III STRENGTH OF FINANCIAL INSTITUTIONS

BANKS

Funding

Households and companies have been reducing their financial leverage and increasing their savings throughout 2010. Foreign trade volumes started growing in the second half of the year, with non-resident deposits in Estonian banks consequently showing an increase. The deposits of both domestic and foreign customers have thus increased during the year and customer deposits as a share of financing sources have reached their highest level of the last four years. The loan-to-deposit ratio has also gradually improved (see Figure 1).

Since loan demand is low, the banks have used the growth in customer deposits to refinance their liabilities to foreign banks and parent banks, with the banks' dependence on debt financing thus moving lower. In the financing structure, funds received from parent banks still make up a bulk of the banks' institutional foreign borrowing.

In the next few months, the financing structure will be affected most by a cut in the minimum reserves. Given the low loan demand in the non-financial sector, the liquid assets released from the reserve requirement may be directed to other liquidity buffers, or external liabilities may be further reduced. Other determinants affecting the banks' financing structure are not likely to change in the next few months. In the long run, we expect loan demand in the non-financial sector to gain momentum, which could slow down the decline of the loan-to-deposit ratio in 2011.

Liquid assets and liquidity risk

The banks' minimum reserve requirement was lowered from 15% to 11% in September and to 7% in November. From 1 January 2011, the minimum reserve requirement in Estonia will be 2%, as it is in other euro area countries (see Figure 2). The lowering of the reserve requirement will release a

Figure 1. Quarterly growth in loans and deposits and loan-to-deposit ratio

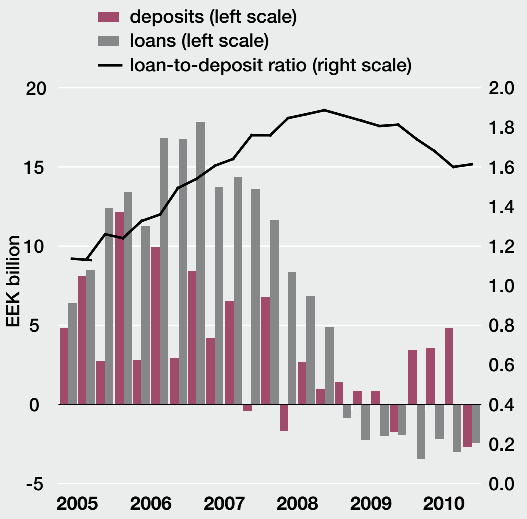
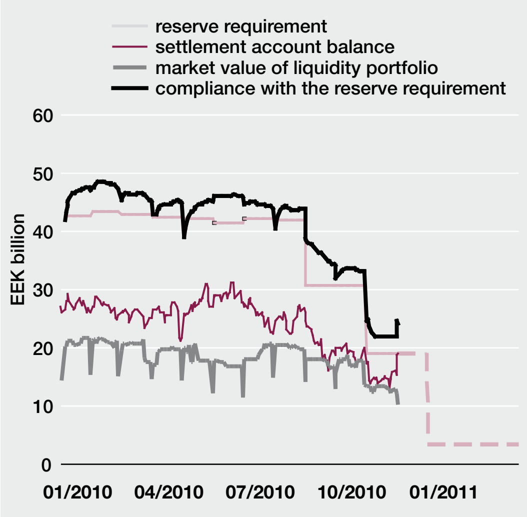


Figure 2. Compliance with the reserve requirement



substantial amount of liquid assets in the banks. So far, the banks have not been very active in restructuring their liquid assets, maintaining a significant volume of excess reserves at Eesti Pank in September, October and November.

Excess reserves have been kept by many banks in the euro area countries during the recession. Despite the lowering of the reserve requirement, the share of liquid assets in the aggregate balance sheet of Estonian banks has remained stable, and has even grown from its level in the boom years. However, different banks have responded differently to the lowering of the minimum reserve requirement: some have restrained the volume of their liquid assets while others have increased it. The excess reserves kept at the central bank are likely to shrink in 2011, as will the banks' liquidity buffers. The liquidity management risks inherent in the process will be reduced by Estonia's participation in the Eurosystem monetary policy operational framework, which gives the banks the possibility of taking monetary policy loans from the central bank, should the need arise.

Another determinant affecting the liquidity risks of banks is the continued growth in customer deposits, above all demand deposits. Low interest rates have facilitated a growth in time deposits, especially deposits with short-term maturities. As a result, the share of short-term liabilities has been growing in the banks' balance sheets since the beginning of the year. At the same time, this is a natural phenomenon that accompanies deposit-based funding. In addition, the banks' liquidity behaviour was more cautious during the economic decline, with the share of short-term liabilities dropping to record lows in the banks' balance sheets in the period.

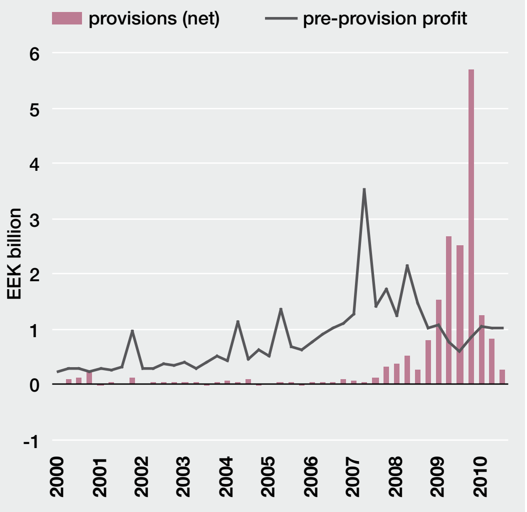
These trends will also affect the banks' liquidity risks in the coming months, as deposit volumes are expected to grow faster than loan demand for quite some time. Moreover, the banks need to acclimatise to a significantly lower minimum reserve requirement, as well as to the Eurosystem monetary policy operational framework.

