

## II BANKING SECTOR STABILITY AND RISKS

### Strategic development of the banking sector

At the end of the third quarter of 2007, seven companies licensed as credit institutions, seven branches of foreign credit institutions and over 170 cross-border banking service providers were operating in the Estonian banking market. Over 30 cross-border service providers have emerged during the past six months.

On 1 September 2007, the name of Bayerische Hypo- und Vereinsbank AG Tallinn Branch was changed to AS UniCredit Bank Estonian Branch as a result of the expansion and merger of UniCredit Group.

As the growth of the loan market has slowed and credit institutions have responded differently to that, market shares have also changed more than usual during the past six months. Major banks implementing more conservative credit policy have lost market share during the last half-year. Greater market share has been achieved by somewhat more active branches. At the end of the third quarter, 95% of the total amount of loans and leases granted in Estonia divided between four major market participants whereas two major market participants occupied 74% of the market. The assets of credit institutions controlled by branches of foreign credit institutions or non-resident financial groups accounted for nearly 100% of the total assets of banks operating in Estonia.

Operating in the neighbouring countries forms an essential part of Estonian banking groups' activities. When in Estonia and Latvia the credit growth is normalising, there is still potential to increase the amount of loans in Lithuania and Russia. Moreover, at the beginning of September, the Central Bank of Russia decided to lift the restrictions on Swedbank

at the beginning of June and permit Swedbank to fully resume its activities.<sup>1</sup>

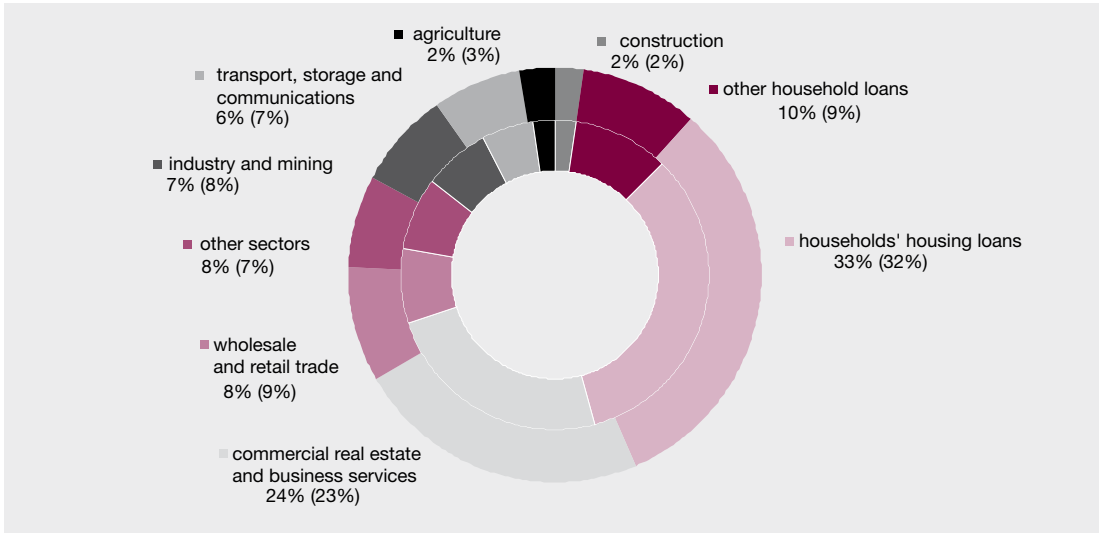
### Quality of assets

The **total value of bank loans and leases** granted in Estonia was approaching 247 billion kroons at the end of the third quarter of 2007. Within the two last quarters, the total value of the financing portfolios increased by 31 billion kroons. The structure of the financing portfolio has generally been stable and the shares of loans granted to different sectors have not significantly changed (see Figure 1).

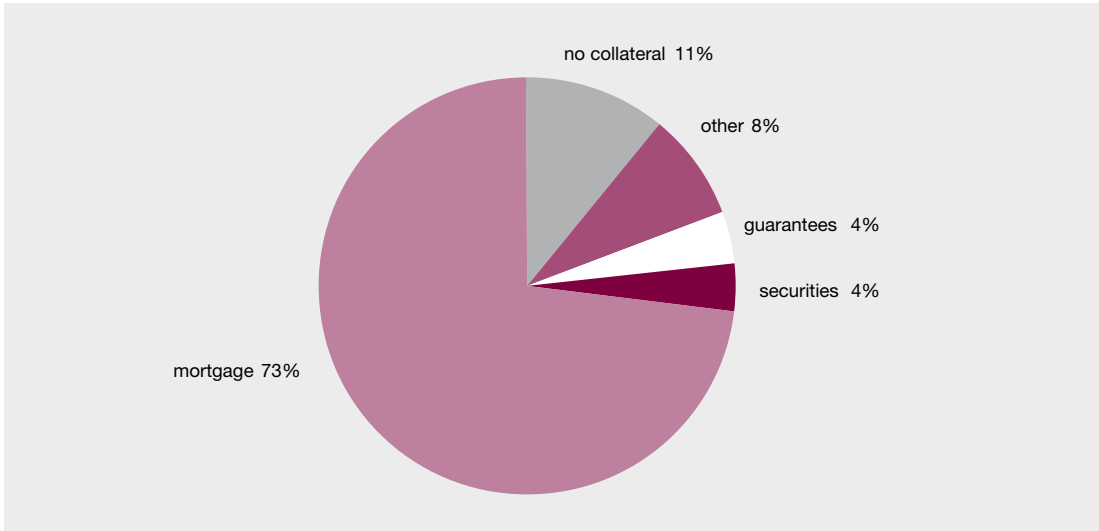
Arising from the structure of the banks' financing portfolio, bank loan **collaterals** consist primarily of real estate. At the end of the third quarter, 73% of granted loans were mortgage-backed. The share of loans without collateral has remained comparatively stable during the last quarters; however, the share of securities has started to increase slightly. Among other household loans (non-housing loans), the share of loans without collateral has remained steady at 32% during the last year. As regards consumer credit, the share of loans without collateral is decreasing evenly: a year ago, 44% of consumption loans were without collateral, whereas in the third quarter of 2007 the respective figure stood at 40%.

