V
FINANCIAL SECTOR DEVELOPMENT

In recent years, domestic financing has been increasingly funded by external resources. Demand for housing loans has remained strong while a decline in interest rates promoting such demand has arisen from cheaper resources for on-lending as well as strengthening competition, which has made the banks reduce their interest margins. However, the profitability of banks has still remained rather solid, supported by cost control and loan quality, which has remained comparatively satisfactory so far.

As for other financial intermediaries, the primary bond market turned out to be relatively active in the first six months of 2004 compared to the second half of 2003 (see Figure 5.1).

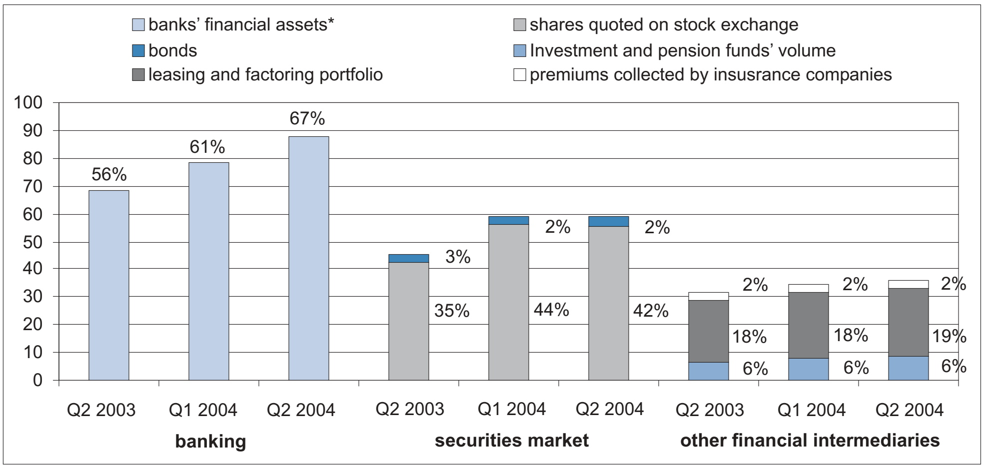

Figure 5.1. Estonian financial intermediaries (EEK bn and % of GDP)

* loans to financial institutions excluded

Share prices, which had seen strong growth at the start of the year, underwent a certain correction early in the second quarter, but started to rise again at the beginning of May. As for funds, the growth has so far focused on equity and pension funds. Meanwhile the growth in the assets of money market and interest funds has continued to slow down.

Banking

Banks' Assets and Their Quality

The total assets of the banking sector increased by 16 billion kroons in the first six months of 2004 and together with the growth in July and August the indicator has risen above the 117 billion kroon mark (see Figure 5.2). The volume of loan and leasing financing in Estonia went up by more than 8 billion kroons in the first half-year. The annual growth rate of financing did not slow down in July and August either and the balance of the loan and leasing portfolio increased by another 3.4 billion kroons.

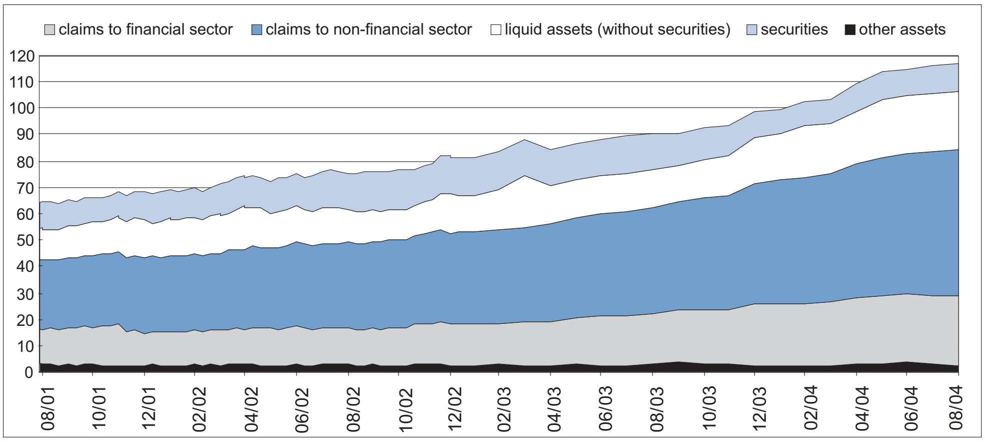

Figure 5.2. Banks' total assets (EEK bn)

Almost half of the growth in financing came from household loans, most of which was used for purchasing and renovating housing. Even though the year-on-year growth in the stock of housing loans and leasing facilities showed a slight slowdown towards summer, loan and leasing stock has, nevertheless, grown by more than 0.6–0.7 billion kroons monthly since March. The aggregate stock of household loan and leasing was reaching 30 billion kroons at the end of August.

