Eesti Pank
Bank of Estonia

Lending Review

June 2011

CONTENTS

SUMMARY

The sovereign debt crisis in some euro area countries still causes concerns over funding related vulnerabilities for a number of EU banks. While the contagion to other euro area economies has so far been largely contained, the funding conditions of EU banks in general have improved over the last six months. The gradual recovery of financial markets and the favourable interest rate level provide fertile grounds for covering the growing loan demand of the non-financial sector. Although economy is gaining momentum, borrowing is still relatively modest in most euro area countries.

In Estonia, which survived quite a deep recession, the recovery of the loan stock of Estonian companies and households will take more time. From autumn 2008 until April 2011, the loan and leasing portfolio of banks dropped by over 15%, and this trend is not expected to turn anytime soon in most loan segments.

Along with increasing economic activity, the credit demand of companies grows, as inventories and production capacity may become insufficient to maintain or increase the current growth rate. In 2010, companies covered their financing needs mostly from their internal cash flows, such as sales revenues and profit growth. However, the first months of 2011 also witnessed a substantial increase in the turnover of short-term loans. Nonetheless, bank loans are still obtained rather modestly to fund investments.

In the new economic cycle, the structure of investments will probably focus less on real estate, although the demand for high-quality housing and infrastructure objects is already evident. Considering smaller need for real estate investments and the fact that apart from construction and real estate development the majority of other fields of activity use less credit, the volume of loans provided by banks is not expected to rise to the level of the previous economic cycle in the coming years. The financing demand of the Estonian economy is additionally covered by external borrowing, which increased to the pre-crisis level of 25% by the end of 2010, owing to the funds obtained from foreign parent companies.

Improved confidence and stronger loan demand of households is primarily reflected in the swiftly growing car leasing market, where the first four months of 2011 recorded an over 80% growth in sales compared to a year ago. The rise in the volume of new housing loans, however, is more modest than expected, although the price level of real estate has remained considerably lower relative to average incomes. Activity in the housing loan market has been curbed by the scarcity of supply in the housing market that would correspond to demand and also by the relatively high debt burden of households. As the financial behaviour of households is still cautious, they prefer to finance consumption from their incomes and savings, instead of taking loans.

Banks' readiness and willingness to offer credit has risen over the year. The capitalisation of banks has further improved and the funding base is much stronger owing to deposit growth. Although the share of overdue loans in the loan portfolio remains high, the main focus of banks has shifted from the quality of existing portfolios to issuing new loans again, and competition on the loan market has increased considerably. This has brought along the expected drop in interest margins, which is most clearly manifested in the housing loan market.

The forecast of loan growth for 2011 is largely influenced by the changed structure of loan demand and the rapid depreciation of the loan portfolio. Despite the fact that more loans are granted to companies and households than a year ago, their turnover remains smaller than the repayments of earlier loans. Therefore, the loan portfolio will also shrink in 2011 and, by the year-end, Eesti Pank expects the stock of loans issued to companies and households to be over 3% lower than a year ago. According to the forecast, the loan portfolio, which has been in decline for almost four years, may start showing positive annual growth rates in spring 2012.

LOAN GROWTH IN THE EURO AREA, FINLAND AND SWEDEN

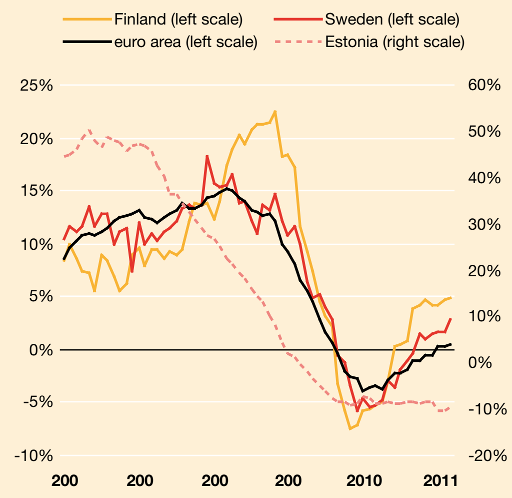
Global economy continues to recover from the recent recession and it has been possible to reduce dependence on national support mechanisms. However, the recovery varies across countries and regions.

