V
FINANCIAL SECTOR

In the structure of financial intermediation the processes originating from previous periods were carried on (see Figure 5.1). Local deposits continued to be the main funding for banks with the exception of one large international-market-oriented bond issue. In financing the channelling of projects into leasing within the banking group was maintained and on banks' balance sheets it has made lending to financial institutions grow most whereas the residents' leasing portfolio grew by 30% over the year. Both in the loan and leasing portfolio corporate lending as well as lending to business and real estate services, in the banking portfolio also lending to commerce have grown most.

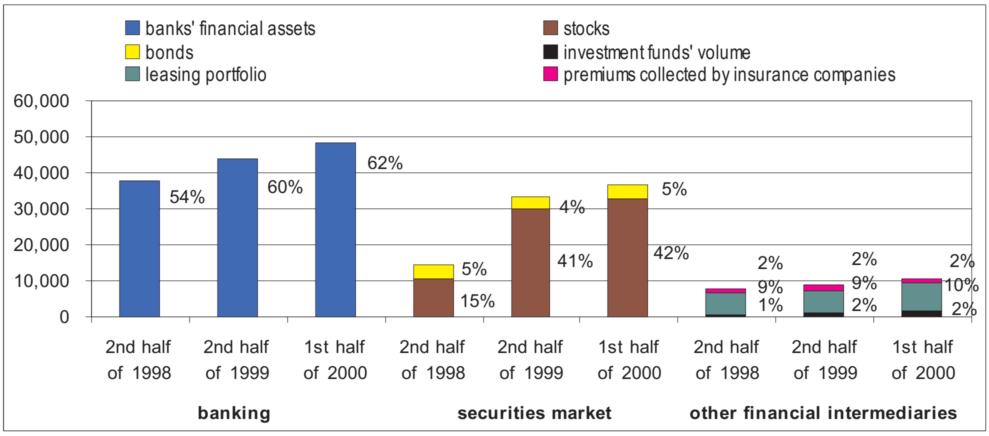

Figure 5.1. Estonian financial intermediaries (volume in EEK mn and structure by % of GDP)

Throughout the first half of the year the volume of overdue loans decreased, mainly at the expense of loans overdue more than 30 days. The ratio drop to 5.8% reflects mainly the growth of the portfolio. Despite such developments there is no reason to anticipate changes in the quality of the group's loan portfolio, as by nature the share of the overdue loans in the leasing portfolio of growing importance is larger.

The insurance sector is recovering from the last year's changes (bankruptcies and mergers). The volume of premiums collected is increasing, partially due to administrative measures the profitability of companies is improving.

Some structural changes have taken place in the bond market: first bonds quoted in euros were issued in the local market, also the first public bond issue by a local real economy undertaking took place. The stock market was relatively idle: prices fell and the turnover was modest. News of the involvement of another strategic foreign investor and small-investor-oriented price offers caused some sporadic activity.

Significant events took place in the institutional development of the banking as well. The major shareholder of *Eesti Ühispank*, *Skandinaviska Enskilda Banken* made an offer to buy all shares, turning eventually the second bank in size in Estonia into a hundred per cent affiliate to the foreign bank. Previously Eesti Pank had sold its qualifying holding in *Optiva Pank* to the Finnish insurance company *Sampo* whereas the latter made a bid to other shareholders as well. As the result of this transaction Estonia's public sector has no holdings in banks. Both for banking and the entire financial sector the replacement of the temporary core investor of the third largest bank with a long-term strategic investor and the turning of both banks into integral parts of the experienced foreign banking group is significant.

Banking

Banks' Assets and their Quality

In early second quarter the intermediation of banks' resources to affiliated banks and leasing companies gained pace, accompanied with risk transfer from banks into affiliated (leasing) companies. Thus, the growth of the loan portfolio has mainly taken place through two independent customer groups: financial institutions and other customers (first and foremost private companies and individuals) whereas the lending to financial institutions grew by 1.6 billion kroons and to others by 1.3 billion kroons (see Figure 5.2).

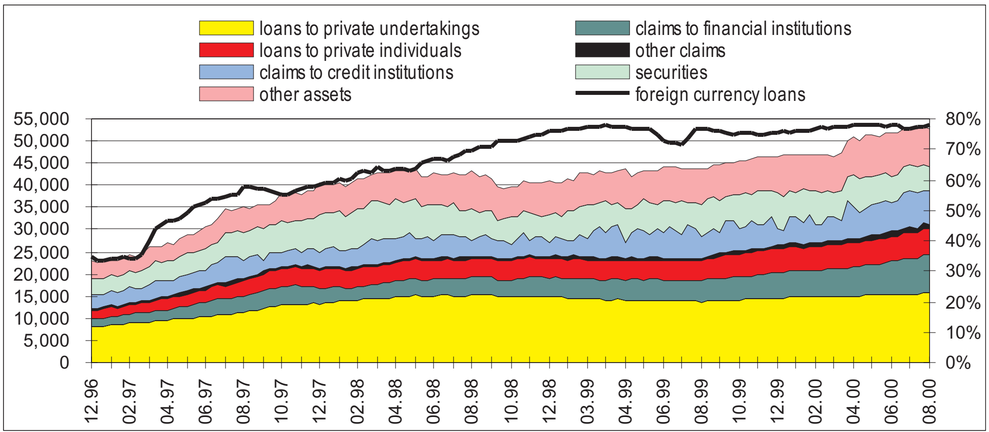

Figure 5.2. Banks' total assets (EEK mn, the left scale) and share of foreign currency loans in loan portfolio (%, the right scale)

