

## SUMMARY

### **External environment and the Estonian economy**

The liquidity situation in international financial markets, as well as interbank confidence have improved further over the past half a year. Several signs refer to the withdrawal of the recession in both the USA and euro area. However, central banks are unlikely to undertake a rapid tightening of monetary policy in the light of low inflation, the continuously weak outlook and growing unemployment. As a result, money market interest rates in the euro area will remain at a very low level in 2010.

According to Eesti Pank's autumn forecast, the Estonian economy will stabilise next year and resume growth thereafter. The baseline forecast scenario expects real GDP growth to amount to 1.4% in 2010 and to 4.7% in 2011. External demand is assumed to pick up, which will give a strong boost to growth. If Estonia is able to meet all the criteria necessary for the adoption of the euro as of the start of 2011, the related increase in credibility will lay a strong foundation for growth in investment activity. The income of Estonia's companies and households will be more modest in the near future, but this will be somewhat alleviated by the low level of consumer prices and interest rates.

### **Financial behaviour of companies and households and related risks**

The **corporate sector** markedly reduced its financial liabilities in 2009, whereas domestic loans declined more than foreign ones. Although the financial position of enterprises has slightly improved owing to the reduction in debt, the growing number of bankruptcy petitions shows the financial situation is tense. Since risks accumulated differently across sectors in previous years, construction and real estate companies are facing the severest financial difficulties at the moment.

The financial behaviour of **households** has become notably more conservative over the past year. Households' loan-based expenditure has been notably curbed, yet, their deposit volume has remained stable irrespective of tense budgets. Negative economic developments have reduced the monthly income of numerous households with a loan burden and also weakened their loan servicing ability. At the same time, owing to the low level of the key interest rates, monthly loan repayments are smaller for both companies and households. However, if the tense economic situation persists, the resources accumulated in good times will be exhausted and payment difficulties may increase.

The developments of the **office space market** in Tallinn were in the past half-year impacted by the large amount of new office spaces due to active real estate development activity in recent years. At the same time, economic difficulties have decreased companies' solvency and their need for new office spaces. As a result, the vacancy rate is expected to grow in the near future, whereas rental prices are likely to fall. On the other hand, compared to Nordic capitals, there are relatively few office spaces in Tallinn, so demand for them should recover in the long term.

Transaction activity in the Tallinn **housing market** has picked up in the second half of 2009, but the pace of price movements is somewhat slower. It is easier for households with an average income to acquire an apartment now than in previous years, although lending conditions have become stricter. Looking ahead, demand for both new housing and the renovation of old dwellings is likely to resume. With this in view, construction companies are likely to start their first new development projects next year.

### **Banking sector**

The 2009 performance results of the **consolidated banking groups of the banks operating**

**in Estonia** have to a great extent been influenced by the need to write down both the non-financial sector loan portfolio and goodwill. In order to ensure credibility, banking groups have increased their capitalisation by extending share capital and including subordinated loans. In addition, banking groups have ceased to pay dividends or decreased the volume of dividends paid.

Looking ahead, posting losses in the next quarters cannot be excluded, but the income base and the level of capitalisation allow to expect that the groups will manage with the need to write down possible new overdue loans.

The continuation of national support programmes has reinforced the banking groups' opportunities to attract funding from markets. However, in most cases this has been done without using the national support measures. The decline in the price of the funds borrowed also shows that risks have diminished.

In the **Estonian market**, the past quarters' activity of banks has been most affected by weak credit demand and the increase in overdue loans. The rapid growth in the volume of **loans overdue for more than 60 days** inhibited in mid-2009 and the volume of such loans even decreased in the autumn months. Overdue loans accounted for more than 6% of the banks' loan and leasing portfolio at the end of October. Write-downs by banks made up some 4% of the value of the non-financial sector's financing portfolio, which means that more than 60% of the overdue loans are already covered by provisions.

Because of weaker credit demand, the banks' need for **additional funds** has declined. Although tensions in the international financial markets have abated and parent banks are able to offer their subsidiaries and branches in Estonia funds at a price close to that of the interbank money market, the local branches of the groups have continued to include deposits at relatively high interest rates.

Since the volume of new loans issued is markedly smaller than in previous years, it is difficult for banks to increase the net interest income without reducing interest expenses. At the same time, it is likely 2010 will be **profitable** for most of the banks, although several banks may post losses in the first half of the year due to write-downs and low interest income.

The average **capitalisation** of the banking sector has increased somewhat in 2009, amounting to 21.4% by end-September (14.5% for groups). This has been caused by both the increase in own funds on account of the addition of audited profits and the decrease in risk-weighted assets. The latter is largely dependent on the transfer of the two largest banks operating in Estonia to the internal ratings based method for calculating the capital requirements for credit risk and to the advanced measurement approach for calculating operational risk. At the start of 2010, capitalisation growth will be supported by the fact that restrictions on the decrease in risk-weighted assets enforced for the period of transfer to the new methods will expire at end-2009.