The output has increased in the euro area since the third quarter of 2009. Real GDP growth posted 1.8% in the fourth quarter of 2010 and for 2011, the European Central Bank estimates euro area growth at 1.5–2.3%. Various indicators refer to increasingly positive developments in investments and private consumption. After over a year-long decline in the stock of loans given to companies, the year-on-year growth remained merely near 0% in the first months of 2011. In the Nordic countries, particularly in Finland, growth has recovered more rapidly.

The financing structure of euro area companies that changed drastically because of the crisis is recovering. The financial and economic decline that began at the end of 2008 aggravated the situation of banks in the euro area, and companies preferred to use existing resources to finance their operations and to issue bonds rather than take bank loans. In the first half of 2010, however, growth in the volume of bonds started to slow and in the last quarter the volume of bonds issued declined.

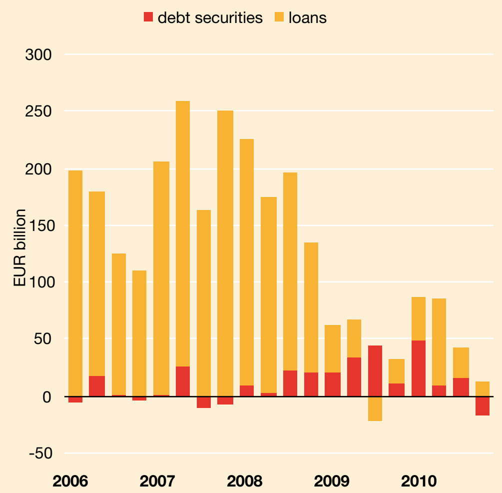
The stock of household loans has been increasing steadily over the last six months. The greatest contribution came from housing loans, as their growth picked up to 5% year-on-year at the end of March 2011. The year-on-year growth in consumer credit in the euro area has also been positive over the last three quarters. In Finland and Sweden the housing loan stock has grown more rapidly than in the euro area, although in Sweden the pace is slowing and the loan stock has been relatively stable there in recent months.

The rise in key interest rates that started in the second half of 2010 also affected the interest



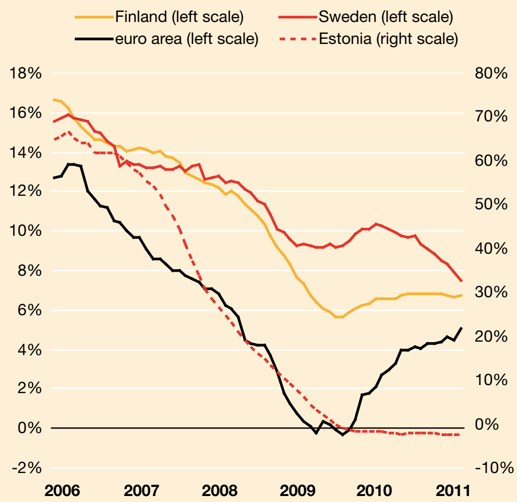
Annual growth in corporate credit

Sources: European Central Bank, Eesti Pank



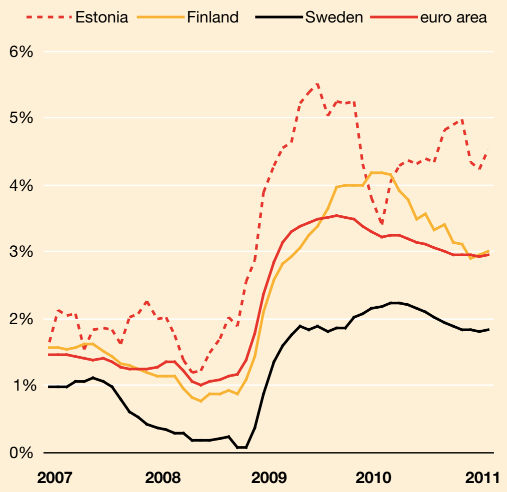
Quarterly change in non-financial debt securities and loans in the euro area

Source: European Central Bank (euro area financial account statistics) rates for loans issued to the non-financial sector. The interest margins in the euro area have remained relatively stable in the last six months, and as a result the rise in interest rates has spread to the cost of financing for companies and households. A slight drop in interest margins could be perceived mostly in loans given to Finnish companies.