In the first half of the year preferred lending targets included industry (change in the stock was +381 million kroons), trade (+300 million kroons) and real estate and business services (+287 million kroons) whereas the latter may have revived due to seasonal factors (see Figure 5.3).

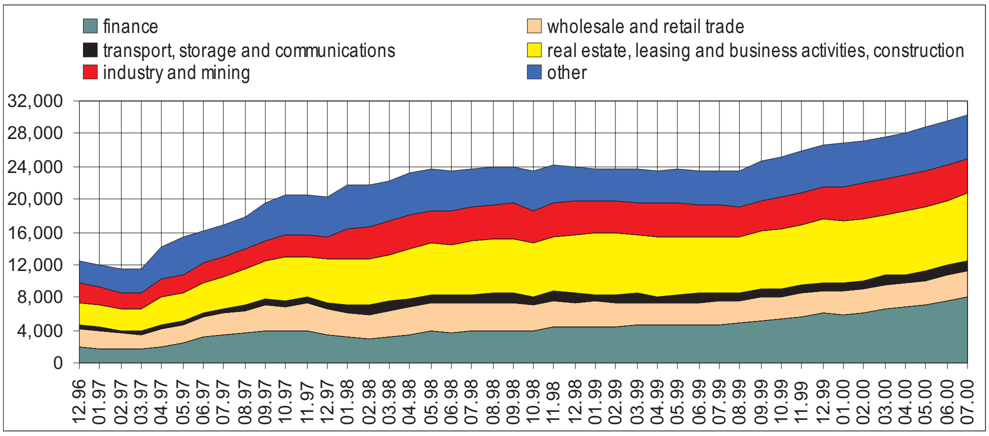

Figure 5.3. Banks' loan portfolio by sectors of economy (EEK mn)

The share of the open sector increased by three percentage points over the half-year, reaching 56%, the share of the export sector by one percentage point, ie to 22%. Such a development reveals a slight shift from domestic consumption to financing export production. The credit turnover of the first half-year recovered the levels of the second quarter of 1997 and the first quarter of 1998[1]. By maturities short-term lending, mostly for working capital, has increased, causing a slight drop in the usage of overdraft facilities.

In order to refinance liabilities and due to unfavourable market situation banks reduced securities portfolio by 24% during the first half of the year – down to 5.9 billion kroons, to the level of the fourth quarter of 1998 (see Figure 5.4). Regardless of the extensive affiliate financing, nearly all of the free funds recovered from securities were deposited with foreign banks. Although this had an implication only on the liquidity buffer, in medium-term this would impact anticipated return on investment. Reorganisation had its implication also on the portfolio structure. The share of the trading portfolio shrank from the end-year 35% to 22% and the share of affiliates grew from 15% to 24%. Contemporaneously, the bond maturities have lengthened over the last few quarters.

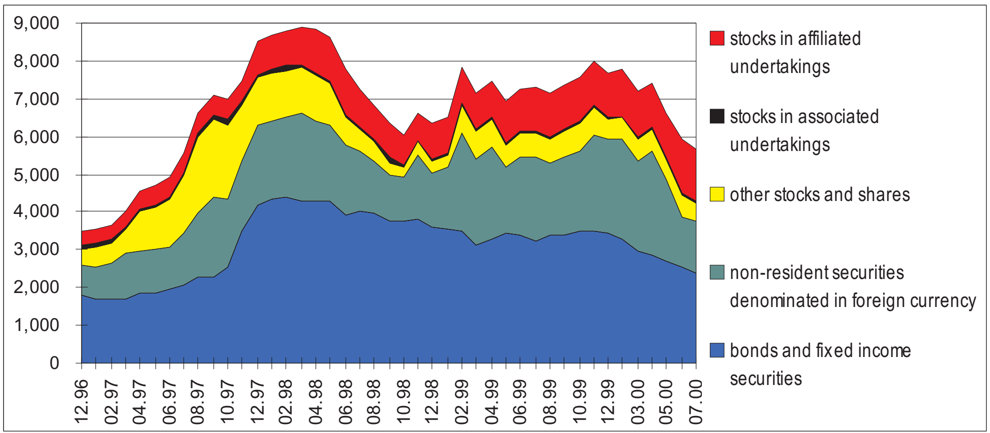

Figure 5.4. Banks' securities portfolio (EEK mn)

The share of overdue loans in the loan portfolio dropped to 5.8% due to the shrinking number of short-term – up to 30 days – debts and reflected mostly the growth of the loan portfolio (see Figure 5.5). Although the stock of loans overdue more than 60 days slightly decreased in the second quarter, the overdue loans could be anticipated to grow mostly at the expense of the loans overdue from 30 to 60 days[2]. By sectors the level of the loans overdue over 60 days in construction, transport and industry has decreased whereas the share of the loans overdue from 30 to 60 days has increased, the collection and write-off thereof would probably need additional expenses in the second half of the year.

