FINANCIAL STABILITY ASSESSMENT

The international financial environment

The main factors influencing international financial markets this year have been that growth has been weaker than expected and inflation very low. Central banks in advanced countries have consequently kept their monetary policies accommodative. Because interest rates have been low, investors are making efforts to seek out investments that could bring them better returns. While prices for financial assets in general have risen, the interest rates for lower-quality bonds have fallen quite a lot. The effect of heightened geopolitical tensions this year on global financial markets remained short-term and minor. The size of the rises in the prices of financial assets has increased the danger that those prices will fall sharply.

The euro-area economy grew more slowly than expected in the second quarter of this year and the outlook for faster growth worsened. Coming on top of the long-term problems of unemployment and indebtedness, the economic sanctions introduced in response to the conflict between Russia and Ukraine started to affect trade and increased uncertainty. Although things improved for big euro-area banks, the stock of non-performing loans continued to grow. The profitability of banks faces challenges not only from the need for write-downs of loans but also from low interest rates and the risks from economic growth remaining slow. Confidence in banks is expected to improve after the European Central Bank has completed its comprehensive assessment before the single banking supervision under the European Union starts.

The real economy and loan quality

The Estonian economy grew modestly in the first half of this year, as it did last year. The real estate market stabilised and household confidence remained the same as last year. Rising incomes allowed some growth in housing loans taken out. Although investment activity did not recover in broad terms, there was an increase in corporate borrowing from the second quarter on. Borrowing still grew more slowly than the economy as a whole, and there was no increase in the indebtedness of companies and households.

The labour market has started to adjust to slower economic growth, and wage growth has slowed, though it still remains fast and affected corporate profits in the past half year. As corporate capitalisation and liquidity are at high levels, the payment behaviour of companies remains good and short-term difficulties should not create difficulties with payments. Higher incomes and low base interest rates mean that the ability of households to service their loans has remained good. The strong financial position of companies and households has helped the loan quality of the banks to improve, and this should continue next year too.

Strength of financial institutions

The improvement in the quality of the loan portfolio helped maintain the profitability of banks. There was less influence on profitability than before from the return to performance of loans that had earlier been written off. Profits helped boost the capitalisation of the banks. In international comparison, the Estonian banking sector remains very well capitalised and the capital levels are well above the minimum requirement.

Banks increased their liquidity buffers in the first half of this year and partially used foreign funds to do so. The funding of banks is still mainly based on deposits, and growth in retail deposits has remained fast throughout this year. Faster growth in lending meant that the improvement in the ratio of loans to deposits slowed. At the same time, most banks fund their loan portfolios fully from retail deposits.

The position of the Estonian banking sector with Russian residents is very small. The effect of the conflict between Russia and Ukraine on banking will be seen primarily in an increase in loan losses, but even there the effect will be small.

The insurance industry was affected by low interest rates, and life insurance companies are more exposed to the negative effect from them than non-life insurance companies are. Interest rates remaining low will create problems in the future in maintaining the profitability of assets for both life and non-life insurance companies.

Settlement systems

The Eesti Pank gross settlement system TARGET2-Eesti has worked without significant incident this year. The liquidity buffers of banks were sufficient that settlements were made without any problems arising and few banks used the intra-day lending facility of the central bank. The ESTA retail settlement system operated by Eesti Pank was closed down in February this year, and so domestic interbank retail payments moved to the cross-border STEP2 settlement system managed by EBA Clearing. The move went smoothly and did not pose any danger to financial stability.

Eesti Pank assessed how the securities settlement system managed by Eesti Väärtpaberikeskus as the overseer of payment and settlement systems met the new requirements for minimising risks to financial infrastructure and for ensuring the efficiency of the system. Eesti Pank found that the system met most of the requirements. The overseer considers that risk management needs to be improved and changes must be introduced by 1 July 2015.

Risks to financial stability

The risks to Estonian financial stability in the next half year are small at present, in autumn 2014. Risks are being reduced above all by the good financial position of Estonian companies and households, and by the high capitalisation of the banking sector, while the danger of imbalances in the economy is lower. The conflict between Russia and Ukraine has clearly increased uncertainty about the external environment, and a widening of tensions could lead risks to increase rapidly. Low interest rates could change financial behaviour, and this could increase risks in the financial sector and the real estate market.

The Eesti Pank assessment of financial stability for autumn 2014 sees three main risks:

1. A deterioration in the external environment, including the effect of the conflict between Russia and Ukraine, could lead to a downturn in Estonia and worsen the loan quality of banks.

The euro-area economy grew more slowly than expected in the first half of this year and the outlook for recovery in growth has worsened. The impact of Russian sanctions on trade and on confidence has been added to the long-term problems and will be felt particularly in Estonia's near neighbours and main trading partners. A delay to the recovery in growth will increase the chances of investors reassessing the financing conditions for sovereign debt, which had improved of late. It is also possible that the results of the comprehensive assessment of the banks could reveal that the banks have more need of capital, which could lead to a deterioration in financing conditions for banks.