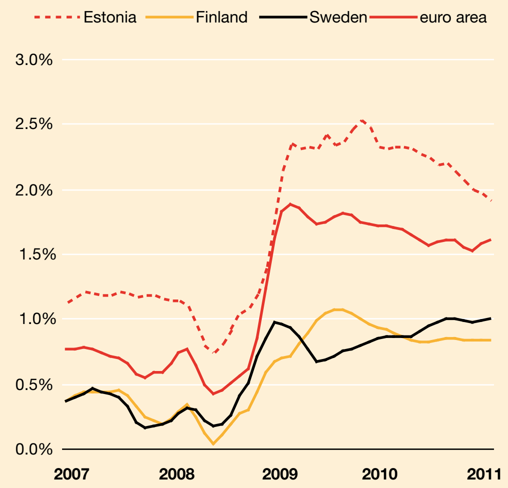
Annual growth in housing loans

Sources: European Central Bank, Eesti Pank, Statistics Sweden



Interest margins for corporate loans (3-month moving average)

Sources: European Central Bank, Eesti Pank



Interest margins for household mortgage loans (3-month moving average)

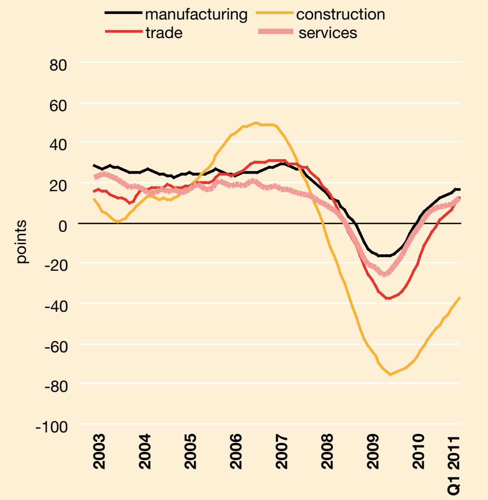
Sources: European Central Bank, Eesti Pank

The impact of the economic environment on financing

Although gradually recovering, the economic environment continues to be quite volatile and negative news may easily affect the future outlook and expectations. The external conditions that are important for the Estonian economy and companies have improved in recent quarters, despite many negative events on the global scale. Economic growth of Estonia's main trading partners – Finland, Sweden and Russia – exceeded the European average, which has had a particularly positive impact on the Estonian economy. Exports posted a record level in April and in light of low domestic demand, companies see a solution in expanding to foreign markets.

According to the Estonian Institute of Economic Research, by the end of the first quarter of 2011 the confidence of Estonian companies had risen to the level recorded at the beginning of 2008. Expectations regarding near future trends and the increase in orders are more positive than they were earlier. In April, 36% of the respondents in the manufacturing sector expected a growth in orders; this indicator was almost 50% in trade and services. In April, manufacturing companies considered export demand to be higher than domestic demand, but the amount of domestic orders will probably increase along with the rising consumer confidence. However, the construction sector is clearly different, as the decline-induced economic difficulties have had a considerable impact on expectations, which are much more pessimistic than before the boom.