Profitability

Fuelled by an increase in net interest income and a decline in provisions to cover loan losses, the profitability of European banks started to grow in 2010, even though the sovereign debt crisis in the euro area added to the tensions of banking groups in some countries and drove down trading revenues across Europe.

After five straight quarters of negative profits, the profitability of the banks operating in Estonia turned positive in the second quarter of 2010, with the banking sector posting an aggregate **net profit** of 736 million kroons in nine months (see Figure 3). A quarter later, positive quarterly results could also be seen in consolidated figures, which add in the activities of subsidiaries including the subsidiary banks in Latvia and Lithuania, with a total aggregate loss for nine months of 711 million kroons.

Figure 3. Provisions and pre-provision profits of banks



The banks' **return on assets** (ROA) continued to improve through the year, reaching 1% in the third quarter, and although it was only half the level achieved before the crisis, the regression of loan losses suggests a further improvement in the near future (see Figure 4). The banks' ROE climbed to 9.6% in the third quarter (see Table 1), and consolidated ROE rose to 13.8%.

The banks' profitability has been raised primarily by the decline in the provisions established to cover loan losses. The previously established provisions were even charged to profit by some banks in the third quarter. Given the banks' strict conservatism in evaluating loan quality, the decline in provisions met expectations, and is likely to continue in the coming quarters.

The **pre-provisions profit** remained relatively stable during the first nine months of 2010, hovering around 1 billion kroons in each quarter. As a ratio of assets, the pre-provisions profit was approximately 50 basis points lower than the annual average before the boom. The pre-provisions profit has been affected primarily by a change in the revenue structure at the end of 2008, when the share of net interest income shrank after the Euribor was lowered.

After the sudden drop, the ratio of the banks' **net interest income** to assets has shown moderate but stable growth (see Figure 5). This growth has been nourished by the **decline in interest expenses**, which gained momentum in the autumn of 2009 with the banks lowering the interest rates for kroon deposits. As a result, the anomalies

Figure 4. Banks' return on assets (% of average assets per quarter x 4)

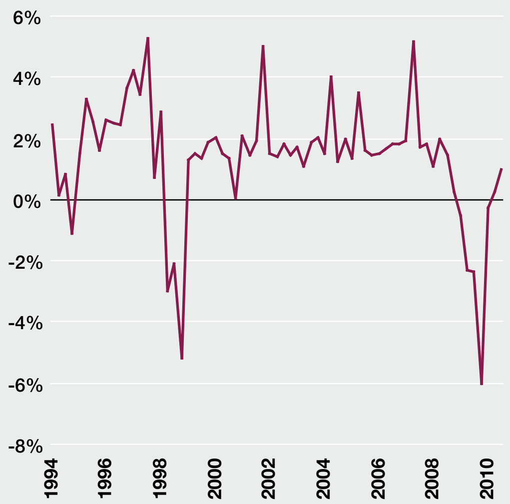


Table 1. Profitability of banks

	30/06/2009	30/09/2009	31/12/2009	31/03/2010	30/06/2010	30/09/2010
Average return on assets in the past four quarters	-0.3%	-1.2%	-2.8%	-2.7%	-2.1%	-1.3%
Return on assets in a quarter (x 4)	-2.3%	-2.4%	-6.0%	-0.3%	0.3%	1.0%
Average return on equity in the past four quarters	-1.3%	-8.8%	-24.5%	-24.1%	-18.9%	-12.4%
Return on equity in a quarter (x 4)	-19.7%	-15.8%	-59.0%	-3.3%	1.2%	9.6%
Net profit in the past four quarters (EEK bn)	-0.9	-4.0	-9.1	-8.9	-6.7	-4.1
Net profit of the quarter (EEK bn)	-1.9	-1.9	-4.8	-0.2	0.2	0.8
Net asset write-downs in a quarter (EEK bn)	2.7	2.5	5.7	1.3	0.8	0.3

witnessed throughout 2009 receded, with the resources received from the parent and other banks being cheaper than those engaged from the local deposit market. On the whole, the banks' cost of capital dropped to the level of the key interest rate of the loan portfolio – the six-month Euribor – by the end of the third quarter (see Figure 6).

As the drop in deposit interest rates, fuelled by the diminishing kroon risk, has ceased, the cost of capital will from now on be governed primarily by the global market conditions, provided that the competition on the local deposit market does not tighten significantly. The need for longer-term financing that emerged in the aftermath of the crisis is expected to keep the cost of capital engaged through the parent banks at a relatively high level in the next few quarters. That said, if the share of deposits in the banks' financing structure grows further, external factors will have a smaller effect on the cost of capital.

After an 18-month drop, **interest income** showed the first signs of recovery in the third quarter of 2010. This was driven, above all, by the rise in key interest rates (the six-month Euribor) in the middle of the year. However, against the backdrop of a continued contraction of the loan portfolio, the increase in income remained sluggish. As loan activity rises, the growth in interest income will be fuelled by the slowly expanding income base, along with the relatively higher risk premium on new loans, compared to the lower margins that currently apply on most of the loan balance. Even though the loan repayment ability of companies and households will improve, overdue loans will remain at a relatively high level. Interest calculation on these loans has been suspended, and so the banks will collect no interest income on these loans. In addition, the banks' interest income will be affected by the lowering of the minimum reserve requirement in 2011. The scope of the impact will depend on the banks' asset structure after all the changes.