The loan-servicing capability of loan customers has remained good despite the tightening economic conditions and stricter credit policy. At the end of the third quarter, the share of **loans overdue by more than 60 days** among loans granted to the non-financial sector totalled 0.5% on an aggregate basis. Following a more conservative approach where the amount of loans overdue by more than 60 days is considered as a ratio to the previous year's loan portfolio, the amount of loans

<sup>1</sup> In June 2007, the Central Bank of Russia decided to restrict Swedbank's activities in Russia for three months, explaining this by Swedbank's possible non-compliance with the law.



**Figure 1. Financing by banks and leasing companies as at 30 September 2007 (in brackets as at 30 September 2006)**

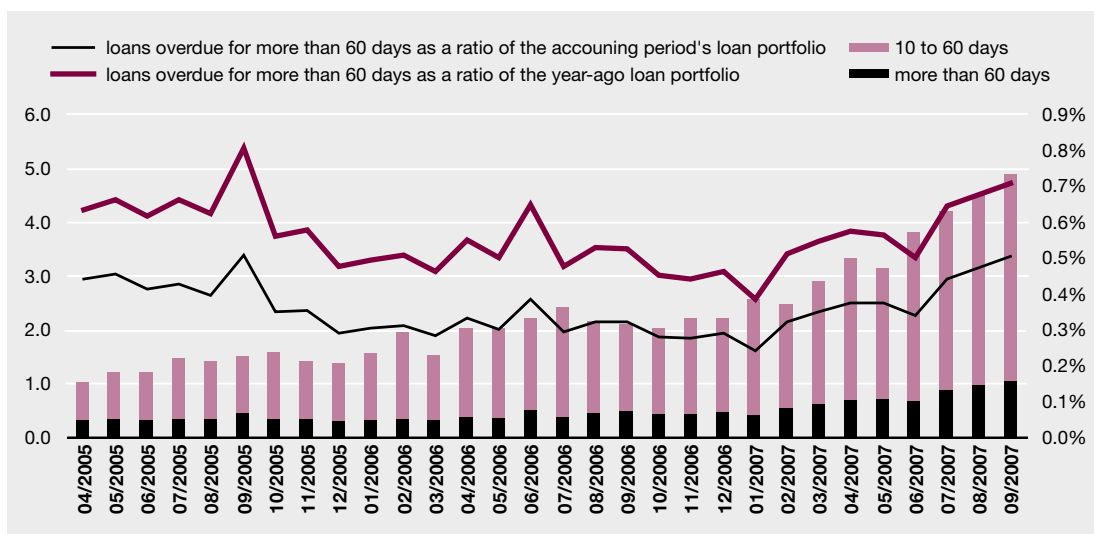


**Figure 2. Loan collaterals by type**

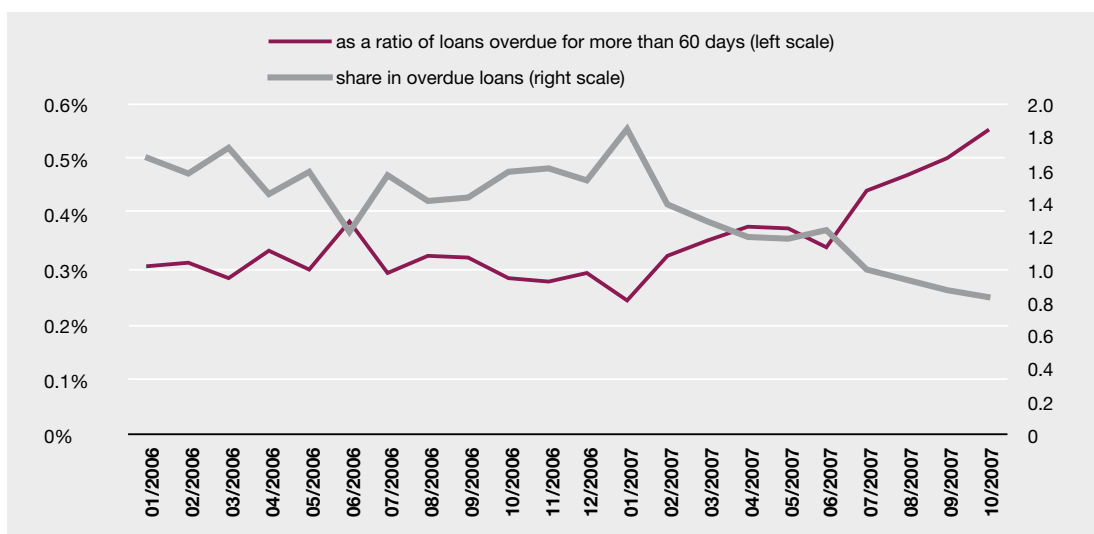
overdue was 0.71% at the end of the third quarter. Compared to the previous year, it had increased by 0.2 percentage points (see Figure 3).

The **stock of provisions for loan losses** (as a ratio to the amount of loans overdue by more than

60 days) has decreased considerably during the past six months (see Figure 4). This is due to changes in accounting principles. Previously, the stock of provisions for loan losses exceeded the value of loans overdue by more than 60 days, whereas since the third quarter of 2007 it has been



**Figure 3. Volume (EEK bn; left scale) and share (right scale) of overdue loans in the non-financial sector's loan portfolio**



**Figure 4. Stock of provisions for loan losses**

lower than the latter. At the end of the third quarter, the stock of provisions for loan losses accounted for 87% of the loans overdue by more than 60 days. This is quite normal, as in Western Europe and Nordic countries this ratio has ranged from 60% to 80% in recent years.

