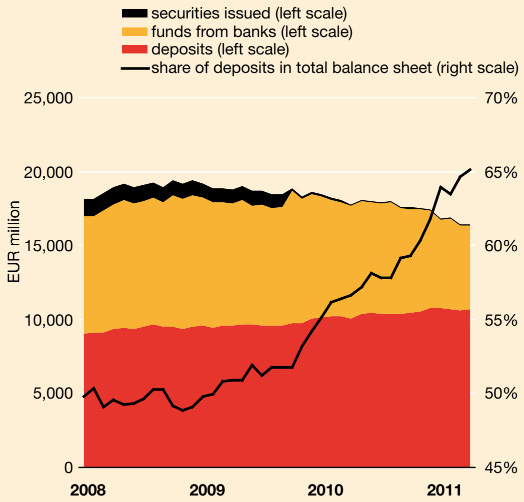
FACTORS AFFECTING THE LOAN SUPPLY OF BANKS

Funding resources

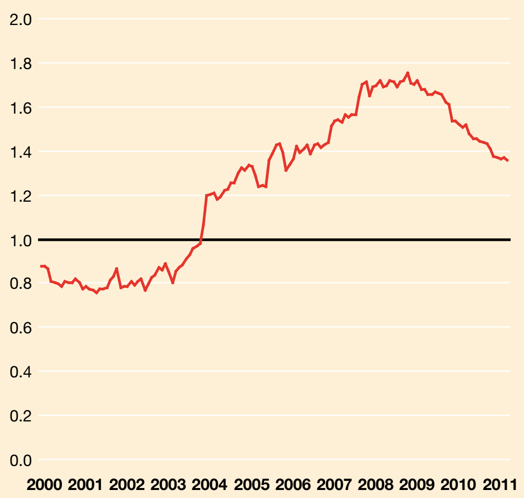
The liabilities of banks operating in Estonia mainly consist of non-financial sector **deposits**, which totalled almost 11 billion euros as at the end of April 2011. In recent years, the volume of deposits has been growing relatively rapidly due to the cautious financial behaviour of households and companies. The volume of loans and leases of the non-financial sector has declined by 15% since the autumn of 2008, while the volume of deposits has increased by nearly 13%. This development has enabled banks to repay funds obtained from their parent banks. At the end of April, the share of deposits in banks' debt liabilities had increased by 9 percentage points to 65% from a year ago.

The loan-deposit ratio that had climbed to 1.75 by autumn 2008 abated to 1.4 by the end of April 2011. Despite a relatively quick drop in the banks' financial leverage, the loan-deposit ratio in Estonia is still quite high compared to similar indicators in other European countries. These large discrepancies across countries stem from the difference in the countries' financial sector structure, for instance different housing financing schemes. After the recession and increased vulnerability in market-based funding, retail deposits have gained more importance as a stable funding resource all over Europe. However, the level of loan-deposit ratio need not, in every single case, reflect banks' need or desire to change their existing funding structure considerably or to urgently reduce reliance on markets. Consequently, the strategies of parent bank groups are not concerned with the current indicators of their Estonian subsidiaries as a factor that would hinder loan portfolio growth.

However, it must be kept in mind that the banks' funding structure has become more balanced largely thanks to the decrease in the loan portfolio. Even if credit growth does not recover rapidly, the spread between loans and deposits will remain relatively large. This funding gap along with the



Structure of banks' liabilities



Loan-to-deposit ratio* in Estonia

* Includes loans and deposits of non-MFIs (households, companies, general government, financial corporations).

need to secure sufficient capital for banks makes the banks operating in Estonia highly dependent on their parent banks. The profitability and capitalisation of **parent bank groups** operating in Estonia is good compared to most other large European banks, and financial markets regard them as less risky. This has allowed the parent banks to obtain sufficient funds from financial markets at relatively stable prices.

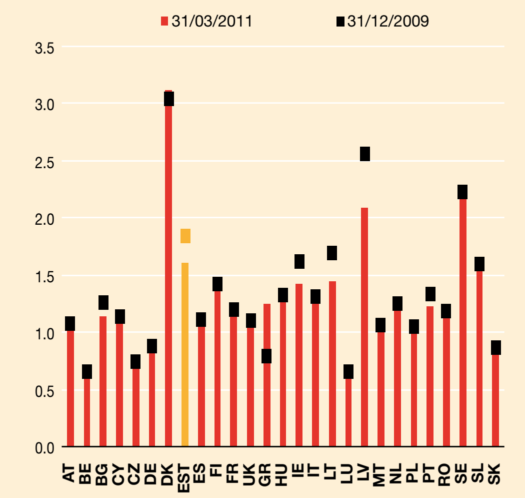
As the funding of Swedish bank groups is largely market-based and the share of retail deposits is lower than in Europe on average, the prevalent trends in financial markets play a great role in shaping the availability and cost of loan resources for banks.[1] The interest rates on the covered bonds of Swedish banks have risen from autumn 2010 owing to a change in the yield curve, but the difference with the yield of government bonds has not changed or has even shrunk a little in spring 2011, which reflects the stabilisation of risk estimates attributed to Swedish banks.