Figure 5. Banks' incomes and expenses by type (% of average assets per quarter x 4)

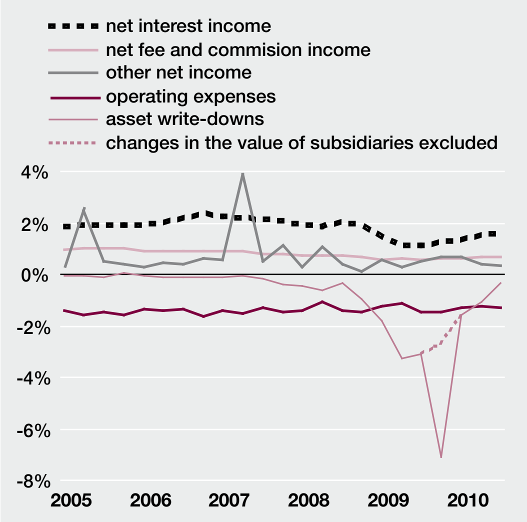
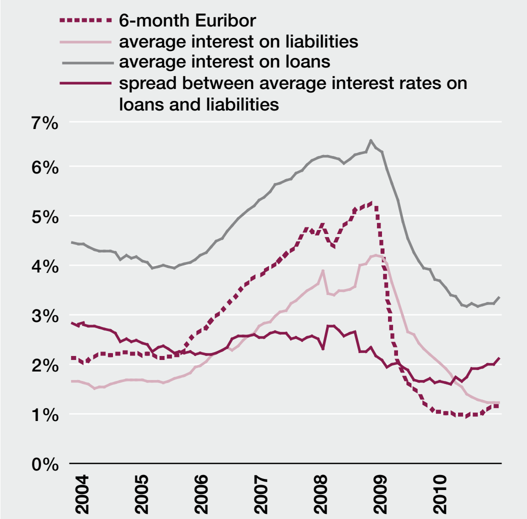


Figure 6. Average interest on banks' liabilities and receivables at end-month and 6-month Euribor



In 2011, the banks' revenue will also be affected by a rise in the quarterly contribution to the Deposit Guarantee Sectoral Fund by 0.022 percentage points to 0.047% (see background information *National guarantee schemes for securing the stability of the banking sector*). Prompted by the growth in deposits and raising of the rate of compensation, this rise may reduce revenues in the banking sector by a total of more than 100 million kroons.

As a ratio of assets, the banks' **fee and commission income** has remained comparatively stable. This stability has been sustained by the relatively large share of revenue collected from payment services (over 60%). The gradual standardisation of domestic and cross-border euro payments is expected to reduce the revenue from payment services in the next few years, even though the number of payments is likely to increase with a rise in economic activity. Apart from payment services, any change in other types of fees and commissions, such as for processing loan agreements, would require a significant revival in the operating activities of the banks.

The adoption of the euro at the beginning of 2011 will have a direct effect on the banks' **financial income**, with the banks losing revenue from currency exchange and from conversion in transactions involving Estonian kroons and euros. Transactions with the euro made up an average of 90% of the banks' currency purchase and sale transactions in the first nine months of 2010, with the banks generating an annual aggregate total of approximately 26 million kroons from the euro bid and ask quote differences in spot and future transactions concluded with customers and other banks. In addition to the revenue generated from currency exchange transactions, the banks will lose a portion of their conversion revenue, for example the revenue from the conversion of repayments of loans denominated in euros and EUR card payments made in foreign countries. This may reduce financial income by a very large fraction.

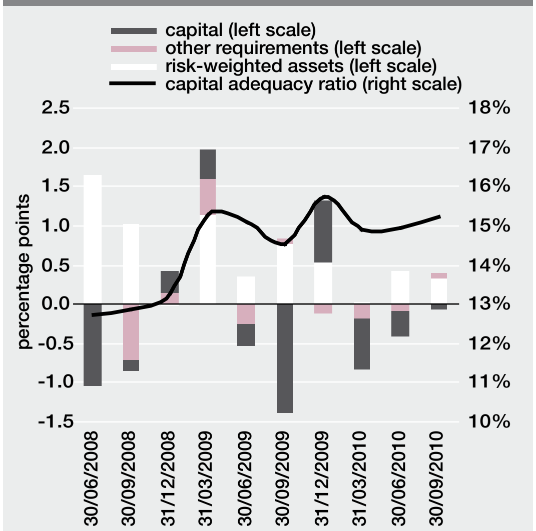
After the major cost-cutting of 2009, which saw wages down 7% and other costs down 15%, the banks' **administrative expenses** have remained stable in 2010 and have, for the most part, followed the changes in the balance sheet volume. The investments made for the adoption of the euro will add to the banks' expenditure in 2010 and 2011, largely through spending on IT capacity and human resources.

Capital adequacy

The credit risk requirements of banks[1] have continually decreased due to the contraction of the loan portfolio. This led to a drop in the banks' capital requirements in the first nine months of 2010, but at a much slower rate than in the same period last year (see Figure 7).

The credit risk requirements dropped by 1.5 billion kroons in the first three quarters; compared to the 5.1 billion-kroon drop in the same period last year.

Figure 7. Change in capital adequacy ratio from previous quarter by components



[1] For this chapter, the figures for the banks have been consolidated.