The slight increase in the share of overdue loans in the last quarters is the result of several aspects. First of all, the growth of financing portfolios has decelerated. If their growth rate in 2007 had remained close to that in 2006, the share of overdue loans would not have changed remarkably and the ratio of overdue loans would have been comparable to the 2006 figure. Secondly, the increase in overdue loans was affected by the slowing economic growth. Thirdly, the specific nature of the business model of some financial institutions had also a role to play; the problem of overdue consumer loans rests with one institution.

By **economic sectors**, other household loans form the largest share of overdue loans. At the end of the third quarter, these loans comprised 2.78%

of loans overdue by more than 60 days (see Figure 5). This figure has been steadily increasing, being 1.4% a year ago. Failing to pay consumer loans by due date is affected by the toughening economic environment as well as by the fact that these loans are readily available.

The amount of overdue housing loans has also increased steadily. While a year ago, loans overdue by more than 60 days accounted for 0.19% of all housing loans, then at the end of the third quarter of 2007 this ratio was 0.41%.

As regards the **total of banking groups**, the share of write-downs in the loan portfolio has remained more or less unchanged at 0.7% of the aggregate portfolio of banking groups. The share of loans overdue by more than 60 days in the groups' financing portfolio has also remained relatively stable, accounting for 0.4% of the aggregate portfolio at the end of the third quarter. Total write-downs of banking groups exceeded the amount of loans overdue for more than 60 days by 1.6 times.

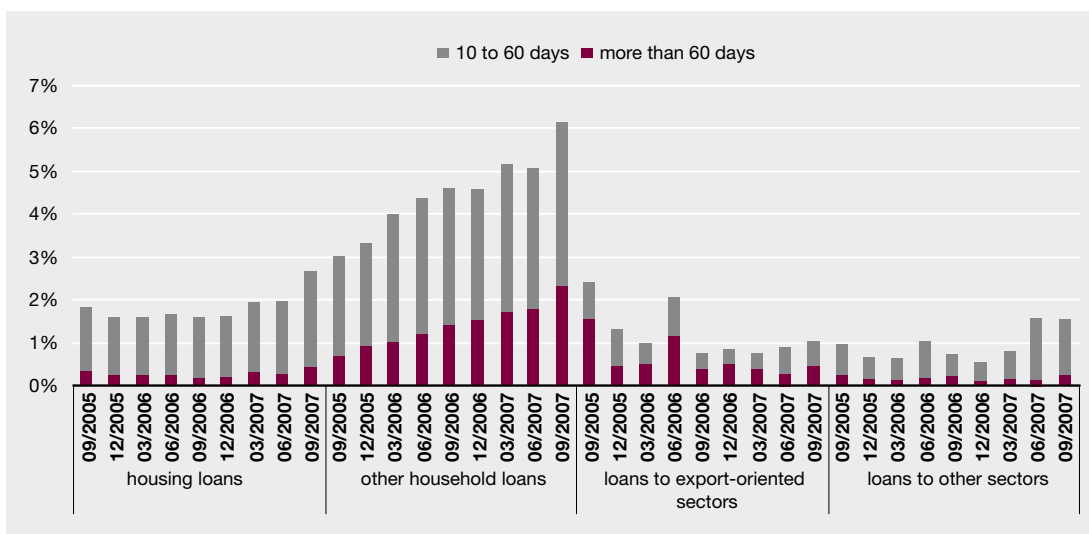


Figure 5. Overdue loans by sectors

## Capital adequacy

On 1 January 2007, the new capital adequacy calculation principles entered into force in Estonia<sup>2</sup>, but all banks decided to use the opportunity to calculate the adequacy ratio in 2007 on the basis of the former system. As of 2008, all credit institutions operating in Estonia start using the standard approach for calculating capital adequacy. The introduction of more complicated methods for calculating capital requirements for credit risk is an issue for the future.

On a solo basis, the **banks' capital adequacy ratio** has been 3–4% above the required minimum level during the last two quarters. At the end of October, it stood at 14.3% (see Figure 6). As banks use very different methods to include additional own funds, there are great differences in their adequacy ratios. Capital adequacy of most banks operating in Estonia exceeds the required minimum level by several percentages, but there are also banks in the case of which the inclusion

of additional own funds is a constant issue. So far, such an operational model has worked satisfactorily – audited profits or additional funds from parent banks have been included in own funds, if necessary. Consolidated capital adequacy indicators, too, differ substantially across banking groups (from 10.4 to 11.2%).

At the end of the third quarter, banks' **net own funds** reached 33.6 billion kroons, 71% of which consisted of Tier 1 own funds (see Figures 7 and 8).

Contrary to previous quarters, the share of Tier 2 own funds in gross own funds decreased again in the third quarter of 2007 (in the second quarter, the ratio was 38%). This was caused by the more balanced growth of risk assets for which the inclusion of additional own funds ceased to be an issue. In order to cover the increasing risk assets, the inclusion of retained earnings in own funds, for instance, will suffice.

