ESTONIA'S BANKING SECTOR: WHAT IS ON THE AGENDA?

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The Estonian banking system comprises four large Scandinavian groups. Their combined market share amounts to 95% in respect of both the bank loans and customer deposits. Two groups have established themselves in Estonia as subsidiaries and two others as branches. The Estonian banking sector is thus fully integrated into the Scandinavian and European markets. It has undergone significant development after the accession to the European Union in 2004, characterized by rapid financial deepening, but also accelerating growth in credit to households and enterprises.

The banks operating in Estonia are well capitalised and profitable, and their liquidity frameworks remain robust. The credibility of the Estonian banking system is underpinned by banks' prudent loan policies, as their income derives mostly from loans to finance enterprises and household mortgages on conventional terms and against good collateral. As regards the credit risk, possible loan losses can well be absorbed by the operating profits and accumulated excess capital buffers.

Post-boom adjustment of credit growth

After a period of rapid financial deepening, the rate of annual credit growth has steadily decreased since mid-2007 and is expected to reach the level of 10% by end-2008. While the decline in yearly growth rates from the earlier level of 50% has been very substantial, monthly growth rates have nevertheless been hovering between 0.5% and 1.1% for the last six months. The Estonian banking system has, thus, avoided the credit crunch and has continued to provide financing to firms and households, commensurate with the economy's adjustment to a more sustained growth path.

In the context of economic adjustment after very strong growth in recent years, the moderation of credit expansion is mostly demand-driven; no major supply-side constraints appeared until this autumn. Most notably, the correction in the real estate market reduced the demand for new financing. Nevertheless, when global financial crisis escalated in the middle of September, the funding risk of parent banks increased. Raising external capital is now surrounded by higher risks for banks operating in Estonia, but as the demand for loans has eased, this will not significantly jeopardize further economic development.

The autumn forecast of Eesti Pank expects the period of modest credit growth to continue: annual credit growth is expected to decline to 4% in 2009 and remain at 6% in 2010. This will result in lower indebtedness both for the households and enterprises. Lower loan growth rates can be primarily expected in the fields of construction and real estate development. Credit to the industrial sector will witness stronger-than-average growth, as this segment of the economy should start a new upward cycle earlier than others. In the long term, however, the loan stock should continue to converge towards the levels similar to other advanced EU and Nordic economies[1].

[1] Income growth entails relatively high growth potential for the housing market, given the large differences in housing conditions across countries.

Funding risks to be assessed at group level

The liquidity management of Scandinavian banks operating in Estonia is centralized at the group level, which substantially reduces the funding risks. Decision-making regarding the allocation of funds between different parts of the group and obtaining market financing are carried out at the group level. Centralized liquidity management substantially reduces the funding risks, as funds can be reallocated among the group's sub-structures as needed. Moreover, the cost of market financing is broadly similar for all parts of the group and depends on the perceived risk of the entire group.

The sizable domestic liquidity buffers of the banking system have been ensured by the high reserve requirement, which is set at 15% of the total liabilities of a bank. As nearly 50% of the liabilities of the Estonian banking sector are accounted for by intra-group financing, the liquidity reserve requirement thus amounts to nearly 30% of customers' deposits. Moreover, centralized liquidity management renders intra-group roll-over risks virtually non-existent.

In addition to the strong liquidity framework, since June 2008 the financing needs of the Estonian banking system have been covered by an increase in domestic deposits and cash flows from loan repayments. The ongoing economic adjustment has supported domestic savings on the one hand, and has reduced the demand for credit on the other. Since this June, the two largest banks operating in Estonia have not increased their net liabilities *vis-à-vis* the rest of the groups.

Loan quality and profitability

The quality of the loan book has remained solid despite the correction in domestic demand, even if the share of overdue loans is expected to increase somewhat from the current levels. At the end of 2006 loans overdue for more than 60 days accounted for 0.3% of the loan portfolio, whereas in September 2008 that ratio stood at 2.2%. Based on the projected economic developments, the share of overdue loans is likely to increase further. According to our preliminary estimates, loans overdue for more than 60 days may range between 3-4% next year, which still remains below the levels reported at the time of the Russian crisis in 1998.

Banks' assessment on possible loan losses is reflected in the stock of loan provisions, which formed 0.4% of the loan portfolio at the end of September. The level of provisions may increase, as banks have already informed of higher possible loan losses for the coming periods. However, the loan losses will likely remain low enough to be covered by accumulated profits.

The average profitability of the Estonian banking sector stood at 17.2% in the third quarter of 2008 and the aggregate net profit was 1.2 billion kroons. This is only 6% less than the year before. Thus, the profit-making ability of banks has remained relatively good even in the context of the current global financial turmoil and the adjustment of the Estonian economy. The impact of banks' loan losses on profitability has so far been modest[2], and profits will increase the buffers for possible loan losses even further.

[2] Though the different provisioning practices applied by banks are reflected also in rather different profitability indicators.

The current capitalisation of banks remains strong, with the aggregate capital adequacy ratio standing at 18% in September 2008. This is well above the 10% minimum requirement. All major banks have included the retained profits of previous periods in their own funds, which are, in part, contributing to the high levels of bank capital.

Policy measures

The recent measures of Swedish government and the Riksbank to improve the funding situation of Swedish banking groups have positive effects on the liquidity of subsidiaries in the Baltic countries. These measures were highly welcomed by the major market participants in Estonia. Moreover, these steps have substantially contributed to the credibility of the Estonian financial system, as positively pointed out also by external observers.

Estonia is well placed to ensure financial stability, in cooperation with home countries as the implementation of crisis management and resolution measures will have a cross-border dimension. Strong fiscal position, the government's sizable foreign assets of around 9% of GDP, virtually non-existent public debt and large cushions in the banking system provide the authorities with sufficient room for manoeuvre, if needed. In the context of the current market turmoil, Estonia has increased the amount of insured deposits to €50,000 and abolished the co-insurance principle in line with the new EU standards. The government is also streamlining technical aspects of the crisis resolution framework, including providing guarantees or capital injection promptly, if needed.