As for other sectors, biggest growth in the first half-year was seen in trade financing (by 1.2 bn kroons), of which 0.5 billion kroons accounted for April. Commercial real estate financing grew by 0.7 billion kroons in the first six months The financing of commercial services increased by 0.6 billion kroons within the first six months while the financing of companies operating in manufacturing and transportation, storage and communications went up by 0.5 billion kroons (see Figure 5.3).

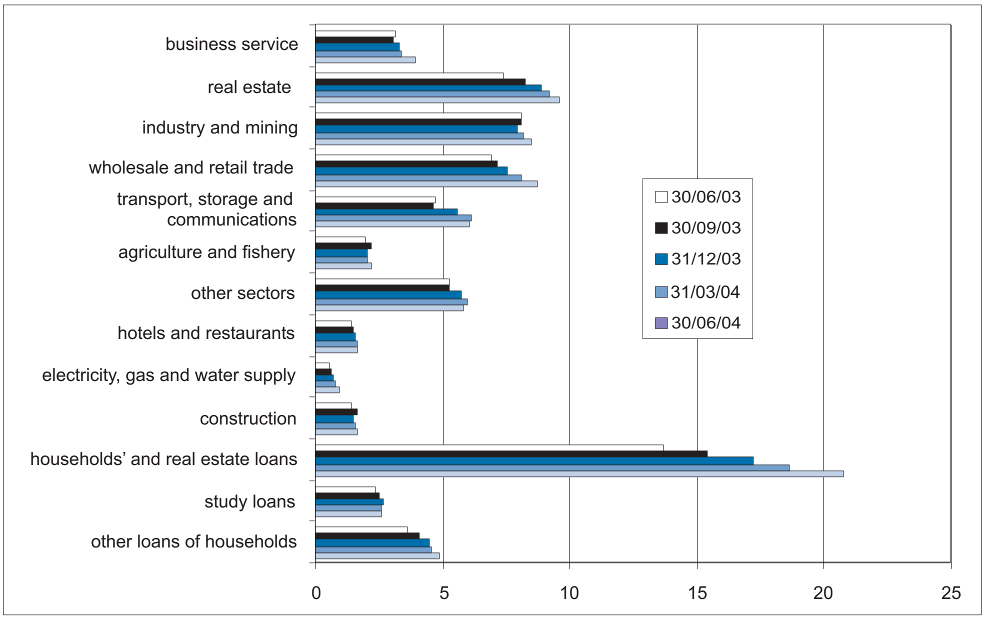

Figure 5.3. Total loan, leasing and factoring portfolio by sectors and purpose of loan (EEK bn)

The quality of the banks' loan portfolio still remained relatively satisfactory in the first half of 2004. The share of loans overdue more than 60 days remained below 1%, and the ratio of loan provisions to the loan portfolio stood at around 1.1% in the second quarter of 2004 (see Figure 5.4). However, when assessing ratios one has to bear in mind the phase of rapid loan portfolio growth. Among economic sectors, it is the industrial sector with the highest ratio of overdue loans (the share of loans overdue more than 60 days was 2.3% at the end of August).

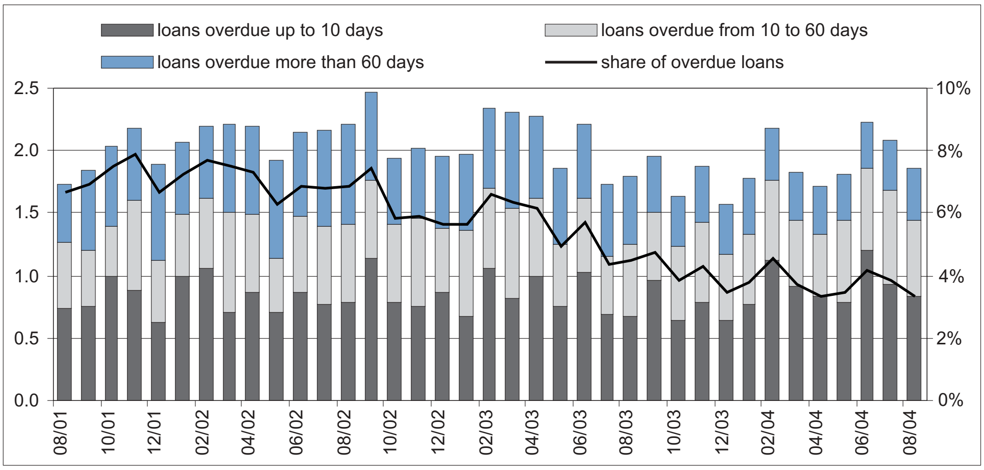

Figure 5.4. Volume of loans overdue (EEK bn; left scale) and their share in banks' loan portfolio (right scale)