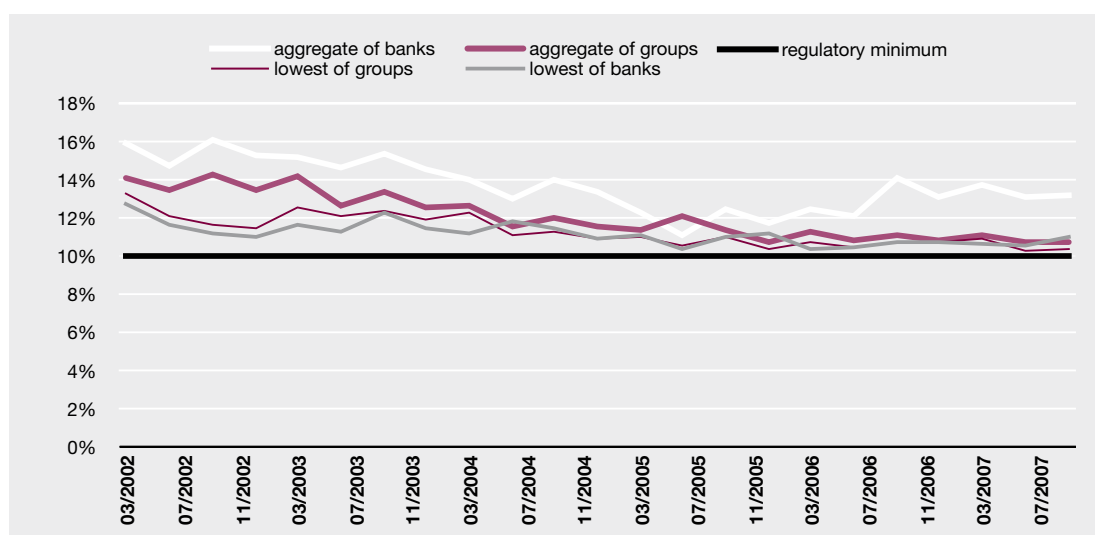


Figure 6. Capital adequacy of banks and banking groups

<sup>2</sup> A more risk-sensitive adequacy calculation system based on the new capital adequacy accord (Basel II).

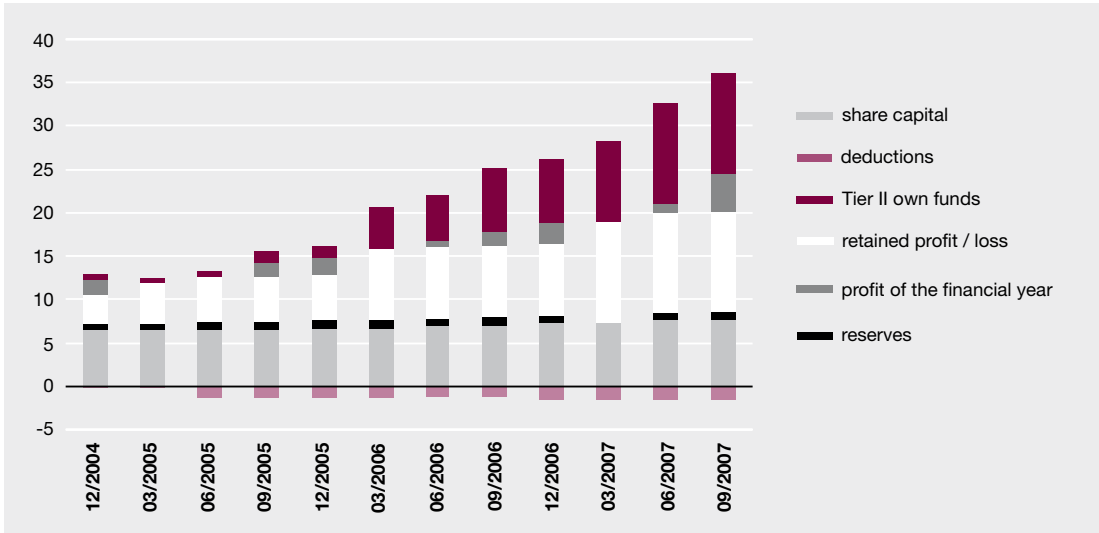


Figure 7. Structure of banks' own funds (EEK bn)

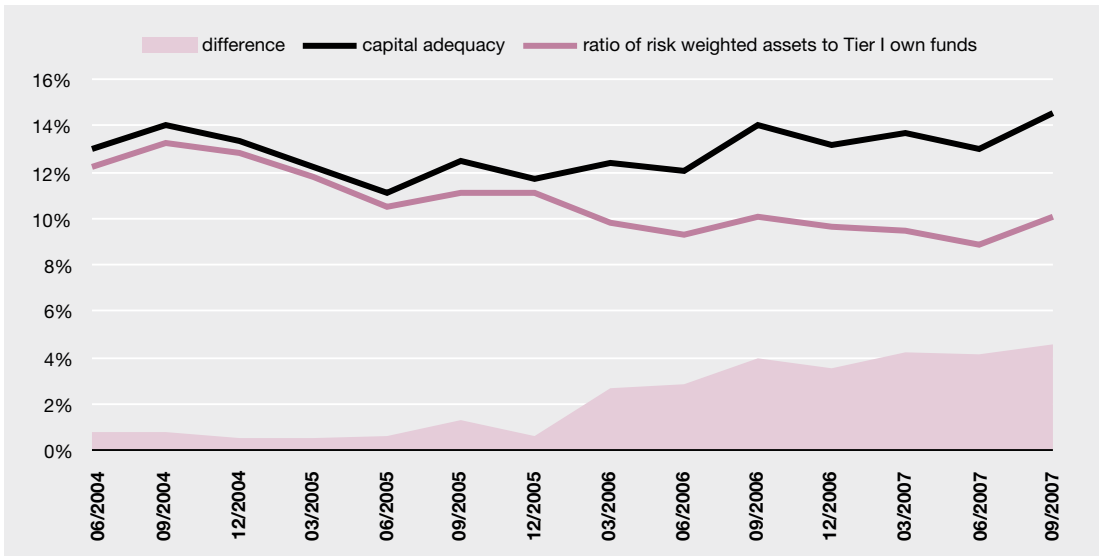


Figure 8. Tier I capital adequacy and the key indicator of capital adequacy

In the course of stress testing overdue loans by using a framework based on macroeconomic indicators, the main scenario of Eesti Pank's macroeconomic forecast was played through. This was done on the assumption that overdue loans would be equal to loan losses (conservative approach) and

that profitability would remain at its current level. According to the forecast based on these criteria, the amount of loans overdue of the non-financial sector will increase to 1.3% by the end of 2009, but all banks will still be able to meet the capital requirements in these circumstances.