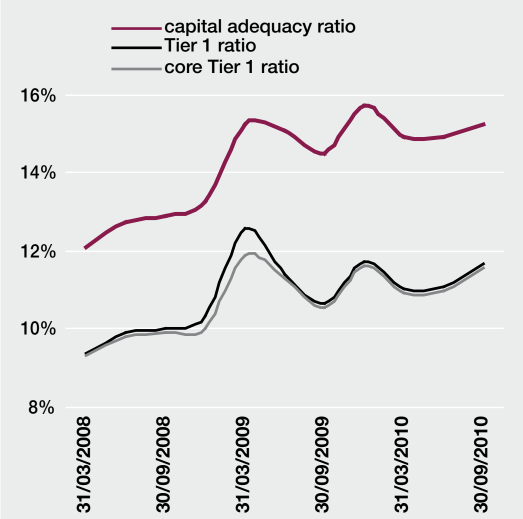
Operational risk requirements have decreased to some extent, compared to the end of 2009, as a consequence of the implementation of the Internal Ratings Based Approach, but the impact of this has been minor. Other capital requirements, on the other hand, have grown due to the increases in foreign currency and interest risk requirements. Once again, the impact of this has been minor.

At the same time, the banks' capital requirements are affected by the minimum requirements related to the transition to the Internal Ratings Based Approach. The capital requirement is 3% higher and the capital adequacy ratio 0.6 percentage points lower than they would be without the transition limits.

The auditing requirement for profits earned by the end of the third quarter meant that banks' own funds, of which their Tier 1 own funds make up 75%, showed no increase. From the end of 2009 to the end of the third quarter of 2010, Tier 1 own funds fell by over a billion kroons, as the consolidated figures were still showing a loss. The banks' lower-quality Tier 2 own funds had fallen by a similar proportion by the end of the third quarter, following repayment of a sizeable amount of subordinated liabilities.

Even though own funds have decreased, the banks' capital adequacy has risen for two straight quarters. This has been caused by an even greater fall in risk-weighted assets. The consolidated capital adequacy ratio reached the high level of 15% at the end of September, significantly exceeding the 10% minimum requirement (see Figure 8). The local banking groups' own funds mainly comprise conventional capital, and so even the most conservative Tier 1 capital ratio, which only recognises share capital, reserves and retained earnings as the instruments best able to bear potential losses, amounted to a relatively high level of 11.6% at the end of the third quarter.

Figure 8. Aggregated capital ratios of the banking sector



Forecast for and stress test of the banking sector

Macroeconomic assumptions

According to Eesti Pank's forecast for 2011-2012, real economic growth will remain lower than the average of the last decade, reaching 3.9%. Loan demand will also remain at a relatively low level, with the loan portfolio showing modest growth of 0.9% in 2011 and 1.5% in 2012. As regards external factors, Estonian loan demand in the forecast period will be affected by the progression of external demand, and the expected modest rise in the six-month Euribor, the key interest rate for a majority of loans. Domestic factors that are liable to affect loan activity and loan repayment ability include problems with the labour market recovery.

Overdue loans and loan losses

In case of expected macroeconomic developments, the volume of loans overdue for more than 60 days will not grow in the forecast period. As the economic situation improves, some loan customers who are suffering from payment difficulties will regain their loan repayment ability, and banks will continue making write-offs from their balance sheets, with the stock of overdue loans thus shrinking. The peak for overdue loans was achieved in August 2010, with overdue loans making up 7.4% of the loan portfolio. The volume of overdue loans is expected to drop to 5% by the end of 2011 and to 4% by the end of 2012 (see Figure 9). Although the levels are different, a similar drop in overdue loans was experienced in Finland after the crisis at the beginning of the 1990s, when the level of overdue loans dropped by nearly 2 percentage points 12 months after reaching a record high (see Figure 10).

Figure 9. Loans overdue for more than 60 days

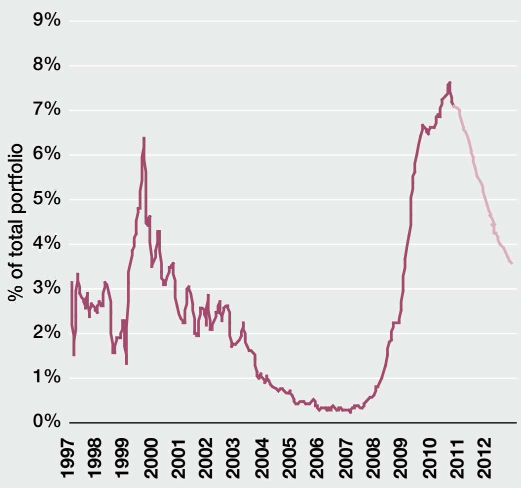
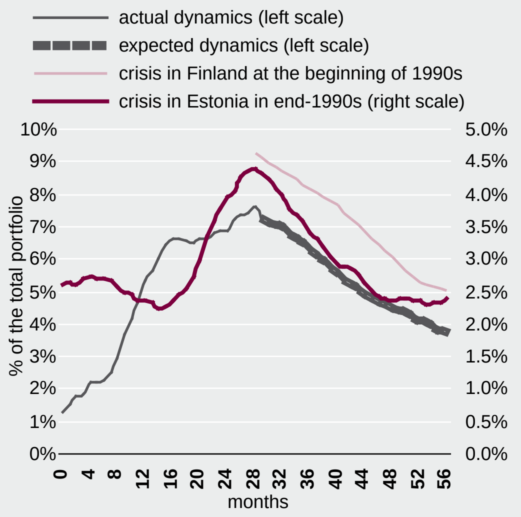


Figure 10. Dynamics of loans overdue and comparison with previous crisis episodes



Sources: Suomen Pankki, Eesti Pank

As the stock of overdue loans shrinks, the banks will reduce the hefty provisions established to cover loan losses (see Figure 11). Nonetheless, the decrease in provisions will be slower than that in overdue loans, and thus the coverage of loans overdue for more than 60 days with provisions is expected to rise from 78% in October 2010 to 88% by the end of 2011.