Developments in global interest rates also affect the **cost of funding** for banks operating in Estonia. The interest rate on banks' debt liabilities (including deposits and funds obtained from banks) dropped to 1.1% at the end of 2010, while at the end of April 2011 it rose by 10 basis points to 1.2% due to the cost of funds obtained from banks and the slightly higher deposit interest rate. At the same time, the Euribor that is used as the reference interest rate for most loan contracts climbed by 37 basis points. The increased interest spread helps to alleviate pressure on the interest margins on new loans.

Banks' loan supply

The average consolidated **capital adequacy ratio** of banks stood at 16.9% at the end of March 2011, with the Tier 1 ratio being 13.4%. Based on the forecast of Eesti Pank, capitalisation will

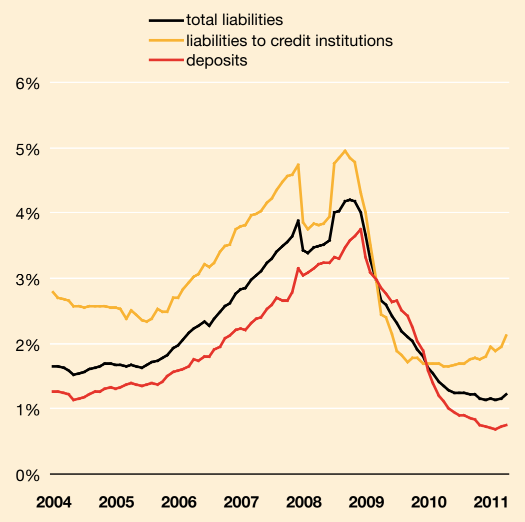
[1] For the risks of parent banks' funding see the Financial Stability Review No 1/2011.



Loan-to-deposit ratio* in EU countries

* Includes loans and deposits of non-MFIs, excluding general government.

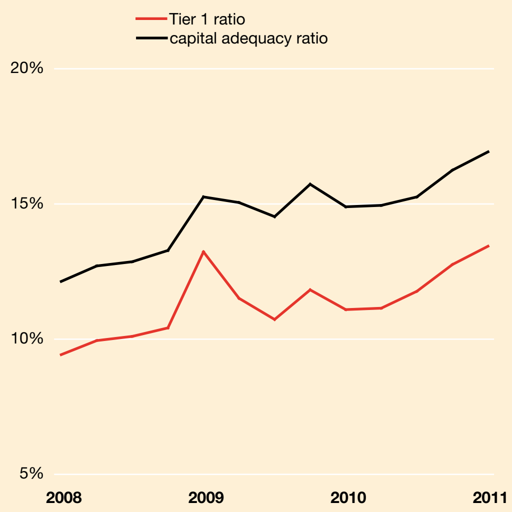
Sources: European Central Bank (MFI statistics), Eesti Pank



Avearge interest rate on banks' liabilities

strengthen as profitability grows further, while loan provisions and risk assets are decreasing.[2]

Considering the current capital buffer and the expected improvement in capitalisation, the tightening of capital regulations along with the implementation of the Basel III capital regulation will not exert great direct influence on the supply of loans by domestic banks or the branches of foreign parent banks operating in Estonia. All banks operating in Estonia were able to fulfil the minimum Basel III requirements that will be fully implemented in 2019 (total capital requirement 10.5% and Tier 1 capital requirement 8.5%)[3] at the end of the first quarter of 2011. However, higher capital requirements may affect the financing environment of banks and the local credit conditions through parent banks.