## Liquidity

### Funding

The growth of loan portfolios has slowed but as deposit growth has decelerated, the **gap between banks' deposits and loans** widened also in the last quarters (see Figure 9). To fill this gap, additional funds have been continually received mainly from parent banks.

At the end of September, the share of **foreign loans** in banks' liabilities reached 47% (128 billion kroons). The structure of banks' external financing has not changed much within the past six months. Resources received from parent banks as deposits and loans account for nearly 80% of the external resources other than deposits from non-resident clients. Another 9% comes from subordinated claims of parent banks; the share of such claims has increased due to the required higher share of own funds as of March 2006.

The share of resources raised by issuing bonds remained almost unchanged also in the last two

quarters. Over two thirds of bond liabilities consist of long-term funds received in earlier periods.

Higher ratings of parent banks have enabled them to raise funds from markets at a presumably more favourable price compared to the opportunities of local banks. This has enabled parent banks to charge lower **funding costs** from local banks compared to what has been paid to local clients for term deposits (see Figure 10). The profitability of banks has continuously been supported by a relatively large share of demand deposits in total deposits, as these are less sensitive to the changes in key interest rates. The share of demand deposits reached nearly two thirds (see Figure 11 and also *Efficiency and profitability*, the development of the spread).

### Liquid assets

After the rearrangement of intra-group financing schemes in the first half of 2006, the **share of liquid assets** in banks' assets has been relatively stable over the last quarters. The higher reserve requirement established in autumn 2006 can also

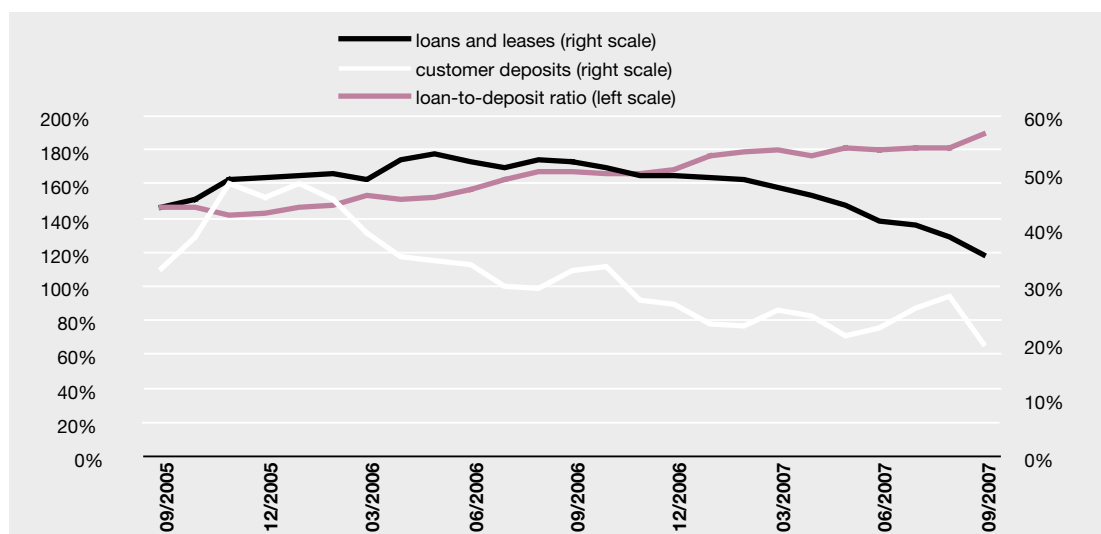


Figure 9. Annual growth of loans, leasing and deposits and loan-to-deposit ratio

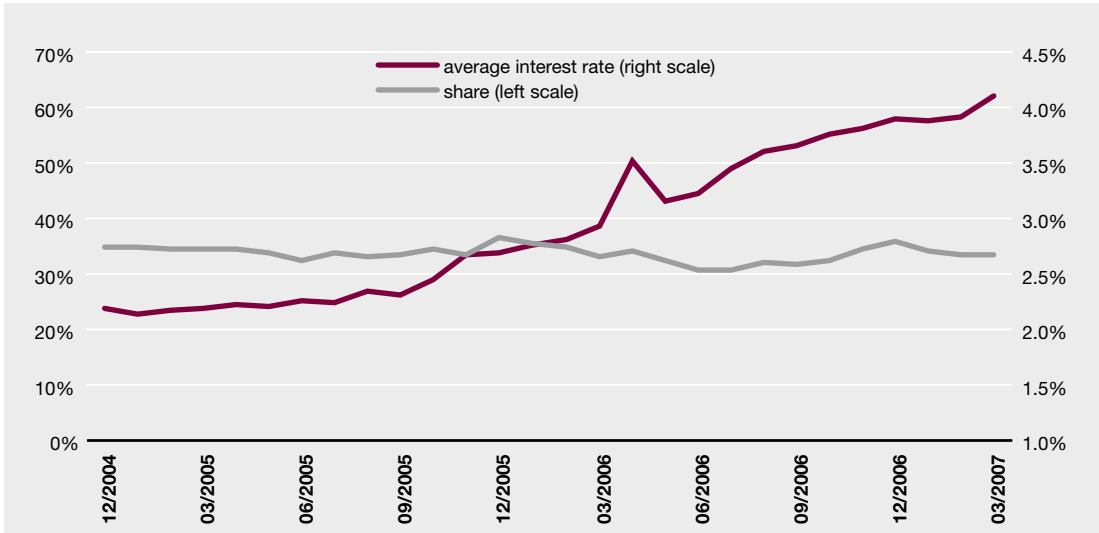


Figure 10. Average interest rate on time deposits and the share of time deposits in total deposits