Profitability

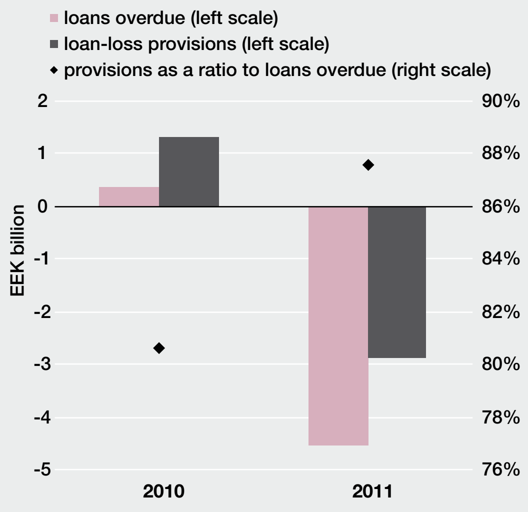
The outlook for pre-provisions profit for 2010 has slightly improved since the spring. Whereas in the spring we forecasted an aggregate pre-provisions profit of 3.5 billion kroons, the current forecast for the banking sector is a profit of over 4 billion kroons. The reason these results have exceeded expectations can be explained by the rise in key interest rates that started in the middle of 2010, and also by a quicker-than-estimated drop in interest expenses due to the combined effect of changes in the structure and cost of capital raised by banks.

The continual rise in the Euribor will fuel further growth in net interest income. The growth in operating profit will be hampered in 2011 by a possible fall in fees and commissions, and by the decline in currency exchange and conversion revenue following the adoption of the euro. Further increases in the banks' expenses can be attributed to the raising of the contribution to the Deposit Guarantee Fund, and the extraordinary expenses related to the adoption of the euro. In total, the banks operating in Estonia are expected to post a pre-provisions operating profit of 5 billion kroons, or nearly 19% more than in 2010.

Capitalisation

As the recuperation of the economy is likely to boost the banks' profits and reduce the volume of overdue loans, the banking sector's capitalisation will show a remarkable increase in the coming year. The main contributors to the increase in capitalisation will include relatively large profits[2], and the transformation of some loan loss provisions into profit. The level of capitalisation will be somewhat lowered by the increase in risk-weighted assets. In total, the capitalisation of the banking sector is expected to increase to over 18%[3] by the end of 2011 (see Figure 12).

Figure 11. Change in loans overdue, loan-loss provisions and provisions as a ratio to loans overdue



Stress test (negative risk scenario)

The purpose of the stress test is to ascertain the banking sector's ability to withstand poorer-than-expected developments. The negative external environment risk entails a rise in money market interest rates stemming from confidence problems on the financial markets or unexpected liquidity

[2] Includes, in addition to the profit forecast for 2011, the unaudited profit for 2010.
[3] Only the capital allocated to cover Estonian risks has been included in the banks' capital.

changes. Given that a majority of the loans issued by banks operating in Estonia are denominated in euros and have a floating interest rate, any increase in the key interest rate would have a considerable negative effect on borrowers' loan repayment ability. The negative risk scenario expects the six-month Euribor to rise to 2.5% by the end of 2011.

The scenario also includes domestic risks, with the loan interest margins expected to remain at a high level in Estonia for the next couple of years. Due to the low levels of loan demand and loan supply, new lending will remain very small, with the loan portfolio showing negative growth in the next two years: –6.4% in 2011 and –3.5% in 2012. In addition, the stress test includes the assumption that, despite enhanced economic activity, the improvement in the loan repayment ability of companies and private individuals will be sluggish.

In the negative risk scenario, the rise in the key interest rate will have a negative effect on borrowers. However, this will be insufficient for the volume of overdue loans to start rising. But the share of overdue loans in the loan portfolio will keep growing until the spring of 2012, reaching 8.3%, as the loan portfolio will continue shrinking in the upcoming years (see Figures 13-14). However, at the end of the forecast horizon, the positive economic environment is expected to fuel the improvement in loan quality, with the volume of overdue loans thus showing a fall in the second half of 2012.