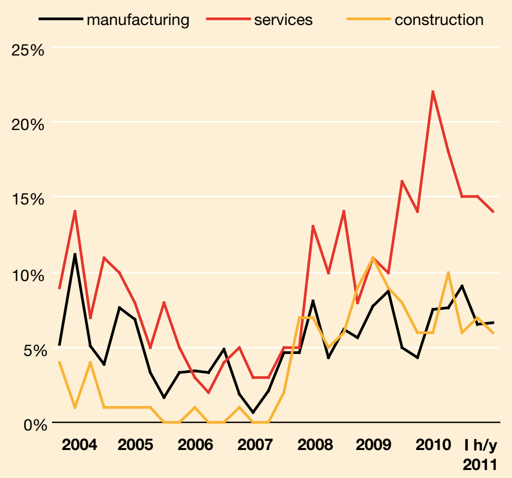
In April 2011, 50% of the respondents in all sectors mentioned demand as the main obstacle to doing business, but the prevalence of this factor over others is clearly abating compared to recent years. From the aspect of financing the economy it is important that with the rising loan demand, the share of companies that see



Demand expectations for the next three months*

*12-month moving average

Source: Estonian Institute of Economic Research



Financial constraints as the main factor limiting production*

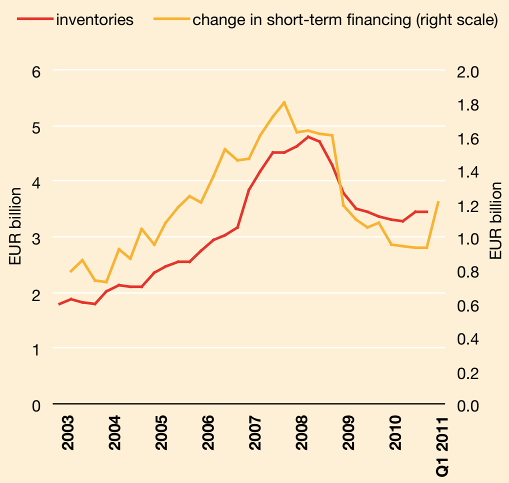
* percentage of respondents claiming this factor as most hindering production

Source: Estonian Institute of Economic Research financial problems as the biggest obstacle to business activity has not increased. In April, it was 14% in services, 6% in construction and 7% in manufacturing. At any rate, there was nothing normal about the situation that prevailed in 2005–2007 when the share of companies that saw financial problems as a hindrance to their expansion was nearly non-existent.

The boom-time sales records created a need, and sometimes unjustified expectations, in almost all sectors to increase their stocks. However, the amount of stocks decreased during the recession. After sales picked up again, trading companies returned to purchasing goods for sale in the last quarters of 2010 and manufacturing companies started to restore their material and commodity reserves. Increasing stocks is presumed to continue along with the rising economic activity and, as a result, the need for working capital will also grow.

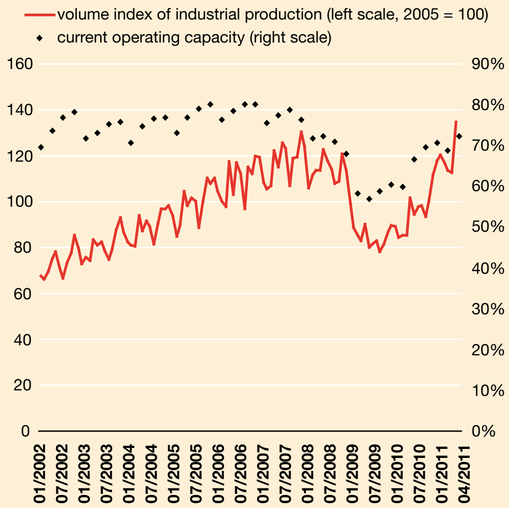
Entrepreneurs' estimates regarding the shortage of materials and equipment, which refer to investment needs, have remained relatively stable over the last year. The shortage of materials and equipment is remarkable only in manufacturing, where in April 14% of entrepreneurs mentioned it as the main obstacle to production (8% in January 2011). Meanwhile, the utilisation of production capacity in manufacturing increased to 72%, which, considering the swift output growth, is not far from its historical peak of 80%. Presuming that the economic environment remains favourable, manufacturing companies will probably have to invest in expanding their production capacity in the near future.