Liabilities

The growth in financing has consistently outpaced that of domestic deposits, and in the first six months the external resources involved (institutional foreign borrowing) increased by more than 9 billion kroons, which raised the share of institutional foreign borrowing to 39% of all liabilities, while liabilities, to non-residents, equity capital exempted, accounted for 47% of all liabilities (see Figure 5.5).

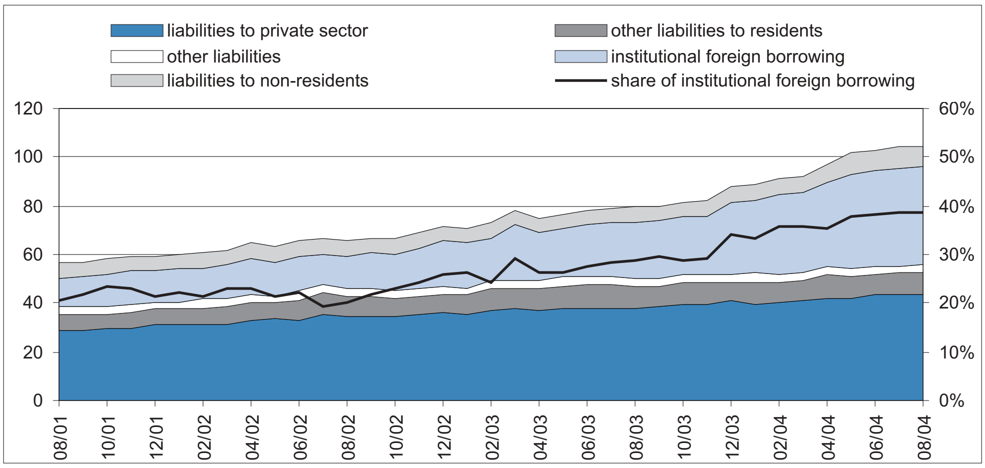

Figure 5.5. Banks' total liabilities (EEK m; left scale) and the share of institutional foreign borrowing (%; right scale)

The banks' total capital adequacy ratio rather declined during the first six months: to 13.0% on solo basis by the end of June. Nevertheless, the capital adequacy indicators of all banks have consistently remained above the 10% minimum stipulated in Estonia and the profits of the first half-year should also reflect in the capital adequacy ratios in the near future.

Return on Equity

Regardless of strong competition, the profitability of the banks has remained rather solid. Banks earned 1.5 billion kroons of profit on a solo basis in January-June, which is more than twice as much year-on-year. Still, a significant part of it accounted for dividend income earned from the activities of subsidiaries. The net profit of the accounting period totalled 1.8 billion kroons on a consolidated basis, which is 33% more than that in January-June last year. Return on equity stood at 20.8% on a solo basis and at 21.4% on a consolidated basis. Besides keeping costs under control (both solo and consolidated aggregate cost-income ratios have consistently declined) the so far relatively satisfactory quality of assets has contributed to maintaining profitability as well (see Table 5.1).

Table 5.1. Banks' profitability indicators

	Q2 2002	Q3 2002	Q4 2002	Q1 2003	Q2 2003	Q3 2003	Q4 2003	Q1 2004	Q2 2004
Equity multiplier	7.31	7.27	7.29	7.44	7.54	7.71	7.88	8.06	8.24
Return on equity	15.73%	21.17%	14.69%	15.38%	17.46%	12.61%	14.15%	13.81%	20.83%
Return on assets	2.43%	2.39%	1.55%	1.62%	1.54%	1.56%	1.70%	1.63%	2.38%
Profit margin	0.23	0.24	0.17	0.18	0.18	0.19	0.22	0.22	0.30
Net interest margin	3.73%	3.69%	3.59%	3.43%	3.32%	3.08%	2.91%	2.78%	2.62%
Spread	3.56%	3.53%	3.44%	3.28%	3.18%	2.94%	2.78%	2.66%	2.52%