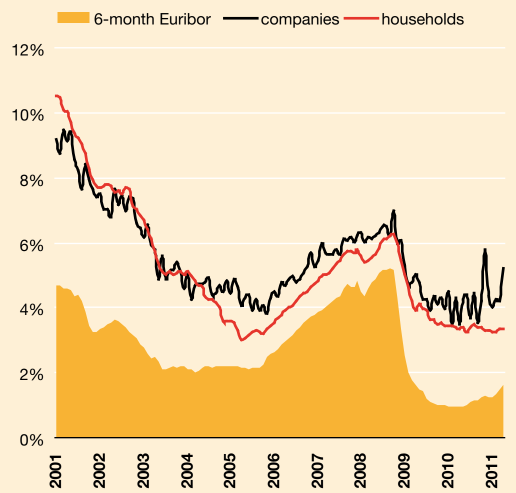
Capital adequacy ratios of banking groups operating in Estonia

Loan interest rates

The interest rates on new loans remain favourable for borrowers owing to low key interest rates. The interest rates on long-term loans reached a historical low in 2010, even though risk margins rose against the backdrop of global economic decline. In recent quarters the key interest rates started to climb, but due to the lowered interest margins this has not transferred fully to loan interest rates yet.

The pricing of housing loans for households increasingly resembles the rapid credit growth period. The risk premiums of new housing loans are more homogeneous than in recent years, although not as concentrated as in 2006–2008.

The margins for long-term corporate loans still point to the rather great risk-based differentiation

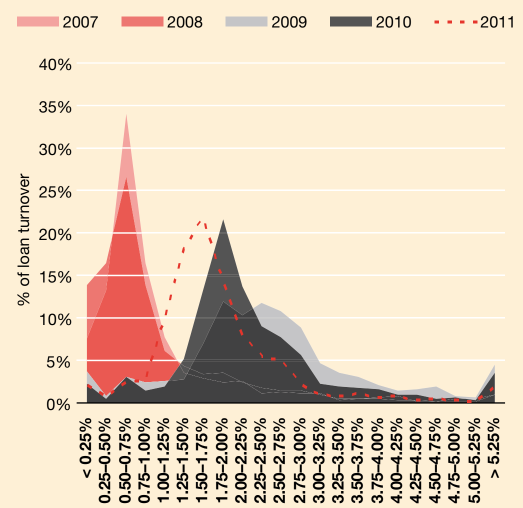


Interest rates on long-term loans and 6-month Euribor

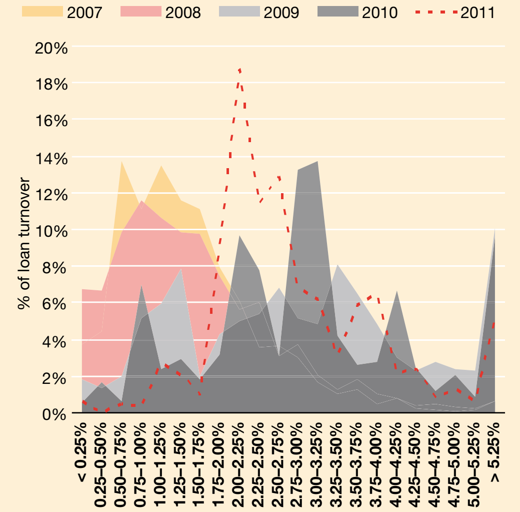
Sources: European Central Bank, Eesti Pank

[2] See the Financial Stability Review No 1/2011.

[3] Both requirements include the 2.5% capital conservation buffer. However, an additional counter-cyclical buffer, ranging between 0.0–2.5% or higher, may be added depending on the economic cycle.



Housing loan margins as a ratio of 6-month Euribor

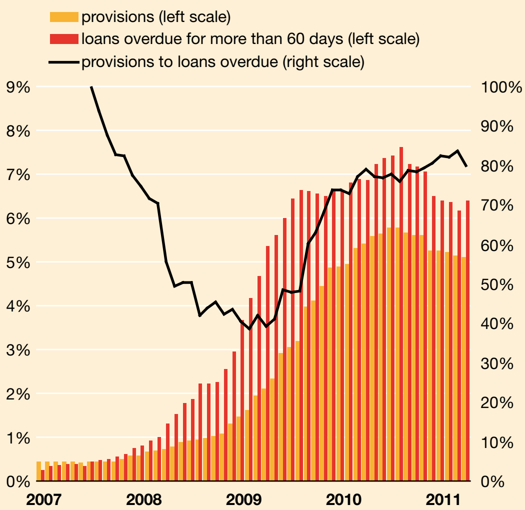


Margins for long-term corporate loans as a ratio of 6-month Euribor

among companies, as indicated by the relatively wide range of margins in 2011. Compared to 2010, however, the differences between margins have decreased somewhat and the average margin is also lower, which means that credit conditions have become slightly more favourable for companies.