The banks' pre-provisions profit in the negative risk scenario is somewhat smaller than in the baseline scenario. Smaller revenues are caused, above all, by the relatively quick contraction of the loan portfolio. Net interest income will be negatively affected by the continual insolvency of some borrowers as a result of the increase in the key interest rate. In this scenario, the banks

Figure 12. Change in capital adequacy ratio by components

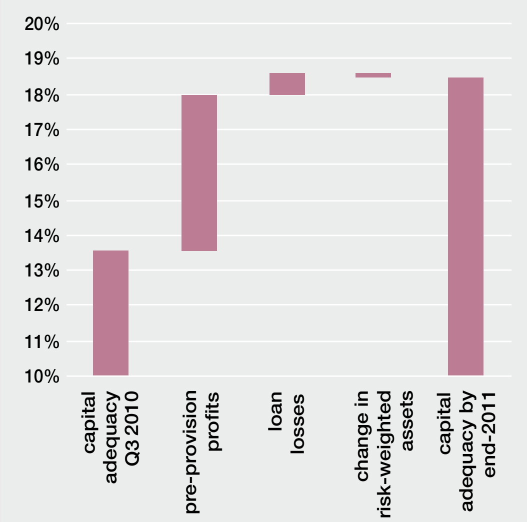
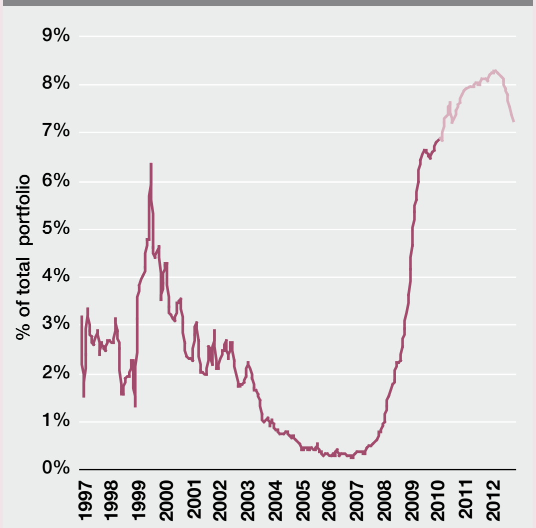


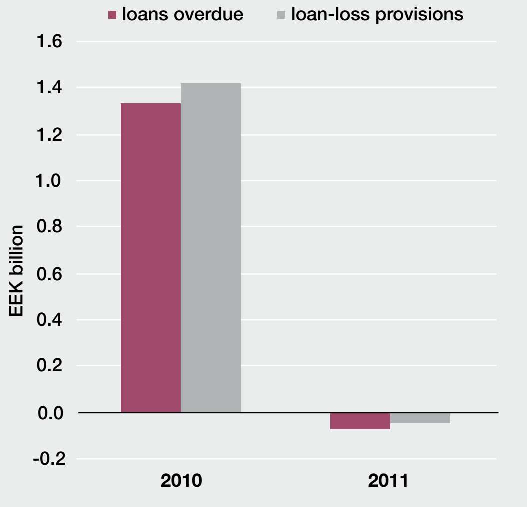
Figure 13. Loans overdue for more than 60 days in the negative scenario



operating in Estonia will post a pre-provisions operating profit of an estimated 4.3 billion kroons in 2011. This result is more or less on par with the result for 2010.

As the economy grows, the volume of loan provisions will decrease a little. The banks' risk-weighted assets will also decrease due to the continual contraction of the loan portfolio. The growth in profits will be the biggest contributor to the increase in capitalisation. Overall, the scenario expects a relatively high level of capitalisation at 18% by the end of 2011.

Figure 14. Change in loans overdue and loan-loss provisions



National guarantee schemes for securing the stability of the banking sector

The deposit guarantee scheme forms a part of the safety network of the financial sector, charged with protecting the depositors and ensuring financial stability and the reliability of the banking system. Adopted on 30 May 1994, Directive 94/19/EC established the deposit guarantee requirement in all Member States, securing at least 90% of the deposits for up to 20,000 euros per depositor. To alleviate the impact of the financial crisis, the coverage level of the guarantee was raised to 50,000 euros in the European Union in October 2008, and the option of a 10% co-insurance requirement for depositors was discontinued. In 2009, depositor protection was further enhanced by an amendment to the directive. The amendments stated that the deposits of bank customers are subject to compensation of 100,000 euros, with the payouts being made within 20 working days. The amendments will enter into force in EU Member States on 1 January 2011.

Estonia

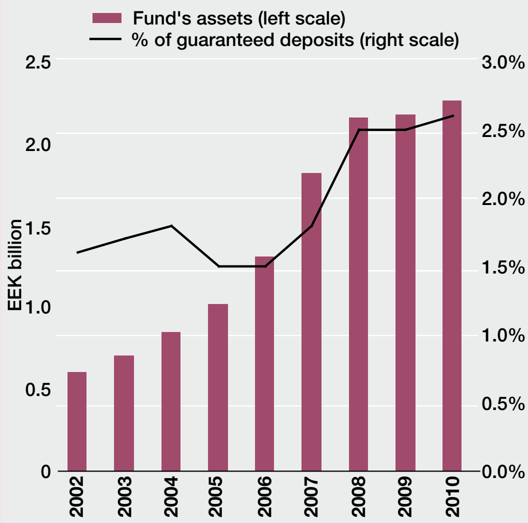
In Estonia, the Guarantee Fund was launched on 1 July 2002. The purpose of the fund is to guarantee protection of the financial resources invested by depositors as customers of credit institutions, investors as customers of investment institutions, shareholders of the mandatory pension fund and policyholders who have concluded pension agreements with insurers. The assets of the Deposit Guarantee Sectoral Fund will be used for to compensate fully the deposits of any depositor in a credit institution within the set limit. In addition to deposits, the interest accumulated until the day the deposits became unavailable will be compensated.

The Guarantee Fund is financed through the contributions of the market participants. On 30 June 2010, the Deposit Guarantee Sectoral Fund covered 2.5% of the guaranteed deposits. At the end of 2009, the fund held 2.18 billion kroons, and it is estimated that by the end of 2010 it will hold

2.26 billion kroons (see Figure 15). Should the assets of the Guarantee Fund prove insufficient to serve the obligations it has assumed and to disburse the compensation, the fund may, under the Guarantee Fund Act, take a loan from credit institutions or other persons, including the state.