The utilisation level of building capacity rose to 62% by the end of 2010. In 2010, the value of performed construction works totalled 1.9 billion euros, which is over 50% less than the peak of the boom in 2007. The turnover is greater in the construction of facilities, where, according to Statistics Estonia, nearly 90% of the production capacity of 2005 had been restored by the end



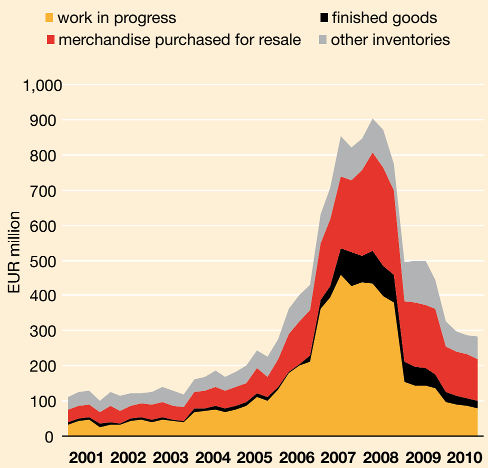
Inventories and change in short-term financing

Sources: Statistics Estonia, Eesti Pank



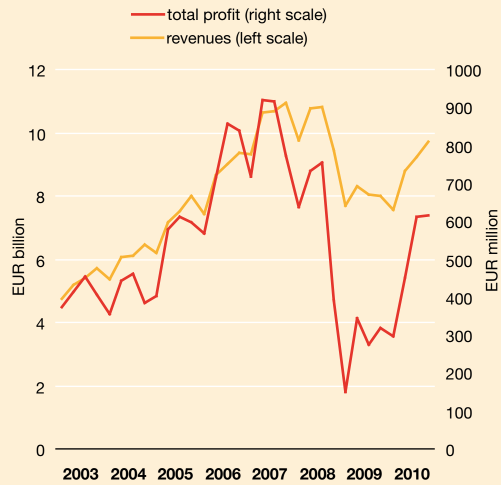
Volume of industrial production and current operating capacity

Sources: Statistics Estonia, Estonian Institute of Economic Research



Construction and real estate sector inventories

Source: Statistics Estonia



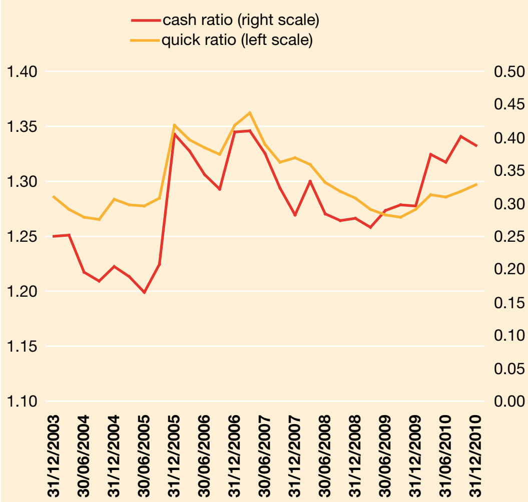
Corporate revenues and profits

Source: Statistics Estonia

of 2010; however, in building construction this indicator was only 70%. Statistics Estonia says that the stocks of construction and real estate companies also dropped to pre-boom levels at the end of 2010. If this trend continues, demand for new investments and for funding them will probably increase.

Internal cash flows

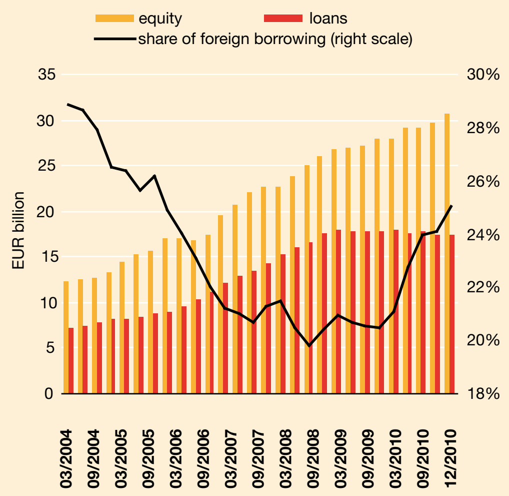
The primary sources of financing, cash flows from business operations, continued rapid growth in the two final quarters of 2010. This was fostered by increasing exports and the gradually recovering domestic consumption. The success of expenditure cuts reveals itself in profit growth, which is occasionally even stronger than the growth in sales revenues. All sectors, excluding education, posted profits in the fourth quarter of 2010. Manufacturing was the most successful sector, where both sales revenues and profits picked up significantly within the two final quarters of 2010. In the fourth quarter of 2010,