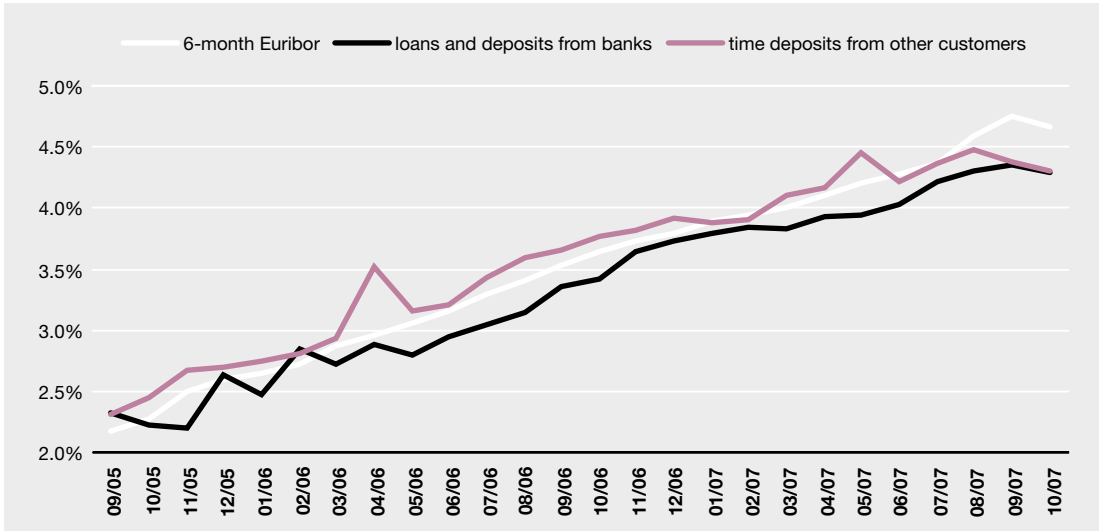
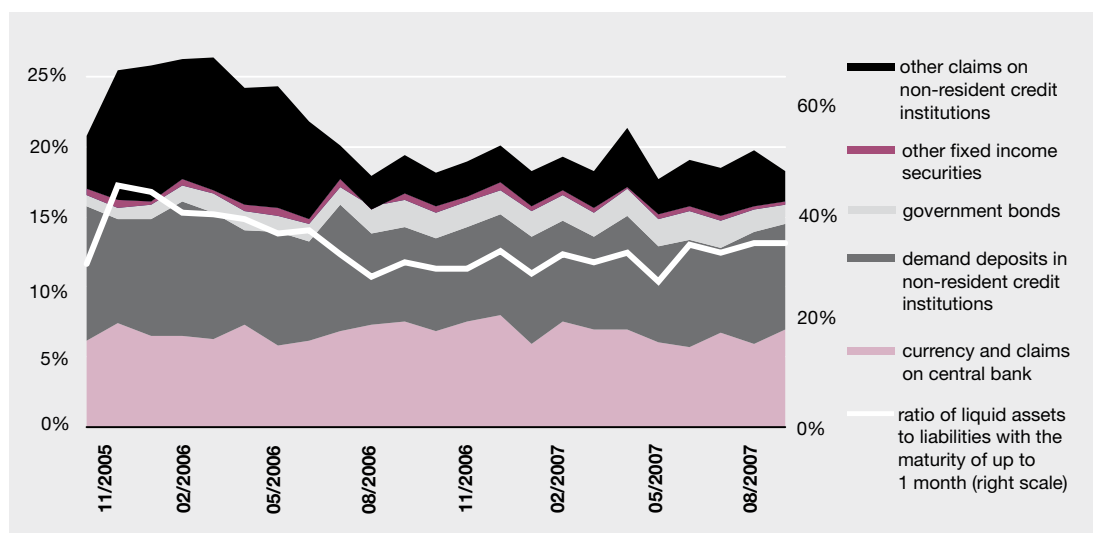


Figure 11. Average interest paid by banks on funds raised and 6-month Euribor



**Figure 12. Liquid assets of banks (% of total assets)**

be considered as a contributing factor (see Figure 12).

On an aggregate basis, the coverage of current liabilities by liquid assets has nevertheless remained relatively similar to previous levels. The ratio of short-term liabilities to short-term claims has remained relatively stable as well.

Since parent banks still play a major role in financing their subsidiaries in Estonia, the banks' liquidity risk is largely related to the parent banks' ability and will to provide funds to local banks.

### Efficiency and profitability

Despite the slowdown in the growth of loan portfolios and higher funding costs, banks' profitability has remained high.

In the third quarter of 2007, banks' aggregate **net profits of the last four quarters** exceeded 7 billion kroons. A large share of the profits comes from the dividend income paid by subsidiaries this year. The **profitability of banks' own funds as the moving average of the four last quarters** has remained above 30% in the last two quarters (see Tables 1 and 2).