The ongoing processes send controversial signals as regards the loan quality. On one hand the growth of the banks' corporate and private individuals' loan portfolios could remain unchanged and the loan quality improve. On the other hand credit resources directed to leasing provide an opportunity to apply adverse selection in order to enlarge client base and ensure the required growth and return on invested resources. The quality of the leasing portfolio on the group level is manifested with time shift and it is more difficult to follow.

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[1] The credit turnover of the half-year was 8.1 billion kroons in the first quarter of 2000 (8.9 billion kroons in the second quarter of 1997 and 8.5 billion kroons in the first quarter of 1998).
[2] At the beginning of the second quarter loans overdue from 30 to 60 days shrank from 300 billion kroons to 100 billion kroons but exceeded 200 million kroons by the end-quarter.

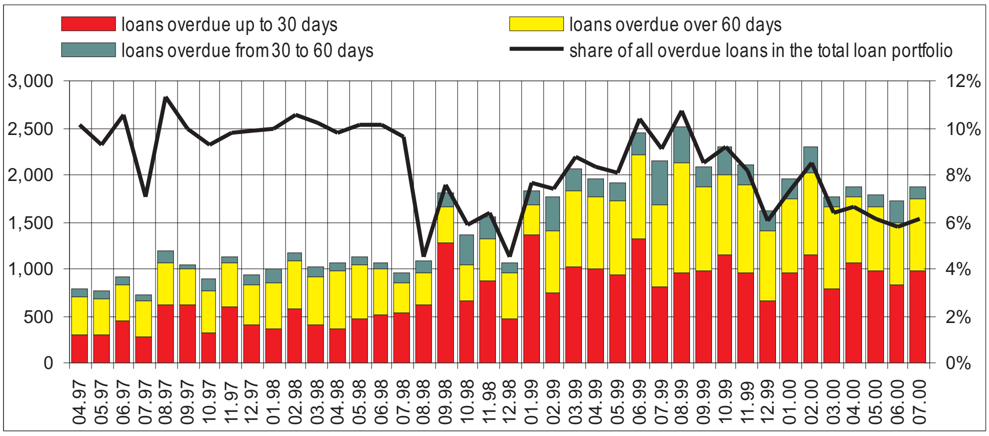

Figure 5.5. Volume of overdue loans (EEK mn, the left scale) and their share in banks' loan portfolio (the right scale)

The preference of financial institutions in lending and the relocation of the liquidity portfolio had a significant impact on capital adequacy in the first half of the year. Although the drop from the end-year 16.1% to 13.8% in June was mainly caused by the 3.5-billion-kroon growth of risk assets (the capital adequacy decreased by 1.4 percentage points), dividend disbursements of previous months, purchasing of a new affiliated bank in Latvia and the growth in capitalisation of the existing affiliated bank had their implications as well.

Liabilities

The consolidated balance grew due to bonds issued by banks and involved customer deposits by 9.4%, reaching 51.7 billion kroons (see Figure 5.6). The deposit growth accelerated slightly in the second quarter, strengthening banks' confidence in long-term lending at the expense of short-term liabilities throughout the first half of the year. In the current situation in which long-term assets are (eg as compared to 1997–1998) covered by long-term liabilities (2 to 5 years) and banks have adequate liquidity buffers, the growth of neither interest nor liquidity risk could be dramatic.

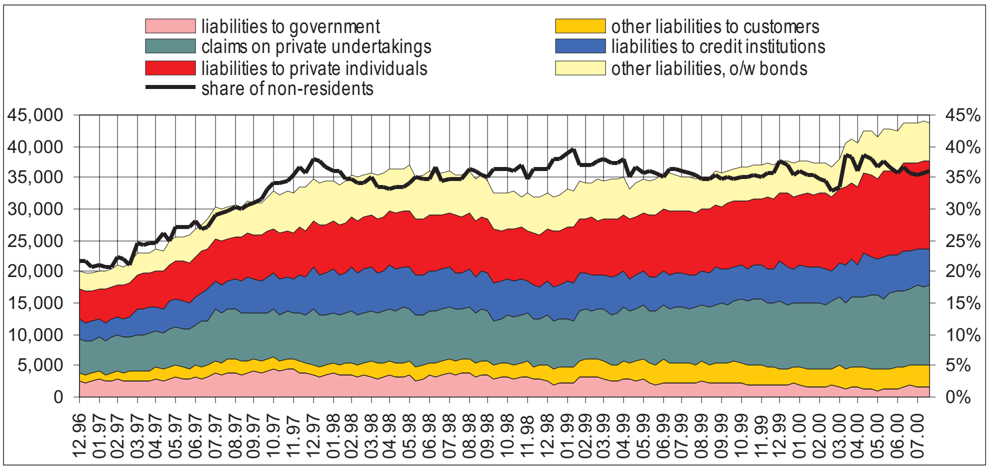

Figure 5.6. Banks' external liabilities (EEK mn, the left scale) and share of non-residents (%, the right scale)