So far, the target volume of the Deposit Guarantee Sectoral Fund has been 3% of the guaranteed deposits. Since the base of contributions to the fund was expanded in connection with the implementation of the requirement to secure the deposits of large companies within the set limit from the beginning of 2011, the Guarantee Fund has established a new target volume of 2.5% of the guaranteed deposits. By 2014, the sectoral fund would thus hold an estimated 3.33 billion kroons. Given the need to meet the target volume of the Deposit Guarantee Sectoral Fund even with the rise of the deposit guarantee limit to 100,000 euros from the beginning of 2011, the supervisory board raised the quarterly contribution to the Deposit Guarantee Sectoral Fund from 0.025% to 0.047%.

Figure 15. Deposit Guarantee Sectoral Fund



Nordic countries

The Guarantee Fund compensates deposits in credit institutions registered in Estonia. As a rule, the deposits in Estonian branches of foreign credit institutions are guaranteed by and subject to compensation within the framework of the deposit guarantee scheme of the home country of the credit institution. The banks operating on the Estonian banking market are predominantly from the Nordic countries, so the safety network of the Nordic banks plays an important role in maintaining the sense of security of the depositors and the reliability of the banking sector.

The total deposit guarantee volume of the Nordic countries is significantly higher than that of Estonia, but even so, the ratio between the guaranteed deposits and the funds collected in Sweden is similar to that in Estonia. At the end of 2009, the total volume of deposit guarantee funds amounted to 630 million euros or 1.09% of the guaranteed deposits in Finland, 21 billion Swedish kronor or 2.37% of the guaranteed deposits at the end of 2008 in Sweden, and 3.9 billion Danish krone in Denmark.

As in Estonia, the deposit guarantee scheme in the Nordic countries is financed by regular contributions paid by the credit institutions, while the level of these contributions is linked to the volume of the deposits to be guaranteed. In Sweden, for instance, the total annual contributions of banks amount to 0.1% of the guaranteed deposits, while the contribution of a single bank may vary between 0.06–0.14%, depending on the capital adequacy of banks. In Finland, the contributions are linked to the banks' own funds and the volume of guaranteed deposits. In 2009, total contributions to the deposit guarantee funds were 886 million Swedish kronor in Sweden and 58.4 million euros in Finland. As the volume of the Danish deposit guarantee fund exceeded its target, no additional contributions were collected in 2009.

In addition to the deposit guarantee scheme, Sweden and Denmark have set up special guarantee funds charged with financing the support of the banking system in the event of a crisis, thus reducing the cost of the crisis. Denmark has set up a separate company for the resolution of banks facing difficulties. Sweden has launched a stability fund with a target volume of 2.5% of GDP. The target volume is scheduled to be achieved by 2023 and additional measures are financed by contributions from the banks. The banks thus contribute to covering the expenditure cost of the crisis, and of ensuring financial stability.

In Sweden, banks are obliged to contribute regularly to the stability fund 0.036% of the liabilities which serve as the basis of the calculation of the contribution, although in 2009 and 2010, the contribution was temporarily reduced by 50%. At the end of 2009, the fund held a total of 31.6 billion Swedish kronor. Together with the deposit guarantee fund, which held approximately 21 billion kroons, the Swedish banking system has a very significant buffer. Sweden is currently deliberating over the possibility of uniting the deposit guarantee fund and the stability fund in the future.

The European Union

The European Union in general is moving towards enhancing the efficiency of the deposit guarantee schemes and harmonising the deposit guarantee principles. The general framework for solving financial crises is being reinforced in order to minimise the harmful effect of crises. As in the Swedish model, the planned changes include the establishment of stability funds in EU Member States.

INSURANCE COMPANIES

Developments in the insurance sector are still characterised by a subdued interest in insurance products. Given the market's link to economic activity, however, the situation is expected to improve. The results for the third quarter of 2010 indicated that the insurance sector as a whole is still in considerable profit, but the risks accompanying low interest rates and the volatility of securities markets have not disappeared.

In the second quarter of 2010, the state-owned KredEx Credit Insurance entered the non-life insurance market, insuring against export-related credit risks. It started concluding contracts in the third quarter, and by the end of September the total value of the credit insurance contracts concluded was 63 million kroons.

Life insurance

As the outlook for markets and the macroeconomic situation have improved, the insurance premiums collected by life insurance companies in Estonia in the second and third quarters of 2010 increased by 6% from a year earlier. Despite a slight rise in premiums, difficulties in concluding new contracts and keeping the existing ones remain an issue for the entire life insurance market. Although the rate of contract termination has not risen, it remains high. In the second and third quarters, 402 million kroons were paid for claims, which is 25% more than a year earlier.

As the European life insurance market generally provides traditional life insurance products[4], low interest rates are considered the highest risk to the sector. They curb the insurance companies' income from their investments and complicate the servicing of insurance contracts with guaranteed interest rates. However, in Estonia nearly half of the premiums are collected from unit-linked

[4] Nearly two-thirds of insurance premiums are collected from capital insurance and other life insurance products with guaranteed income (source: CEA, European Insurance – Key Facts, September 2010).

life insurance, where the investment risk is fully incurred by the policy holder, meaning that low interest rates have mainly affected the incomes of policy holders. Although in the last six months the investment yields of companies were more modest than expected, with year-on-year growth of –23%, their average annual yield still reached over 7% in the third quarter. All Estonian insurance companies have earned higher incomes from their investments than would be secured with the interest rates guaranteed by the insurance contracts.