**Table 1. Profitability of banks (%)**

	2004	2005	2006	Q1 2007	Q2 2007	Q3 2007
Return on assets	2.1	2.0	1.7	1.8	2.8	2.7
Equity multiplier	8.8	9.9	10.7	10.7	10.6	10.6
Return on equity	20.0	21.0	19.8	21.2	32.3	31.0
Cost-to-income ratio	45.8	45.6	46.6	45.1	35.8	35.9
Net interest margin	2.4	2.0	2.2	2.3	2.4	2.4
Spread	2.3	1.9	2.1	2.2	2.2	2.2

**Table 2. Profitability of banking groups (%)**

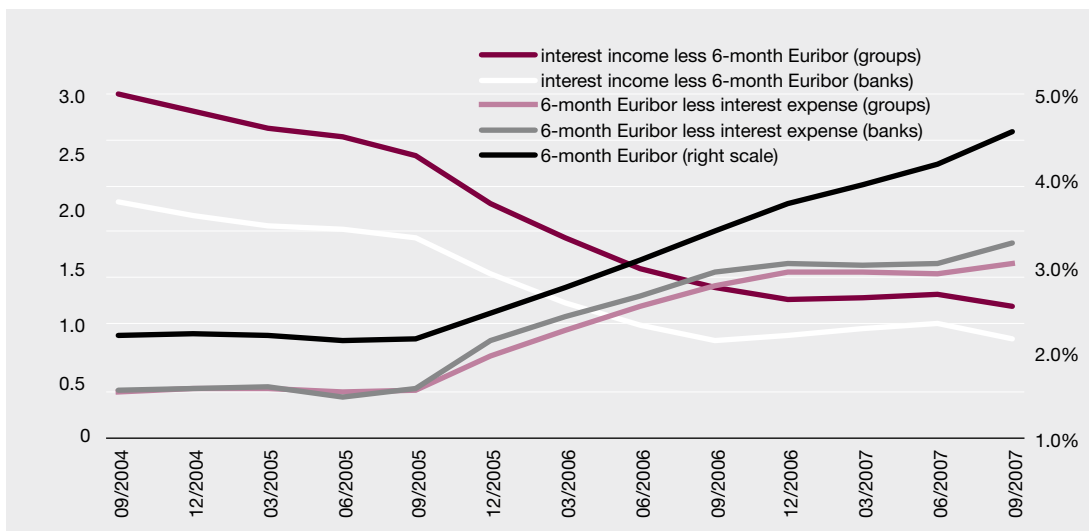
	2004	2005	2006	Q1 2007	Q2 2007	Q3 2007
Return on assets	2.2	2.1	2.0	2.0	2.1	2.1
Equity multiplier	9.7	10.7	12.4	12.7	13.0	13.1
Return on equity	22.8	23.5	25.5	26.5	28.8	28.6
Cost-to-income ratio	49.7	46.6	43.3	42.3	41.2	41.4
Net interest margin	3.4	2.9	2.8	2.9	2.9	2.8
Spread	3.3	2.8	2.7	2.7	2.7	2.6

At the end of the third quarter of 2007, the net profit of banking groups as the sum of four consecutive quarters reached 9.8 billion kroons. This means that the annual growth exceeded even 60%. Despite the modest fall in the third quarter, the profitability of banking groups has remained above 28%, thus still exceeding the results of major Nordic banks even by as much as a third.

Although **funding costs have risen** and the spread between the income on assets and interests paid on liabilities has slightly decreased, the ratio of net interest income to average assets has remained almost similar to the second-quarter figure both in terms of banks and banking groups. In

the case of banks, the growth of funding costs was largely passed on to clients, whereas its impact on banking groups was somewhat stronger (see Figures 13 and 14). The recent volatility of financial markets has not influenced banks' profitability substantially. The figures for the **trading income** of banking groups indicate slightly lower results for the third quarter compared to the second quarter. Banks, on the other hand, posted even higher results quarter-on-quarter.

Even more than the higher funding costs and the volatility of financial markets, the profitability of assets has been influenced by a slowdown in the growth of **fee and commission income**. This