Securities Market

Stock Market

At the end of 2003 the Tallinn Stock Exchange embarked on a robust and broad-based growth, which by the end of the first quarter of 2004 led the stock index to stand 19% higher than it had been at the end of 2003, i.e. at 339.38 points. The start of the second quarter witnessed a downward correction in share prices, which was yet followed by another rise at the beginning of May led by Hansabank's shares. In early July the stock index surpassed its pre-correction level (354.96 points), continuing to shift around that point until mid-September. The rise in the market turnover is an indication of renewed activity (see Figure 5.6). The average daily turnover of the Tallinn Stock Exchange amounted to 47 million kroons in the first half of 2004 (compared to 31 million kroons year-on-year).

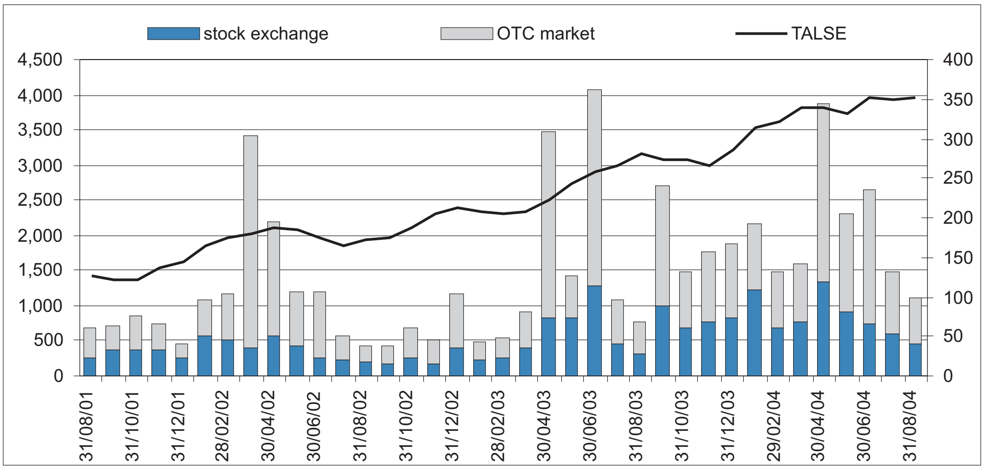

Figure 5.6. Stock turnover on the Tallinn Stock Exchange and over-the-counter market (EEK m; left scale) and the TALSE index (points; right scale)

Bond Market

The primary bond market was comparatively active in the first half of 2004. New bonds with the total value of 1.1 billion kroons were issued during the first two quarters, which boosted the market capitalisation to 3.1 billion kroons by the end of June. More than a half of the new bonds were issued by resident banks, while the rest accounted for non-residents and local companies. A couple of new issuers entered the market in the first quarter as well. The turnover of the secondary bond market remained lower in January-June 2004 compared to the previous year. The average daily turnover stood at 7 million kroons (see Figure 5.7).

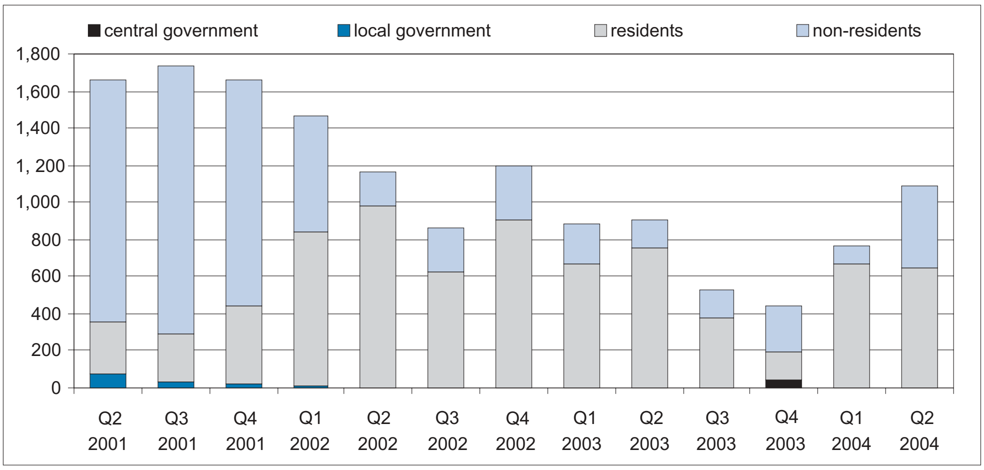

Figure 5.7. Volume of bonds issued during the quarter by issuers (EEK m; left scale)

