of loans overdue did not start to decline in the second half of the year, but rather it rose even further. Second, the loan portfolio shrank by more than expected[5]. The deterioration of the loan quality, as measured by the level of loans overdue for more than 60 days, shows that when a borrower encounters payment difficulties, the

Figure 14. Loans overdue more than 60 days



[5] The contraction of the loan portfolio only contributed less than 10% of the rise in the NPL ratio.

problem may persist for a while and the recovery of loan repayment ability is unlikely or takes a long time. Since spring 2010 the loan quality has mainly deteriorated in tradable sectors such as manufacturing and transport and communications, where the stock of loans overdue by more than 60 days grew by 680 and 260 million kroons respectively in the past six months (see Figure 15). This development may seem somewhat surprising, considering that the structure of the marcoeconomic revival has facilitated export-oriented companies, particularly manufacturing companies. However, it should be noted that manufacturing and other sectors are not homogeneous in structure, and may also contain non-performing companies (see *Loan repayment ability of companies*).

The labour market has been recovering very sluggishly, and as a result the household loan portfolio has deteriorated: at the end of September housing loans overdue for more than 60 days accounted for 4.6% and other loans 11.4% of the portfolio (see Figure 16).

The loan portfolio of the commercial real estate sector has improved in the past six months, as the value of non-performing loans had shrunk by more than 700 million kroons by the end of September. About half of the rise in the loan portfolio quality stems from the write-off of 368 million kroons of non-performing loans from banks' balance sheets during the past nine months. The other half can be explained by the improving situation for real estate companies, as Estonia's real estate market has stabilised (see *Real estate market*) and a number of non-performing loans have probably become performing again.

As relatively few new non-performing loans have emerged in the past six months, banks have made considerably fewer **loan provisions**. From March to September 2010 only 0.5 billion kroons of provisions were made in total, while around 80% of loans overdue for more than 60 days had been

Figure 15. Change in loans overdue for more than 60 days over last 6 months (31/3/2010–30/9/2010)

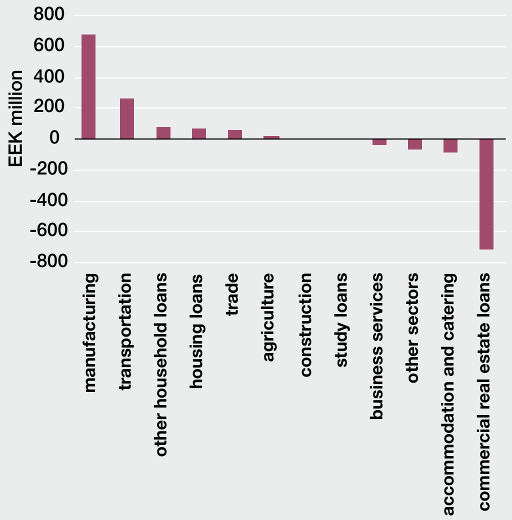
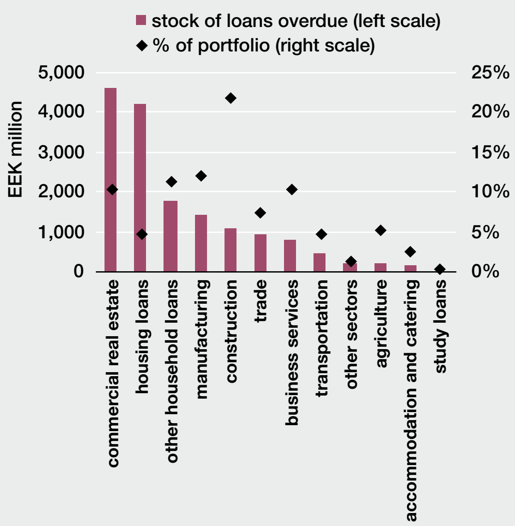


Figure 16. Loans overdue for more than 60 days by sectors



recorded under losses by the end of September (see Figure 17).

Banks made practically no general provisions in the past six months, though this was common practice at the start of the crisis, and provisions were made only on the basis of individual loans. Moreover, some banks also started to lower their specific provisions in the last couple of months. This may stem either from the restored loan repayment ability of loan customers or from smaller risks related to collateral due to improved economic environment. The drop in specific provisions is still small and banks are not lowering the general provisions on their portfolios.

The provisions to cover loan losses are gradually falling, but the cycle of actual loan losses incurred responds with a longer lag and is showing an upward trend. Balance sheet write-offs have jumped to more than 1.7 billion kroons in total in the last four quarters (see Figure 18), although the claims written off had already been recorded under losses as provisions. Presumably, the amount of claims written off in the next couple of quarters will remain high, because the final insolvency of borrowers occurs with a long lag.

Figure 17. Banking sector loan-loss provisions

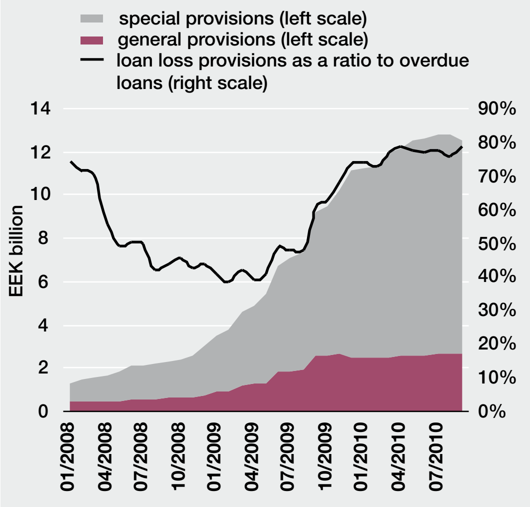


Figure 18. Banking sector gross write-offs