Like in previous quarters, deposits by private individuals displayed more stable growth (+21.5%) and despite the fall at the beginning of the year the depositing by private undertakings gained pace as well in the second quarter (+9.7%). The record high stock of private individuals' time deposits in recent years[3] can be considered a balancing factor in extending assets' maturities. The refinanced *Hansapank* bonds, which would primarily help the bank to repay the group's expiring short-term liabilities and reduce the price of external financing, are moving in the same direction.

Return on Equity

The banks earned 186 million kroons of profit in the second quarter, which is about 15% more against the year-ago period; parallel to the drop in profit margin the return on equity diminished as well (see Table 5.1). The latter was still supported by growing deposits, although inadequate to compensate modest loan growth, dropping interest rate margins and depreciation of investment value. Apart from the above the interest expense growth exceeded that of interest income. The rapidly growing banks' liabilities have despite the continuously increasing lending-induced interest rate income also inflated the banks' interest expense.

Table 5.1. Banks' profitability indicators

	31.03.98	30.06.98	30.09.98	31.12.98	31.03.99	30.06.99	30.09.99	31.12.99	31.03.00	30.06.00
Equity multiplier	9.37	8.92	8.66	7.08	6.25	6.35	6.31	6.37	6.27	7.01
Return on equity	6.78%	-6.67%	1.59%	-9.74%	2.04%	2.38%	2.13%	2.63%	3.24%	2.55%
Return on assets	0.72%	-0.75%	0.18%	-1.37%	0.33%	0.37%	0.34%	0.41%	0.52%	0.36%
Profit margin	15.16%	-25.49%	16.78%	-50.29%	10.43%	11.56%	12.12%	14.32%	18.76%	13.64%
Assets utilisation	4.78%	2.94%	1.09%	2.73%	3.13%	3.24%	2.79%	2.88%	2.75%	2.67%

The gradually shrinking asset utilisation reflects the changes taking place in the assets structure for the second quarter already: idle lending and maintenance of liquidity buffers. In **interest income** the changes in assets structure are fully reflected, although the banks have quite efficiently used deposits to offset the return downfall in the bond market[4]. **The interest expense** grew mainly at the expense of sustained high cost of capital and demand deposits[5]. The optimisation of the banks' capital structure enhances lowering of the cost of involved loans. The trend as well as the shrinkage of expenditure is expected to continue.

Both **spread** and **net interest margin** (NIM) express possibilities to earn interest income. The 4% drop of both in the second quarter was mostly due to lower asset utilisation amplified by the 2-percentage-point growth in interest expense. Besides, NIM has also suffered from rapidly growing income base, which is invested into low-income instruments.

In the second quarter the growing service charge income had a positive and the depreciation of long-term financial investments by 34 million kroons a negative implication on **the non-interest revenue**. The net profit from financial transactions fell as well.

The growth of **the equity multiplier,** based on the rapidly growing liabilities, could significantly improve the annual return on equity if such trends continue. Currently it is not much dependant on financial leverage but rather on the banks' ability to identify new ways to allocate assets more profitably.

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[3] Time and saving deposits had an annual growth of 25%.

[4] The average deposit interest income moved upward from 1.3% to 1.8% in the second quarter whereas the interest income on securities moved downwards from 1.9% to 1.7%.

[5] The interest expense on demand deposits has after a brief leap been suspended whereas the interest expense of items of capital character have undergone a sharp rise mainly in the second quarter, leaping from 1.3% to 2.1%.

Securities Market

Stock Market

The first months of 2000 revealing positive signs for the development of the stock market, remained exceptional as the turnover has been considerably lower in the following months. The idle market is characterised by the triple drop in the turnover, mostly in stock exchange transactions. Due to the price decline of the shares listed on Tallinn Stock Exchange, the market capitalisation dropped by 6 billion kroons during the second quarter – down to 39 billion kroons (see Figure 5.7). On one hand it reflects the price fall taking place in most of the European markets, on the other hand, foreign investors' passive investment tactics in Estonia. Contemporaneously, listed companies continue involving strategic foreign investors and applying for delisting on the stock exchange[6] whereas the beginning-of-the-year amendments to the Securities Market Act should ensure better protection of small investors' interests and favour their stay on the stock investors' list.