Other Financial Intermediaries

Investment and Pension Funds

Besides shrinking yields of money market and interest funds (quarterly average of 1.7% and 3.3%, respectively) **the average yield of equity and pension funds declined in the first**

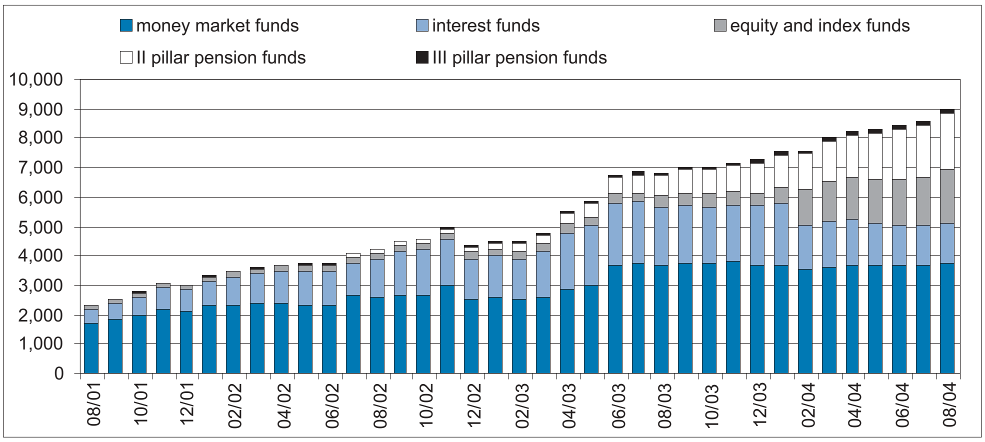

Figure 5.8. Volume of investment and pension funds (EEK m)

half-year as well, but still remained at a quite high level (e.g. the average yield of equity funds was 28%). As a result, the growth in the assets of money market and interest funds slowed down too and the rise focused on equity and pension funds, which, among other things, was also reflected in the launch of a new investment fund. The assets of investment and pension funds grew by 1.14 billion kroons in the first half of 2004, of which the assets of pension and equity funds increased by 666 million and 558 million kroons, respectively. Meanwhile the assets of interest funds shrank by 84 million kroons (see Figure 5.8).

Insurance

Life insurance companies collected 397 million kroons of gross premiums in the first half of 2004, which is 65% more than in 2003. The largest growth was in premiums collected under unit-linked and endowment insurance contracts, which also include insurance contracts for supplementary funded pension.

Non-life insurance companies collected 1.2 billion kroons of gross premiums in the first half of 2004, up 18% year-on-year (see Figure 5.9). Most of the growth came from premiums collected under motor third party liability insurance and voluntary motor insurance contracts. Property and travel insurance contributed significantly as well.

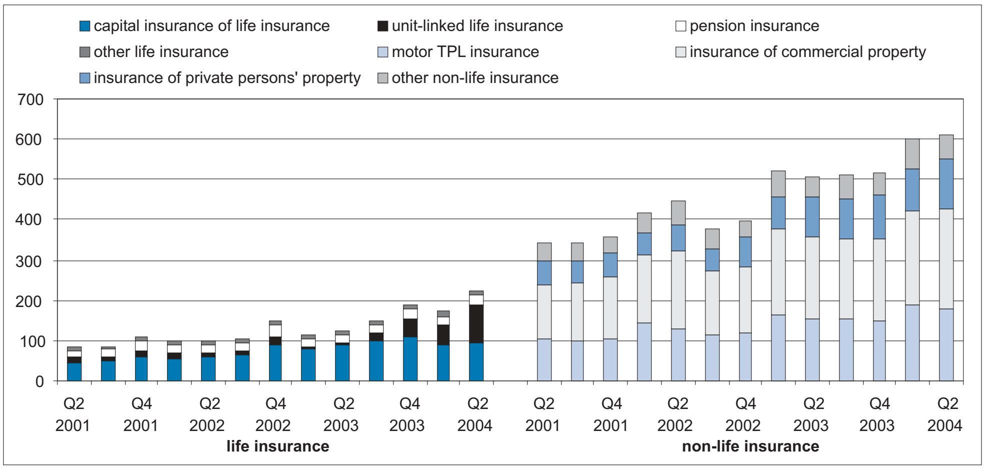

Figure 5.9. Gross premiums collected by insurance companies (EEK m)