Corporate sector liquidity

profits grew by nearly 14% and totalled 196 million euros.

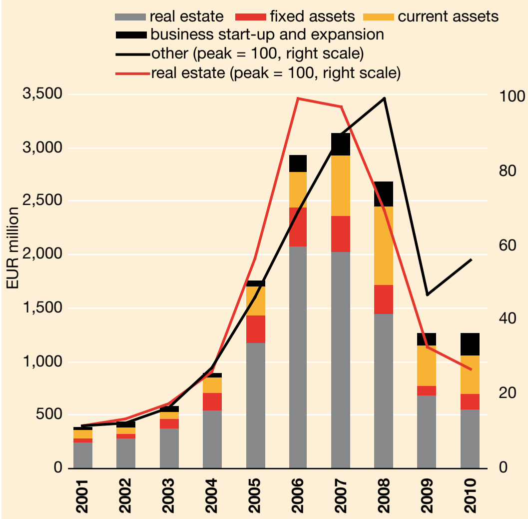
Corporate liquidity indicators improved further at the end of 2010, as sales revenues and profits recovered, and the volume of deposits increased to 4 billion euros. However, in the first three months of 2011 corporate deposits contracted, which has probably also slowed down the further rise of liquidity indicators. On the one hand, the improving liquidity of companies refers to the sufficient availability of circulating capital and to the fact that they have no need to borrow from banks. On the other hand, liquidity indicators refer to the strength of the companies' economic situation, and this is one of the prerequisites for obtaining a loan. In other words, it would be easier for companies to receive bank loans in the future. Generally, however, companies' conservative behaviour in the post-recession situation is common and greater buffers allow them to hedge risks better during a growth cycle.



Corporate sector's equity, loans and share of foreign loans

External financing

In 2010, companies continued to repay their loans and to increase equity, reducing their dependence on external financing. With the year, the stock of loans decreased by over 0.4 billion euros, while equity grew by a total of 2.7 billion euros. Non-financial companies' debt has shrunk due to the repayment of domestic loans, but raising funds from abroad has increased. At the end of 2010, the share of foreign loans had climbed to 25% again after several years. Foreign borrowing has grown mainly owing to local manufacturing companies who have obtained intra-group loans, while liabilities to creditors outside the group have generally decreased.



New lending to companies by loan purpose

Domestic borrowing

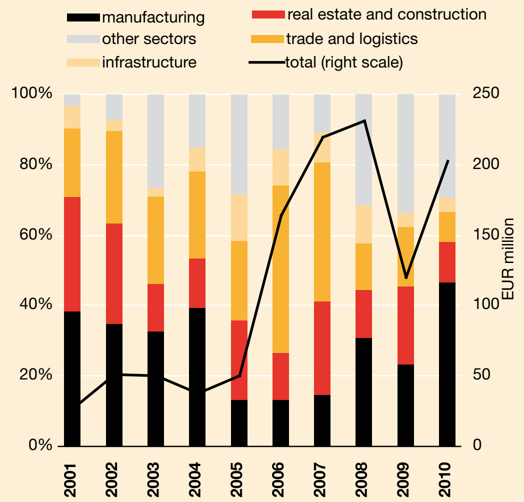
In addition to the more than 50% drop in the turnover of domestic loans, the objectives of borrowing also changed considerably with the recession. Contrary to the boom period, when over two-thirds of loans were obtained to purchase real estate, in 2010 the majority loans were taken for other purposes than real estate. Their turnover also dropped significantly during the recession, but contrary to real estate loans the turnover of loans for other purposes increased by nearly 20% in 2010.