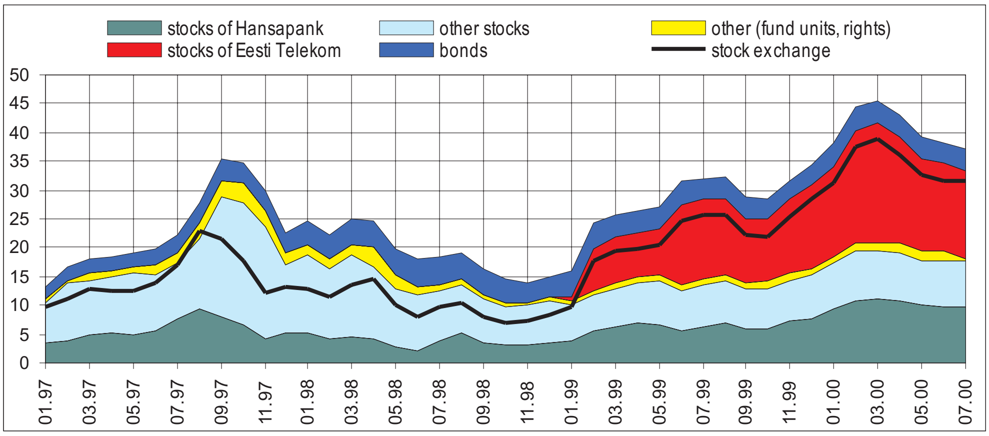

Figure 5.7. Securities market capitalisation (EEK billion)

The prices of the service sector stocks dropped most (–25%), particularly due to the depreciation of the stocks of *Eesti Telekom* (Estonian Telecom). This was mostly an after-effect of the depreciation of technology stocks in April-May, although unlike other markets' technology stock price changes, there was no price adjustment in the *Eesti Telekom* stocks. The Tallinn Stock Exchange index TALSE dropped by 20% over the second quarter whereas the price of banks' stocks fell only by 11%, and mostly in May (see Figure 5.8).

Despite the decreasing price level foreign investors were not observed to leave Estonia's stock market. Their share in the market capitalisation is about 70%. This reflects the maintenance of the larger positions acquired by foreign investors at the beginning of the year which has its implications on the market activity. Among foreign investors' countries of origin Sweden is leading (more than 50%), reflecting the participation of SEB and *Swedbank* in large banks and that of *Telia* in *Eesti Telekom*. US investors have their 15% share mainly in GDRs[7]. Both British and Finnish investors have "representation accounts'" investors dominating. Those and Dutch investors have each a 7% stake. This structure has remained unchanged since the second quarter of the last year.

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[6] In summer 2000 the Tallinn Stock Exchange was notified of Reval Hotel Group and *Optiva Pank* having involved a strategic foreign owner and intending to apply for delisting on the stock exchange.
[7] Global Depositary Receipt.

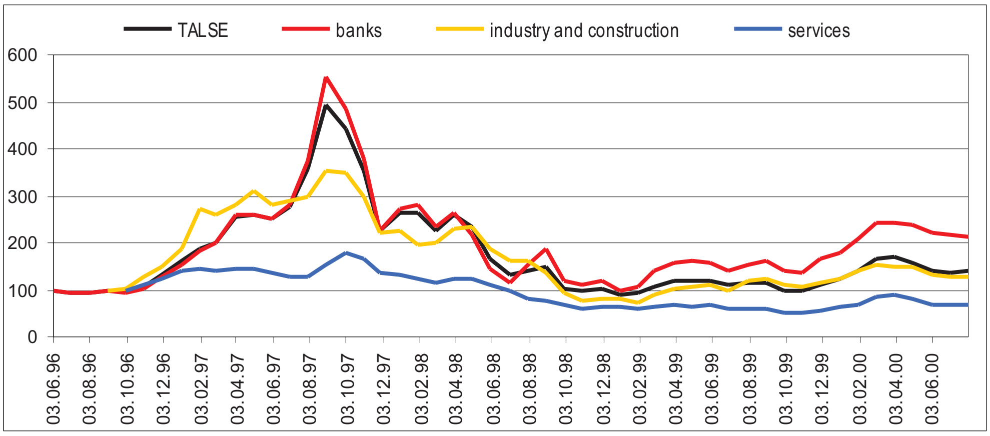

Figure 5.8. Indices of stocks traded on the Tallinn Stock Exchange by sectors of economy and TALSE (points)

Bond Market

A number of interesting events have taken place in the bond market: in February the guidelines for public issue were amended, the first local-market oriented bonds denominated in euros were issued, local undertakings appeared as new issuers in the market, public bond issue by *Eesti Telekom* took place [8]. Despite amendments private placements for financial investors are still dominant in the market and key issuers are large local undertakings, larger local governments and non-resident credit and financial institutions.

In June the volume of local undertakings' bonds dropped shortly to 3.7 billion kroons. Nevertheless, key issuers have identified an optimum volume of bonds – 4 billion kroons on the average, acceptable at such a risk and price level for the local market. On the other hand, several local financial investors have acquired foreign bonds.