Other factors affecting loan supply

The accumulation of loan repayment problems during the economic recession considerably affected the risk awareness of banks, and until the middle of 2010, banks focused on managing their existing loan portfolio. Although the quality of the loan portfolio has been on the rise since the autumn of 2010, the share of **non-performing loans** is still high. Given that loans overdue for a longer period and restructured loans are covered by sufficient provisions, the materialisation of credit risk does not set significant constraints for the volume of new loans. Meanwhile, the level and history of overdue loans should influence the risk estimates for granting new loans, which



Loans overdue for more than 60 days and provisions as a ratio of the loan portfolio

will probably be reflected in a higher interest rate margin compared to the pre-crisis period. Moreover, the level of non-performing loans will affect the rate of amortisation of the loan portfolio, as it may take quite some time to write bad loans off the balance sheet. As a result, the banks' loan portfolio may contract by 2–3% in 2011-2012.

Competition on the loan market has been on the rise since 2010, as evidenced by the smaller range of interest margins and banks' own observations regarding the loan market (see Annex 1 *The results of the Bank Lending Survey in the first quarter of 2011*). As noted by banks, competition has been especially strong on the loan market of large companies, but since the first quarter of 2011 also in the segment of loans for households and small and medium-sized companies. Compared to companies, households are a more homogeneous group of borrowers and the signs of competition in this segment are thus also more apparent. Stronger competition is reflected in shrinking housing loan margins and their convergence between banks. Banks' market shares in the supply of new housing loans are also more even since in the second half of 2010.

After a break of five years, banks launched housing loan and car lease campaigns in spring 2011 to attract new customers, which expresses banks' readiness to increase their loan volumes. Although the main goal of these campaigns is to secure a strong customer base by offering more favourable housing insurance or credit card terms, they also entail a slight easing in credit conditions, in particular a drop in interest margins.

Annex 1. The results of the Bank Lending Survey in the first quarter of 2011

The Eurosystem's Bank Lending Survey gives an overview of the changes that have occurred and may occur in loan standards and demand in the near future. The survey is conducted on a quarterly basis and the results reflect the last month of a quarter. The survey on the Estonian lending market includes qualitative estimates of four major credit institutions operating in Estonia.

The survey results **revealed a slight tightening of credit standards for euro area companies in the first quarter of 2011.** This stemmed from the banks' poorer access to funding and the deterioration of their liquidity position. The corporate credit standards for **banks operating in Estonia** generally remained the same, but credit standards for large companies were slightly loosened. This was fostered by the improved operation environment of companies, tight competition between banks and their capital and liquidity position. As for credit conditions, loan margins have dropped. The non-interest rate charges of banks have slightly decreased and the volume of the credit lines for large companies has increased somewhat.

The tightening of **household credit standards** in the euro area is related to banks' greater funding costs and balance sheet constraints. The deterioration of risk perception in the euro area contributed to the rise in interest margins. Banks operating in Estonia, however, estimate the risks to be lower and have loosened the credit standards for loans issued to **Estonian households** because of heavy competition, although there are exceptions too. Nevertheless, average credit standards have remained relatively unchanged in the Estonian loan market and housing loan conditions have eased in many cases. One bank has reduced its interest margins considerably and half of the banks have lowered the loan-to-value ratio (LTV) requirement. The terms of consumer credit did not change in the first quarter.

In the euro area, credit standards for companies and households are expected to tighten further in the second quarter of 2011. However, most banks in Estonia do not plan to change the general credit standards. The standards for long-term corporate loans may be lowered somewhat. One bank also intends to loosen housing loan standards.

In general, the **loan demand of companies** has been rising in the euro area, boosted both by the need for inventories and working capital and for funding fixed investment. In Estonia, the demand for short-term loans has improved the most. Over half of the respondents mentioned also increased borrowing by small and medium-sized companies.

Households' demand for housing loans has broadly remained the same in Estonia, while the demand for consumer credit has decreased slightly more. Housing loan demand is supported by the improved outlook for the housing market and the increasing confidence of households, but it is curbed by non-housing consumption expenditure, savings and borrowing from other banks. The demand for consumer credit and other loans has dropped as households prefer to use their savings as an alternative source of financing.

In the second quarter of 2011, corporate loan demand is expected to increase in the entire euro area. The banks operating in Estonia forecast a growth in demand mainly among small and medium-sized companies. Half of the banks presume that households' demand for both housing loans and consumer credit will pick up.