The conflict between Russia and Ukraine has increased geopolitical risks, which could affect the Estonian economy and financial stability. The direct and indirect effects on the Estonian economy and financial sector of the sanctions that the European Union and Russia have imposed on each other are small. Although Russian import restrictions have had an impact in some sectors and companies, the impact still remains quite modest for the business sector as a whole. As the capitalisation of banks is strong and loan quality is good, a possible increase in problem loans does not pose a major danger to financial stability. A further widening of the conflict and additional sanctions could increase the risks to economic growth and financial stability.

The strong financial position of Estonian companies and households means that loan quality for the banks is good and in the baseline scenario of the forecast it will continue to improve. Problem loans increase in the risk scenario of a worsening of the external environment, which considers a two-quarter reduction in exports, but they do so by less than after the downturn of 2008-2009. Although banks earn less profit than in the baseline scenario because of their additional provisions, the capitalisation of banks remains good.

2. A reassessment of the risks to the Nordic economies and banks by financial markets will increase the financing and liquidity risks of the banks.

Expectations of growth in the Nordic countries have deteriorated in recent months as export opportunities have worsened. The Nordic economies have been affected by the slower growth in the euro-area economy and they are also more exposed than the European Union average to risks related to Russia. The Russian economic sanctions have the most effect on Finland, where economic growth is not being given support from domestic demand, unlike in the other Nordic countries. The economic integration of the Nordic countries means that investors treat the region as a single whole, so problems in one country could lead to a change in risk assessments for all the Nordic countries.

Although the economy has grown more slowly than expected, real estate prices in Sweden have continued to rise and housing loans to grow, indicating a further build-up of risks. The rapid growth in Swedish real estate prices is supported by growth in household incomes, low interest rates and particular features of the loan and real estate market. The large Swedish bank groups mainly use funds from financial markets to finance their loans for housing, and this increases the risks to financial stability.

The banks are made more vulnerable because the market-based financing is partly short-term and in foreign currency. There is a danger with such a model that if the investors in the Nordic economy should reassess the risks to the Nordic economy or banks because of an external shock, it could make the financing of bank groups much more difficult or expensive. On top of this, a fall in real estate prices could lead to lower economic activity levels because of a reduction in private consumption and investment, and this could worsen loan quality.

As subsidiaries and branches of the Nordic bank groups have over 90% of the Estonian banking sector, and Swedish banks have over 80%, then there would be a significant impact on Estonian financial stability if this risk were to be realised. This is partly because the risk of negative economic growth passing to Estonia through external trade would increase, and partly because of the financing and liquidity risk to banks that would come through the banking groups. The Swedish financial supervisory authorities have announced measures to dampen the risks by increasing the liquidity and capital requirements of banks.

3. Low interest rates and rising incomes will accelerate the rise in Estonian real estate prices, which will increase the risks to the financial system.

Prices in the Estonian housing market have been rising more slowly since the second quarter of the year, and the number of transactions is lower than a year earlier. Although wages are rising more slowly, real estate prices may start to climb again if demand is boosted as interest rates remain low and incomes rise.

The earlier rise in real estate prices has increased the profitability of projects for real estate developers, and so the supply of residential space is increasing. This should ease the shortage of supply of high-quality property that is driving price rises, and so should ease price pressures. Although the total value of housing loans issued by the banks has increased, the risk margins on loans and the loan conditions have not changed.

Measures to lower risks to financial stability

There will be several important changes in macroprudential supervision: a single rulebook for recovering solvency in banks and for crisis management came into force in the summer; single banking supervision begins in November; and measures to strengthen bank capitalisation have been passed or planned in Sweden, Norway and Denmark.

As the Estonian economy and banking sector are very exposed to risks from the external environment, a worsening of that environment could lead to a rapid deterioration in loan quality and a weakening of the financing position of banks. To reduce risks from the vulnerability of the structure of the economy and banks, Eesti Pank introduced a 2% systemic risk buffer for banks from 1 August 2014.

Eesti Pank not only assesses and aims to reduce structural risks, but also observes factors that affect the credit cycle. Changes to the Credit Institutions Act that came in on 19 May 2014 gave Eesti Pank the right to set requirements for the conditions of loans issued by credit institu-

The main risks to Estonian financial stability

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A reassessment of the risks to the Nordic economies and banks by financial markets will increase the financing and liquidity risks of the banks	→
Low interest rates and rising incomes will accelerate the rise in Estonian real estate prices, which will increase the risks to the financial system	↓

arrow indicates changes in the risk level from the assessment of April 2014

minor risk *major risk*

tions. The new macroprudential tools Eesti Pank plans to use are a limit on the loan-to-value (LTV) ratio of new housing loans, a limit on the debt service-to-income (DSTI) ratio, and a limit on the maximum maturity of loans. The levels planned for the limits are based on the current conditions of housing loans issued by banks, and the purpose of the requirements is to ensure that the conditions on housing loans from the banks take sufficient account of possible risks. If the risks around housing loans increased, Eesti Pank would be able to set stricter requirements.

As the indebtedness of Estonian companies and households has not increased and credit growth is forecast to be lower than nominal economic growth this year, and considering other indicators of the credit cycle, Eesti Pank does not find it necessary to set countercyclical buffers for banks in the fourth quarter of 2014 or the first quarter of 2015.