The volume of the bonds issued during the second quarter was among the smallest in the last three years – 800 million kroons (see Figure 5.9). The change is mainly due to the extension of maturities over the last half-year and mainly for foreign issuer's bonds as they have no need to rapidly replace the bonds issued with new ones. The marginal drop in the average interest rate is caused by interest rate decline of bonds of a year/half a year maturity. Whereas the interest rate of bonds of up to three-months maturity has increased, reflecting recent changes in TALIBOR.

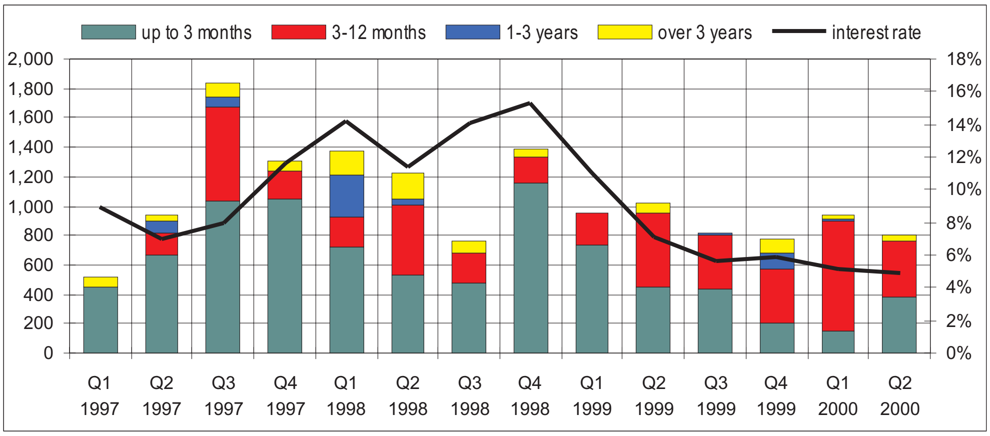

Figure 5.9. Volume of bonds issued in a quarter by maturity (EEK mn, the left scale) and average interest rate of kroon bonds (the right scale)

[8] Prior only *Hüvitusfond* (the Compensation Fund) had had public issues.

Other Financial Intermediaries

Insurance

During the first half-year non-life insurance companies collected 633 million kroons of premiums, exceeding the year-ago period by 15% (see Figure 5.10). The growth was fed by administratively increased compulsory motor TPL insurance premiums and insurance of legal persons' property increasing due to active lending. Life insurance premiums revealed a more modest growth of 9% (reaching 110 million kroons). This should partially reflect the distrust in insurance companies as the result of bankruptcies taking place last year and the disappearance of relatively high-yield products from the insurance market.

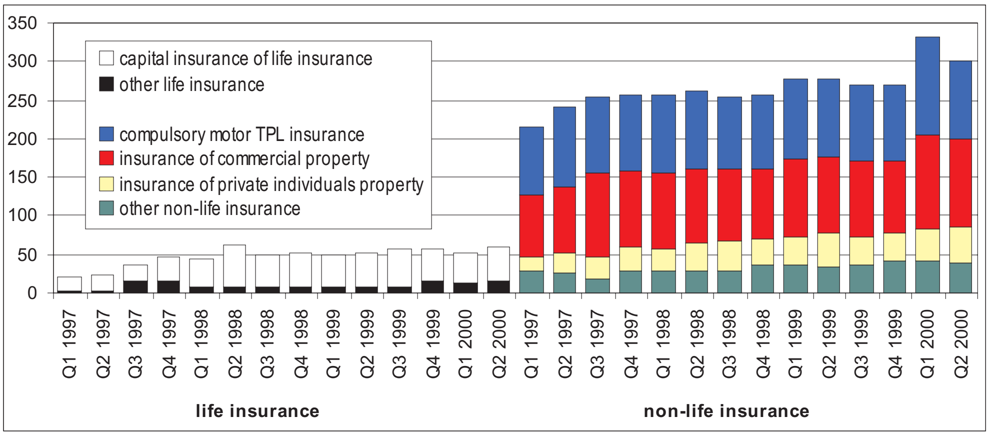

Figure 5.10. Gross premiums collected by insurance companies (EEK mn)

Over the last year mainly foreign-investor-owned non-life insurance companies have increased their market share to 84%, mostly through buying up local companies. Three out of seven non-life insurance companies can be considered local, although they all have foreign shareholders. No such consolidation has taken place in the life insurance market; there has always been a dominant company in the market. This year a new market participant was added – *Sampo-Elu* (Sampo-Life). Considering the companies owned by large banks also belonging to foreign investors, non-residents were holding five life insurance companies and their market share was 97%.

As of end-March the balance of life insurance companies reached 480 million kroons (+7%) and that of non-life insurance companies 1.3 billion kroons (+3%). The increase in the significance of bonds and time deposits in the investment portfolio is positive, as the share of non-liquid assets in insurance companies' total assets is relatively high. The non-life insurance companies have improved their profitability both due to the growing premium collection as well as lower operating costs. Among life insurance companies only the bank-owned ones revealed positive results in the first quarter. Other life insurance companies have made additional expenses to penetrate the market, both in launching their operations and as single expenditure in taking over portfolios of bankrupt companies.