At the end of the third quarter of 2010 the balance sheet of life insurance companies totalled 12.9 billion kroons, 45% of which consisted of the investments of unit-linked life insurance contracts. Other financial investments by the companies comprised half of the total assets. In a climate of lower deposit interest rates, companies have started to seek alternative investments, and since the end of the first quarter of 2010 this has boosted the volume of share holdings by 23%. Nevertheless, at the end of September shares comprised only 12% of total investment (see Figure 16). The majority of investments, 55%, are still invested in highly rated bonds and other fixed-income securities, which reduces the market risk for the companies.

As the risks are smaller, Estonian companies have enjoyed larger profits than companies in various other European Union countries[5]. In the third quarter, life insurance companies earned a net profit of 113 million kroons, which is 18% more than a year ago. The profit stemmed from the positive technical results of all companies. The coverage of net liabilities from reinsurance arising from insurance contracts by financial assets remains at 150%, which means that the liquidity risk is not currently very significant.

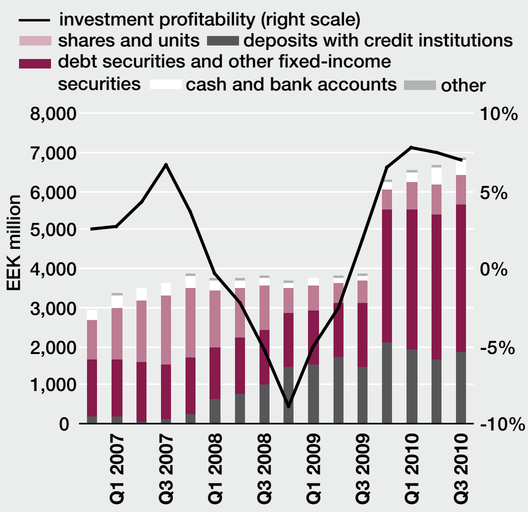
[5] In 2009–2010, 14 insurance companies in nine Member States (Spain, the Netherlands, Ireland, Iceland, Italy, Greece, Sweden, Romania and Slovenia) have become insolvent (source: CEIOPS, "Spring Financial Stability Report 2010: First half-yearly report").

Non-life insurance

The Estonian non-life insurance market fell back 8.5% in the third quarter of 2010, compared to the same period a year earlier. Non-life insurance companies collected 837 million kroons of insurance premiums from residents. Although the number of premiums collected continues to decrease, the drop in the level of premiums has halted (see Figure 17). The motor third party liability insurance and casco insurance of land vehicles, which accounts for the majority, 65%, of the non-life insurance market, has shrunk the most, by 11%, but the situation is looking up, judging by the slight improvement in car sales.

Although sales have fallen, insurance companies earned 149 million kroons of net profit in the third quarter of 2010, with technical results producing 126 million kroons of that. The positive technical results are related to cuts in operation costs and smaller insurance claim payments. The net loss ratio[6], having grown at the beginning of the year

Figure 16. Structure and profitability of life insurance companies' investment



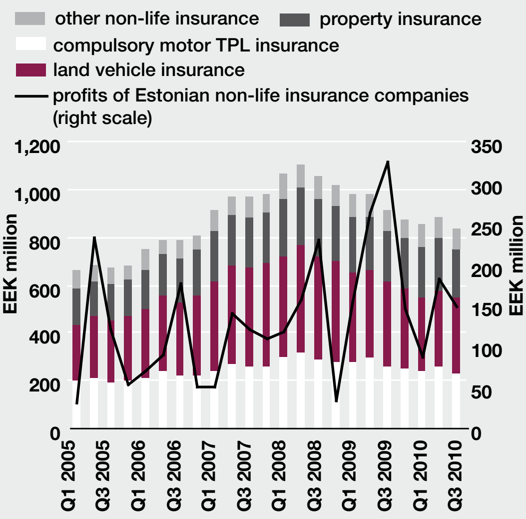
[6] Net loss ratio = claims incurred, net of reinsurance / earned premiums, net of reinsurance.

due to extraordinary weather conditions, receded back to its average level of 61% (see Figure 18). In international terms, the loss ratio is regarded as ordinary, within the range of 40–60%. At that level, companies collect enough insurance payments to cover the claim payments and operation costs, and also to earn profits.

Net income on investment in the third quarter was around 33 million kroons, which is 65% less than it was a year ago. Income on interest, which has so far been a steady source of income, has decreased as year-on-year growth amounted to –31%, and in the third quarter the annual yield of investments shrank to 2.4%. By the end of the quarter, companies' total investment rose to 6.1 billion kroons, with year-on-year growth of 19%, comprising 85% of total assets. The structure of investment did not change considerably. In the past six months, the share of deposits has increased by 6 percentage points to 40% on account of securities investments, but bonds still comprise nearly half of the investment portfolio.

At the end of the third quarter, financial investment exceeded technical provisions by 2.9 billion kroons, which provides better coverage than was the case at the end of last year and guarantees even greater liquidity for the companies. In addition, 18% of the technical provisions were covered by reinsurance contracts. Owing to profitability primarily larger insurance companies have enjoyed an improvement in capitalisation during the past six months.

Figure 17. Profit of non-life insurance companies and premiums from residents



Sources: Statistics Estonia, Eesti Pank

Figure 18. Non-life net loss ratio