

SUMMARY

The developments in the international money and capital markets in the second half of 2007 have increased investors' aversion to risk, which will continue to have an impact on the development of the Estonian financial sector also for at least the next six months. In this respect, market sentiment towards the European banking and real estate market as a whole is much more relevant for Estonian financial intermediaries than the direct impact of the rise in money market interest rates or the correction in the stock market.

In addition to the tightening of the global liquidity environment, international investors and the community in general became more risk averse towards the economic and monetary policy outlook of the Baltic States. However, the accompanying greater activity in the money and foreign exchange market has not undermined the functioning of the Estonian financial system. In the same way, it has not tightened the funding conditions, since the funding costs have increased here just as much as elsewhere in the region.

Although the domestic demand of Estonia's main trading partners may decrease next year, the export outlook of Estonian enterprises remains good. As a logical follow-up to the rapid growth in recent years, Eesti Pank expects Estonia's economic growth to slow next year, falling below the historical average (to 4.3%), but recover then and reach a moderate level (5.7%) by 2009.

Financial behaviour of companies and households and related risks

Although the total profit of **enterprises** grew fast also in the first half of 2007 (over 30%), aggregate profitability has somewhat declined compared to the second half of 2006 owing to the rapid increase in costs. Further decline in profitability and the accompanying weakening of loan-servicing capability is to be expected also next year.

Slowing growth has brought along a decline in investment growth and thus also a slower increase in corporate debt. In the case of corporate loans, the shift from the real estate sector to other sectors has occurred as expected. Low interest rate margins persist owing to banks' competition in financing good investment projects.

Supported by favourable labour market conditions and rapid wage growth, the economic situation of **households** has remained good. However, their confidence in further income growth and economic outlook has decreased. Since demand in the housing market diminished, the monthly changes in the volume of housing loans started to decrease in comparison to previous year in the late spring of 2007. Although the growth of other household loans has remained robust (over 50%), it has slowed starting from the third quarter. The volume of non-housing household loans has grown to constitute 11% of GDP, but it is still considerably lower than in most other EU countries.

All in all, the financial position of households is satisfactory. Although it is weakened by rising interest rates and inflation, the favourable labour market situation in conjunction with more moderate but still robust wage growth has a reinforcing effect.

By autumn 2007, the decrease in demand and in the volume of transactions in the **housing market** had not yet brought about a considerable decline in prices. Calculations based on the distribution of household income indicate that at the current price level, loan potential is still there and the demand for housing suffices also in the longer perspective. Therefore, the most plausible scenario for the immediate development of the real estate market would be stagnation of prices; in other words, the stability of the current average price level instead of a sharp price correction.

While the volume of housing transactions is decreasing, the number of new dwellings put on sale

is growing. For some real estate developers, this may lead to problems with liquidity and capitalisation. Since the outlook of profitability in the housing market has become less favourable, the amount of new office space developed will increase in the upcoming years. However, banks' exposure to the risks of this market segment is considerably smaller compared to residential development projects.

Banking market

The banking market is showing signs that credit institutions have become more risk sensitive. This is mainly reflected in their increased prudence in granting credit. **Asset quality** has been good for the past two quarters across banks as well as banking groups. Taking into account the slowing economic growth, it is likely that loan losses will start to rise. So far they have been quite low. However, given the current capitalisation level, the banking sector can endure a relatively extensive increase in loan losses.

The **capitalisation** of banks and banking groups has remained similar to spring levels. As of 2008, all credit institutions operating in Estonia will implement the standard methods of the new procedure for calculating capital adequacy. The adoption of the new calculation methods without any adjustments would have resulted in a considerable decrease in own funds required from banks. For this purpose, Eesti Pank decided to require banks to include the housing loans issued in Estonia in the risk assets in the extent of 60% instead of the usual 35% (so far in the value of 100%). The present 10% own funds requirement as a percentage of banks' risk weighted positions will remain unchanged.

The share of **liquid assets** in the banking sector's total assets has not changed considerably over the last half-year. The reserve requirement, which is 15% of banks' liabilities as of September 1, 2006, has helped to ensure that.

The biggest banks in the local banking market belong to the Nordic banking groups that are operating simultaneously in regions which are in different phases of the economic cycle. On the one hand, this leads one to presume that this circumstance reduces the financing risks of those parts of the group that have a higher risk level. On the other hand, higher risk estimate of some part of the group will bring about an increase in the entire group's risk estimate. Therefore, the group's ability and readiness to raise additional resources if necessary and send them to different parts of the group is more important than before.

The **profitability** of banks has remained good so far. In the upward phase of the key interest rates, profitability has been supported by the high share of floating rate loans in banks' loan portfolios. The decline in loan interest margins has stopped in Estonia. Continuously low loan losses have also contributed to profitability. Banks' ability to manage expenditure – to improve the cost-to-income ratio or keep it stable – is an important factor in ensuring the further profitability of banks.