**Figure 13. Interest margins**

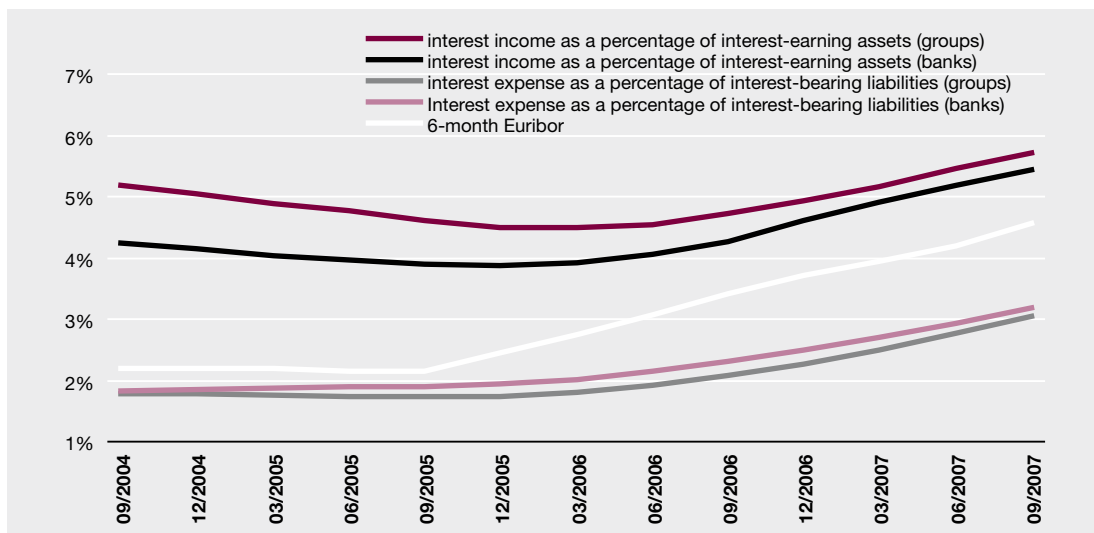


Figure 14. Spread

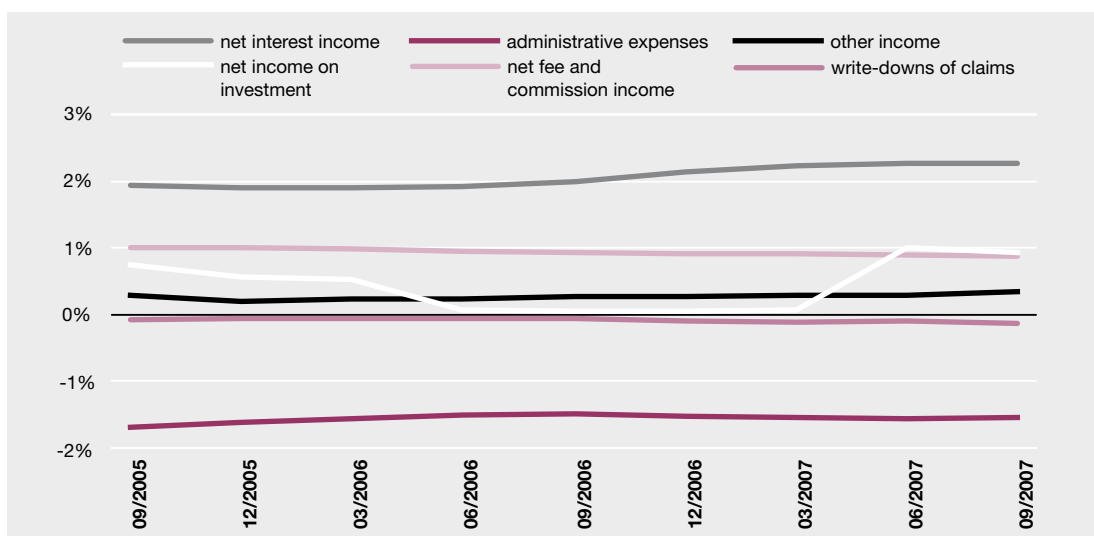


Figure 15. Income and expense items of banks (% of total assets)

could be observed in the case of banks as well as banking groups (see Figures 15 and 16). Although banks receive the majority of fee and commission income on payment intermediation, the increase in income has been inhibited, inter alia, by changed market conditions for borrowing and changing loan

terms and conditions. Since key interest rates have gradually risen, a stronger demand for fixing the interest rate could be expected. However, statistics do not confirm any substantial changes in loan terms and conditions.

The slowdown in the growth of asset utilisation has been offset by a moderate rise in **administrative expenses** both across banks and groups.

At the same time, an **increase in the write-downs of claims** has reduced the expected favourable impact of the cut-down on expenses. Consequently, on an aggregate basis, banks were unable to retain the second-quarter profitability of asset in the third quarter. In the case of banks, write-downs have curbed net profits by 4.5% (0.3 billion kroons) in the last four quarters. As concerns groups, without write-downs their profits over the past four quarters would have been 9% (0.9 billion kroons) higher.

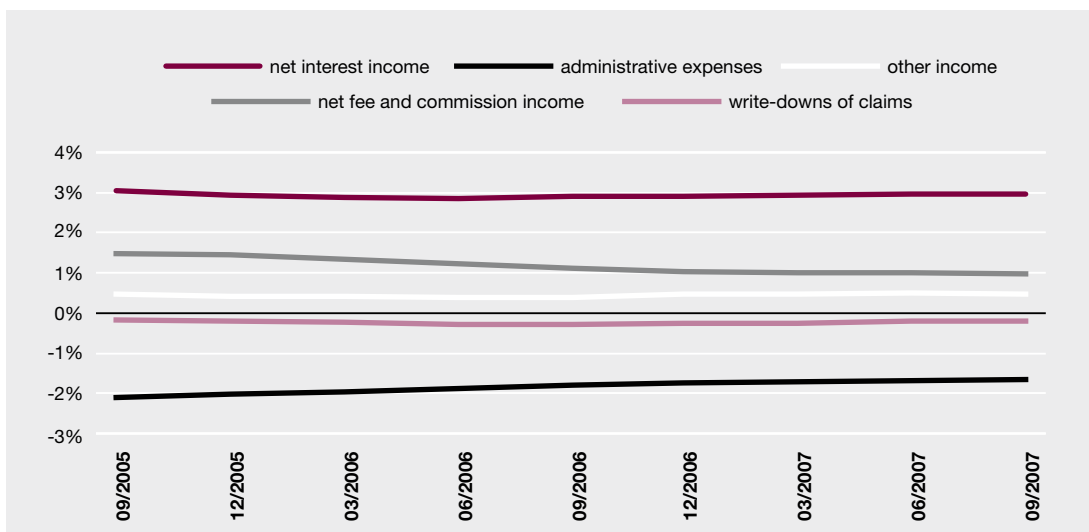
The future **profitability of banks** depends, on the one hand, largely on the further developments in funding costs. As most of the loans in Estonia have been granted with a floating interest rate, the growth of funding costs is to a great extent transferred on to clients with some delay. On the other hand, profitability is supported by the large share of demand deposits, as these are less sensitive to the changes in key interest rates. Yet in the case

of loans granted by banking groups in other markets, the use of fixed interest rate is more common. The growth in the share of resources received from parent banks increases the dependency of banks' profitability on the price that parent banks ask for funds.

The slowdown in credit growth manifests itself also in fee and commission income. At the same time, local banks earn the majority of fee and commission income on payment intermediation services, whereas the volume of these services is not expected to fall abruptly.

The future profitability of banks will definitely be affected by further changes in customers' ability to service their loans and banks' flexibility in cost management.

Banks' third-quarter results give some confidence that although the profitability might slightly decrease in the future owing to loan losses and the slowdown in credit growth, banks are capable of responding to that relatively fast (though probably in a limited scope) by cutting down on expenses.



**Figure 16. Income and expense items of banking groups (% of total assets)**