Leasing

The volume of the leasing portfolio continued growing at high speed also in the second quarter, **the total portfolio reaching 7.9 billion kroons. Together with factoring this totalled 8.5**

billion kroons and the annual growth was 32% [9] (see Figure 5.11). By leasing types finance lease and sale by instalments grew most, supported by real estate and equipment leasing. Operating lease had more modest growth – mainly in car leasing. The market share of non-resident leasing companies shrank by 2% during the quarter.

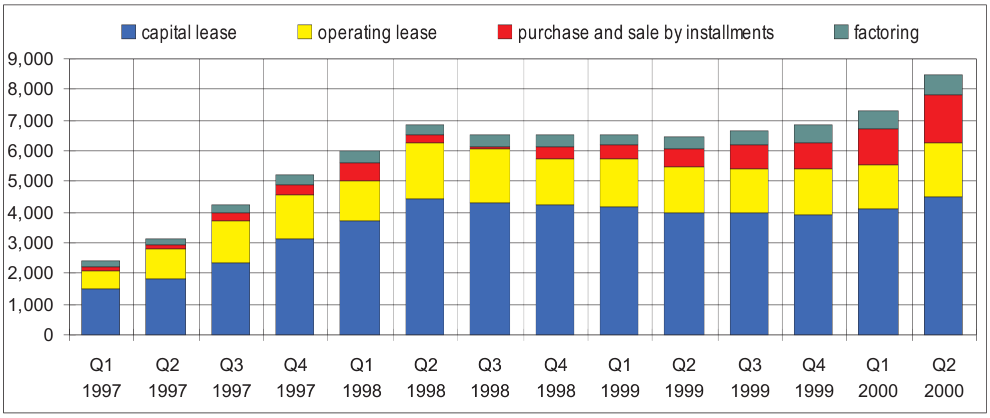

Figure 5.11. Volume and structure of leasing companies' portfolios (EEK mn)

Traditional leasing of cars and equipment manifested continuous moderate growth although they achieved the highest volume ever. The leasing portfolio of vehicles increased by 15%, reaching 3.6 billion kroons during a year. The real estate leasing has displayed rapid growth (the annual growth being 140%), mainly the corporate one, whereas the volume of private individuals' real estate leasing has changed moderately. The real estate leasing portfolio was 1.7 billion kroons, mainly characterised by real estate development programs being transferred from the banks' loan portfolio to the leasing portfolio (see Figure 5.12). The revival in economy and trade is best reflected in the largest factoring portfolio ever (0.6 billion kroons).

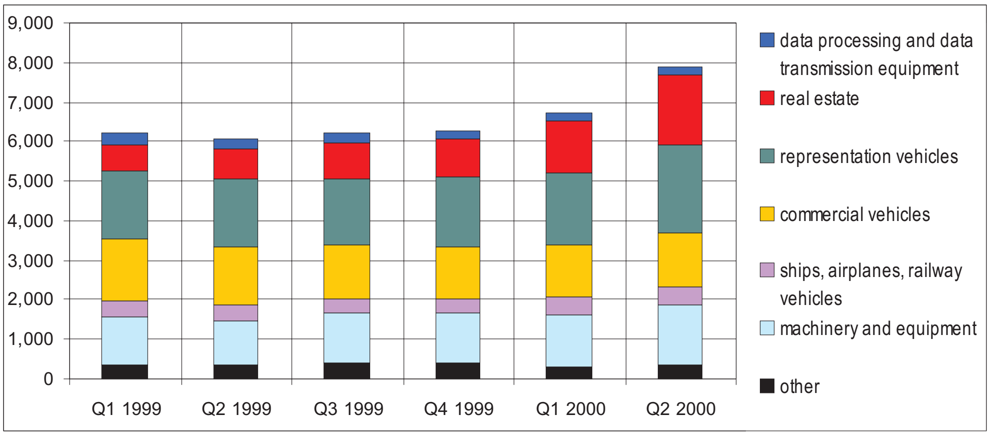

Figure 5.12. Volume of leasing portfolio by leasing objects (EEK mn)

The largest growth took place in industry and real estate and business services whereas the growth in other sectors was modest. As in banks' balance sheets the quality of real estate and business service sector loans has deteriorated, it is likely to indicate a most problematic sector for the banking groups.

[9] In the second quarter leasing grew by 1.2 billion kroons and factoring by 0.1 billion kroons.

Another issue is the quality of the leasing portfolio as the share of overdue loans exceeds that of the loan portfolio. The above is mostly due to different ways of handling problematic agreements as well as low agreement criteria. The issue is even more problematic considering the improved quality of the loan portfolio under the current economic recovery, which cannot be said about the leasing portfolio. On the other hand it could also indicate evolving hidden risks in the loan portfolio.

