FINANCIAL STABILITY ASSESSMENT

Financial markets

The acceleration of economic growth at the end of 2010 has instilled many European countries with confidence in the financial markets, with the funding situation of banks improving to some degree. This is regardless of the increased tensions in sovereign bond markets and a severe negative feedback on banking sector funding in some euro area countries. The banks in countries suffering from the sovereign debt crisis are still unable to raise capital and to cover their liquidity needs on the financial markets, and are forced to rely on the governments and central banks.

The crisis has paralysed both the state budget and the funding of banks in debt-stricken countries. Along with persistent budget cutting in these countries, measures must be taken to manage the crisis and to restore confidence in their banking sector and avoid the spread of the crisis to other markets. As one of the measures taken, the European Banking Authority (EBA) is about to conduct EU-wide stress tests of banks and to publish the test results. The results will be used for strengthening the balance sheets of banks.

Besides the risks closely interlinked with public finance, the financial markets have, in recent months, been negatively affected by major geopolitical tensions brewing in the neighbourhood of Europe, and the accelerating inflation. Interest rates, which have remained low for quite some time, may accumulate risks on some markets. In the long run, all market participants must take into account the imminent rise in interest rates.

The Nordic parent banks of the banks operating in Estonia have retained a good financial position, with the corresponding risk assessments by market participants showing no deterioration in recent months. Even though the capitalisation of Swedish banks generally exceeds that of many other large European banks, Swedish banks are still highly sensitive to market developments and prevailing trends due to their smaller share of deposits. In this respect, we must also consider the risks stemming from the potential imbalances of the Swedish economy, including risks related to the high indebtedness of households and the past growth in real estate prices. Through the funding of parent banks, the materialisation of these risks, even at a rather low likelihood, would have a highly negative impact on the Estonian financial system.

The risk level of the Estonian stock and bond market remains high owing to the volatility of global markets. The smallness of the Estonian markets poses additional risks to investors. Even though potential price corrections could thus prove steep, the development of these markets will have no significant impact on financial stability.

Real economy and loan quality

The credit risk of banks operating in Estonia has decreased. On the one hand, loan repayment ability is expected to improve, fuelled by an increase in incomes and favourable interest rates. On the other hand, the financial behaviour of Estonian companies and households in the current economic and financial conditions has remained conservative, with new loans taken prudently in the last six months. At the same time, deposits have shown a stable growth. Such behaviour of the non-financial sector after a steep economic decline is well expected. The strong financial position of companies and households will provide a good foundation for the banks to improve credit risk management in the new growth cycle.

The positive effect of the acceleration of growth on loan quality could already be witnessed in the early autumn of 2010 when the volume of overdue loans began to drop. These trends continued in the first months of 2011, with Eesti Pank expecting the share of loans overdue for more than 60 days to fall below 5% of the portfolio by the end of the year. The volume of problem loans is curtailed, above all, by the write-offs of uncollectible loans from banks' balance sheets. In the improving outlook for economic growth, we can also expect some loans to start performing again. The real estate market, which is showing the first modest signs of recovery, could serve to provide a quicker solution to the problem loans.

Both non-performing loans and restructured loans have been covered with sufficient provisions, and do not thus pose a risk of further loan losses for the banks. New risks inherent in the loan repayment ability revolve around the potential deterioration in external demand. The real incomes of borrowers are affected also by the risk of inflation stepping up. Although key interest rates are expected to climb further in 2011, the expected increase in incomes helps to cushion possible negative effects on the loan quality of banks.

The strength of financial institutions

The improvement in loan quality has allowed banks to start scaling down the provisions established for potential loan losses in previous periods. Though banks will still hold loan projects that are unable to generate positive cash flows even in the stage of growth, the estimated negative impact of loan write-downs on operating profit is relatively low. In other words, the volume of new write-downs is smaller than the drop in earlier provisions.

In addition to the decline in loan losses, banks have a better outlook for generating net interest income in 2011. The increase in interest income will be curbed by the continuing contraction of the loan portfolio, but the foreseeable rise in key interest rates and the cutting of the interest expenses in connection with the changes in the liabilities structure will provide a good foundation for a moderate increase in net interest income.

The aggregate capital adequacy ratio of the Estonian banking sector climbed to 16.2% by the end of 2010, prompted by a decrease in credit risk requirements and a growth in own funds. Considering the outlook for economic growth and developments in the financial environment, the capitalisation of banks is expected to progress further in 2011, fuelled, besides the contraction of the loan portfolio, by enhanced profitability.

The capitalisation of the Estonian insurance sector remained strong in the last twelve months, as well. Even though fewer premiums were collected, compared to previous periods, due to low domestic demand and prudent investment behaviour, the risks of the insurance sector are well-managed and profitability is high.

Banks' minimum reserve requirement was lowered in 2010, but this has not added to the liquidity risk of the banks operating in Estonia. A majority of the banks retained their liquidity buffer on the level of 2010. In banks where the share of liquid assets dropped, the risk was hedged by the centralised liquidity management by their parent banks.

Settlement systems

The changeover to the euro in the Eesti Pank's settlement systems was without failures, and settlement in the first months of 2011 was smooth. Upon adoption of the euro, the Estonian Central Securities Depository successfully replaced the securities settlement system, with none of the failures occurring in the system in 2011 jeopardising settlement in securities.

Prompted by the lowering of minimum reserves, the banks' funds held with the central bank dropped to several times below the level required for settlement. As the funds held with the central bank may, in some cases, prove insufficient for effecting payments and banks have little experience in settlement system liquidity management in the euro area, this may cause temporary operational risk. Nevertheless, single operational problems have not added to long-term liquidity risk and have had no negative effect outside the settlement system.

Conclusions

Overall, no major changes have occurred in the risk assessment of the Estonian financial stability since the late autumn of 2010. The recent months have merely explicated the probability of materialisation or scope of the risk with respect to certain risk factors.

The financial environment affecting the European financial sector is still volatile, mostly due to the debt crisis in some of the euro area countries. The risk of further deterioration of the financial environment and deceleration of economic growth remains high. The external conditions having an immediate effect on the Estonian economy and financial system have improved against the backdrop of growth in Europe. The Estonian economy has been also nourished by the strong financial position of parent banks. The risks stemming from international financial markets and the potential imbalance of the rapid economic growth in Sweden are alleviated by the tightening of the monetary policy and prudential regulation by the central bank and supervisory authority of Sweden.

The domestic sources of risk within Estonia have abated with the recovery of growth. Banks' profitability and capitalisation are expected to improve, although loan repayment ability may deteriorate to some degree against a moderate rise in interest rates and a modest growth in real incomes. Given the forthcoming changes in the capital regulation internationally (the adoption of Basel III principles), the enhanced capitalisation of banks in Estonia can be considered a positive development. The upcoming decisions concerning profit allocation or capital management should keep in mind the planned capital requirements both in terms of the volume and the quality of capital.

The liquidity management decisions made by banks in the first months of 2011 serve to mitigate liquidity risks. In order to ensure smooth liquidity risk management in the future, depending on a bank's business model, attention must be paid to either enhancing efficiency of cross-border cooperation or to maintaining the liquidity buffer.