Securities market and other financial intermediaries

Bond market capitalisation as well as the turnover of the secondary bond market grew in volume owing to the increase in the volume of issues by resident non-financial sector companies. The liquidity problems in the global financial markets that resulted from real estate loans with higher risk level, as well as the depreciation of the US dollar affected the stock markets of the Central and Eastern European countries and, to a great extent, also the Estonian **stock market**. Market developments were characterised by the sharp fluctuation of stock prices and the general downward trend. By the end of November, the value of the Tallinn Stock Exchange index OMXT decreased by nearly 16% compared to the beginning of the year, dropping back to the level of end-October 2006.

Due to the developments in the stock market and the high comparison basis, the growth of assets of **investment fund** slowed. The majority of the new capital in investment funds was invested in stock funds, most of it channelled to the EU stock markets. The growth of investment fund assets was boosted by the addition of seven new funds in the list of funds registered in Estonia. The most popular investment region of the new funds is the European market.

Pension fund assets have continued robust growth: the volume of second pillar pension funds exceeded ten billion kroons and the volume of third pillar funds is approaching one billion. The volume of fund assets still forms approximately a third of the pension system's third pillar; the rest is covered by voluntary pension insurance. The pension funds' management companies registered in Estonia prefer to invest the capital placed in the funds into other funds, thus spreading the risks better.

The growth in the **life insurance market** was supported by the establishment of life insurance companies as European companies in Estonia, where the activities in all of the Baltic States are coordinated. This structural change tripled the profit of life insurance companies and contributed to the growth of collected gross premiums. The growth in the **non life insurance market** has been quite stable, supported by the so far favourable economic environment and credit growth.

Payment and settlement systems

There were no such incidents in the operation of the Estonian **payment and settlement systems** that would have threatened the stability of the systems and the whole financial sector. The growth in the turnover of the Real-Time Gross Settlement System of Eesti Pank (EP RTGS) was accelerated by the considerably higher turnover of the foreign exchange transactions between the central bank and credit institutions. In the summer of 2007, the

interbank direct debit infrastructure was introduced in the Estonian market. It helps to improve competitiveness in the retail payments market and expand the services provided to bank customers. The new infrastructure enables to conclude direct debit agreements and make payments initiated on the basis of direct debit orders even when the settlement accounts of the payer and the payee are opened in different credit institutions.

The international comparison of Estonia's payment environment and the use of different payment instruments revealed that Estonia is among the European countries with an advanced payment environment. In the use of non-cash payment instruments, Estonia resembles Finland and Lithuania the most, whereas its level of cash payments is lower than the euro area average. The use of payment cards is more common in Scandinavian countries, and Estonia is approaching them in that respect.

Conclusion and financial stability risks

Although the period of slower economic growth that has just started augments the credit risk and the higher risk aversion of investors increases the liquidity risk, **the risks to financial stability may still be considered low. However, the likelihood of the materialisation of these risks has increased.** The consequences of the possible materialisation of risks can be alleviated by the capital and liquidity buffers built earlier. These help the local financial intermediaries survive the forthcoming period without any major problems.

The materialisation of the credit risks that accumulated during the economic boom is only natural in the current economic cycle characterised by slower income growth. This is expressed by the relatively fast increase in the share of non-performing loans. The volume of non-performing loans has so far been very small against the rapid credit growth. Thus, their growing share can be considered normal and it does not pose a threat to the smooth

functioning of the financial system. Stress tests of banks' loan portfolios indicate that in the near future, possible loan losses will not expand to the extent that banks operating in Estonia should look for opportunities to recover capital in order to continue with their day-to-day functions.

As regards the corporate debt, the highly-leveraged real estate sector may be considered at the most risk. Real estate developers and construction companies that have taken higher risks and whose share of own funds is small are the most likely to experience difficulties in servicing their loans. The situation of this market segment is further complicated by the very cautious attitude of households to property investments. This may inhibit the activity in the housing market even further.

Besides the credit risk, the liquidity risk deserves also more attention in the periods ahead. Namely, it has increased because of the tensions in the global liquidity environment. The materialisation of the liquidity risk of the Estonian banking sector depends primarily on the ability of parent banks to raise additional funds, if necessary. Based on the current information, there are no circumstances that would considerably restrict parent banks' access

to funding to a greater extent than general changes in the environment, or significantly increase the funding costs.

The opinion expressed this autumn by foreign investors reflected a more sceptical attitude towards the Baltic economies. This provides a supplementary negative undertone to the slowing growth and turbulence in the global financial markets. Nevertheless, the actual economic developments are determined mainly by the behaviour of the local financial intermediaries, enterprises and households.

It is necessary to thoroughly consider possible future developments, understand them and adjust one's behaviour accordingly, ignoring the messages of those confusing and intimidating the public by speaking about an economic collapse. The time ahead will make a good lesson, helping to understand economic mechanisms. In addition, it is a good opportunity to prepare a good starting position for the new upward cycle. Financial intermediaries, who have a good understanding of how the economy functions, have the possibility to act as level-headed guides in the process of economic adjustment.