#### **Other financial markets**

The very low **bond market** activity characteristic of previous periods was triggered by two large emissions: that of the city of Tallinn and the emission performed to restructure the GILD Arbitrage Venture Capital Fund. The market capitalisation of bonds declined by 20% year-on-year, to 10 billion kroons, most of which was composed of bonds with a high credit risk.

The transaction activity and prices in the **Tallinn Stock Exchange** were boosted by TeliaSonera AB's announcement in August concerning the acquisition of Eesti Telekom. This caused the stock exchange index to rise by 33% and the capitalisation of the market grew to 32 billion kroons by end-September. The average daily turnover increased by nearly threefold on earlier months.

Since turbulences in international financial markets have eased, the average annual yield of most of the **investment and pension funds** has gone up. Their asset volume also grew in the past half-year, mainly owing to the price rise. Although the state ceased to contribute to the second-pillar pension payments at the start of the summer, more than a third of those having the second pension pillar have expressed the wish to continue paying their instalments in 2010.

Because of the low economic activity, interest in **insurance** has abated. However, insurance companies have managed to post profits owing to increased investment income and relatively good technical results. Although life insurance activity indicators refer to market stabilisation, non-life insurance is likely to continue to decline in the near term.

### **Payment and settlement systems**

Since an increasing number of people receive their income into bank accounts, the number of bank customers and the users of various payment channels has increased. In general, payers prefer to use one payment instrument they have got used to. The choice of payment channels also depends on habits and convenience, but security, comprehensiveness and the cost of a payment have become more important in recent years.

The value of payments has been decreasing in Eesti Pank's settlement systems – the value of retail payments has declined to the level of mid-2007. The settlement systems functioned smoothly and there were no events to pose a risk to financial-sector stability. Within the overseer's assessment, Eesti Pank analysed the ECSD's plan to start settling claims arising from securities transactions in euro and concluded the transactions would not be accompanied by risks to the functioning of the settlement systems.

### **Assessment of financial stability and risks**

The international liquidity environment has further improved compared to half a year ago, but the confidence of market participants is still fragile. The extensive support measures of central banks and governments have supported the liquidity of the financial sector and stimulated the economy. Once the measures are withdrawn, it is important to avoid significant setbacks to the credibility of the financial sector and to the functioning of the economy, both of which have been restored in the course of the past year.

The parent banks of the banks operating in Estonia have in recent quarters been able to raise funds from the markets at a price lower than before, and in several cases, also without the help of the national support measures. The sufficient capitalisation of banks also means that **risks to financing the Estonian economy have decreased**. At the same time, the risk assessment of international investors regarding the Baltic region has not much improved and the Estonian economy is still vulnerable to risks from neighbouring countries. Estonia's steady course towards joining the euro area will significantly help reduce liquidity and financing risks.

If confidence and thus also competitiveness in the Estonian credit market grow, it is possible banks will be more flexible in credit conditions, which means loan margins may decline somewhat. In the light of the current very low key interest rates, credit conditions are not the key factor why borrowers have postponed their investment and consumption decisions. Domestic and external demand have been very weak throughout 2009, so enterprises and households have curbed their consumption and investment and resorted to internal reserves. If demand improves, credit growth can be expected to pick up no sooner than in the second half of the next year.

**The credit risk has materialised in a smaller extent than it was anticipated in spring.**

This is partly related to the fact that both borrowers and banks have been more active in preventing problems and in finding solutions to maintain the loan servicing ability. It is likely the growth of the accumulation of overdue loans took mostly place in 2009 and the volume of such loans will grow much more slowly in the future. Although the share of the loans overdue for more than 60 days in the aggregate portfolio of banks remained at 6.4% for several months in a row in the autumn of 2009, Eesti Pank's assessment is the indicator will reach 8% in the spring of 2010 due to the continuously weak economic environment.

The banks' conservative assessment of credit risk is expressed in the high share of write-downs. If the situation of borrowers improves along with the resumption of growth, the recovering share of the stock of provisions for loan losses will be available to be taken into account as earnings, thus it will support the profitability of banks and their capitalisation in the new growth cycle. The need to write down loans will be notably smaller next year. Irrespective of the ongoing pressure on net interest income, it is possible the banking sector as a whole will post a small profit by end-2010.

**To sum up, risks to financial stability have decreased compared to spring.**

Risks to financing the economy have slightly withdrawn and the quality of loans has been better than anticipated. At the same time, regardless of some optimistic signs, it must be noted the impact of exiting the global financial crisis on the European financial sector and economy is not yet clear. The income level of Estonia's households and enterprises will also remain low year-on-year. This will, in turn, tighten budgets, which means the borrowers' capability of servicing their debt will remain the greatest threat to financial stability in Estonia.