Investment Funds

No significant changes have taken place in the investment funds' market, the total volume shrank by 80 million kroons over the quarter, although in April the assets had hit the record high of the last two years – 1.6 billion kroons (see Figure 5.13). The volume shrank in money market funds and to a lesser extent in stock funds. This year two new funds have been added, launched already in the first quarter, totalling the number of funds to 15. No significant changes have taken place in productivity of interest rate and money market funds, in the former case it has been about 4–5% and in the latter – 3–4%. Thanks to the stock price increase earlier in the year, the annual yield has remained positive.

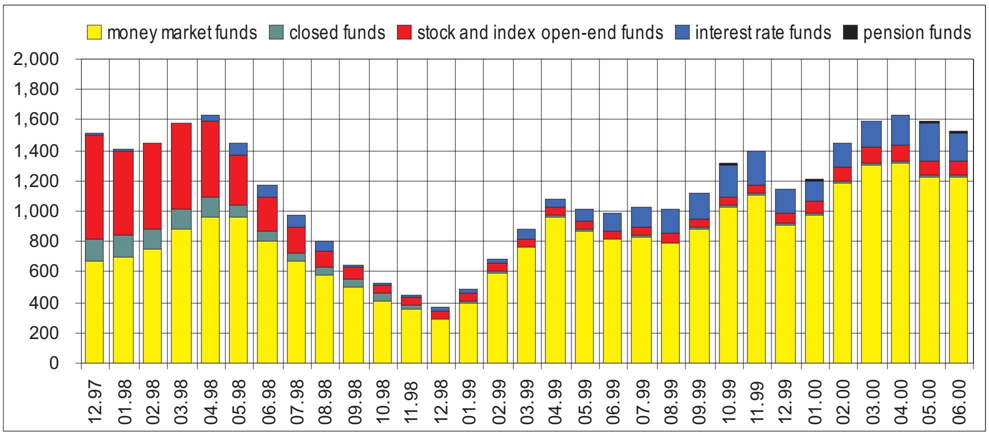

Figure 5.13. Volume of investment funds (EEK mn)

As regards competition, some changes have taken place in investment funds services. Since the second quarter the branch of Estonia's only foreign bank has offered Estonian investors an easier possibility to invest in foreign funds managed by the asset management company belonging to the same banking group.

Payment System

Against the second quarter of 2000 the number of payments has increased by 26%, reaching 4 million transactions per month. The payment turnover grew by more than 4% for the same period. A major change took place in domestic payments, the turnover increasing about 6%. The turnover of outgoing external payments increased over 4% and that of the incoming external payments more than 1% (see Figure 5.14).

In the first quarter of 2000 the competition to attract customers by electronic channels has gained pace. Within the innovative campaign the large banks have developed mostly new electronic product groups, mainly WAP-based banking products. In the second quarter Estonia's only branch of the foreign bank started offering Internet banking services. The local large banks upgraded their Internet banking as well, starting to provide apart from traditional banking services also other services (motor TPL insurance, access to telephone and electricity bills, e-commerce services, etc).

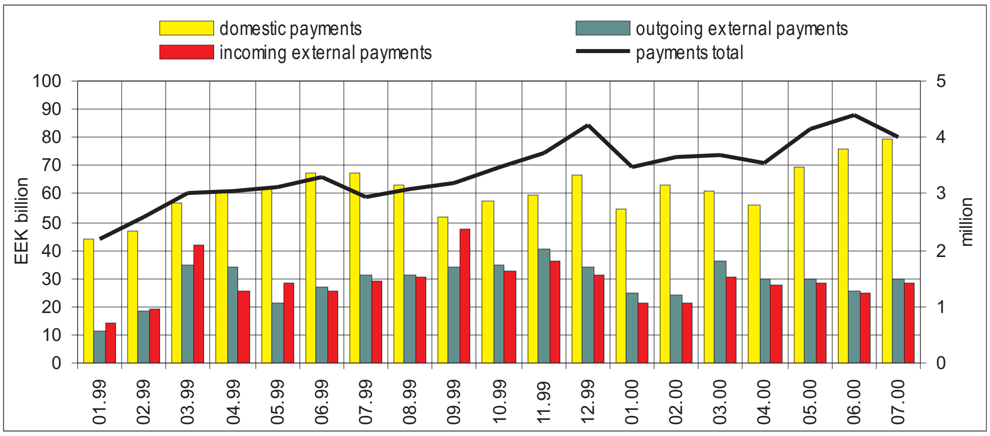

Figure 5.14. Turnover of payments by types (EEK billion, the left scale) and total number of payments (million, the right scale)

The results of the campaign have also influenced the payment structure: the shares of Internet banking and card payments in the electronic payment mode have grown the most, from 9.5% to 14.5% and from 25% to about 29%, respectively. Conventional paper-based payment orders keep decreasing in numbers. In the second quarter of 1999 the share of paper-based payment orders was about 19%, decreasing to 10% by the second quarter of 2000.