Borrowing to finance real estate has started to recover in 2011 and is expected to increase further in the near future, considering that confidence is improving and the real estate market is regaining momentum.

Borrowing to finance fixed assets, however, is still marginal. Companies need to start replacing their depreciated fixed assets sooner or later, which probably requires also bank financing. Looking at the distribution of investments by sectors, it is the manufacturing companies that prevail, which uses financing resources different from those of other sectors. Contrary to earlier periods, investments are probably funded much more with own funds and foreign loans. Moreover, the still high level of non-financial sector debt may curb the desire to take on new long-term liabilities.

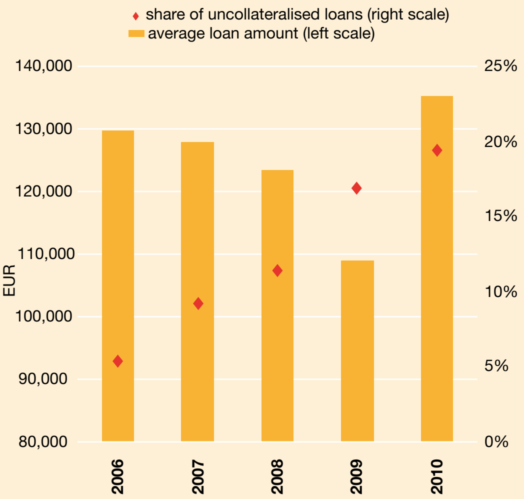
In the coming quarters the loan turnover will probably grow on account of short-term financing, which is increasingly needed in the current improving economic environment due to growing business volumes.

The fact that it is possible to receive funding for good ideas and strong business plans is indicated by the growth in the turnover of loans obtained for starting or expanding business. In 2010, the turnover of such loans increased by nearly 70%. Naturally, the majority of the growth stemmed from manufacturing, which relies on export growth. In 2010, the turnover of loans granted for starting or expanding business also increased in some other fields of activity,



New lending for start-ups and expansions by sectors

Source: Eesti Pank

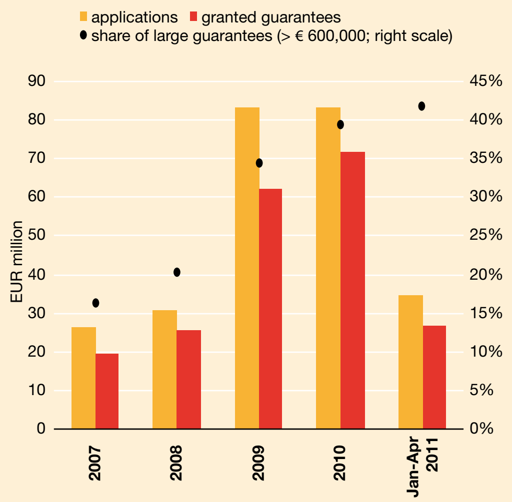


Average corporate loan amounts and share of uncollateralised loans (excluding overdrafts)

including companies engaged in knowledge-intensive professional, scientific and technical activities, although the volumes of this sector are nonetheless quite small. With domestic demand improving, loans to the trading sector to start or expand business witnessed strong growth in the first quarter of 2011. The need to expand operations and to try out new ideas in the recovering economic environment will probably grow in the near future, and this will increase also borrowing activity.

The increase in the average loan size and the growth in uncollateralised loans point to the dominant role of large companies on the loan market, while the loan activity of smaller companies dropped further in 2010. Developments in recent quarters indicate, however, that the loan market bottomed out at the end of 2010 and the loan activity of smaller companies is expected to recover in 2011.

Companies also express further interest in obtaining loans that are guaranteed and collateralised by KredEx, as confirmed by the statistics for the first four months of 2011. The fact that the products of KredEx are popular among large companies is indicated by the growing share of large sureties among the applications approved.



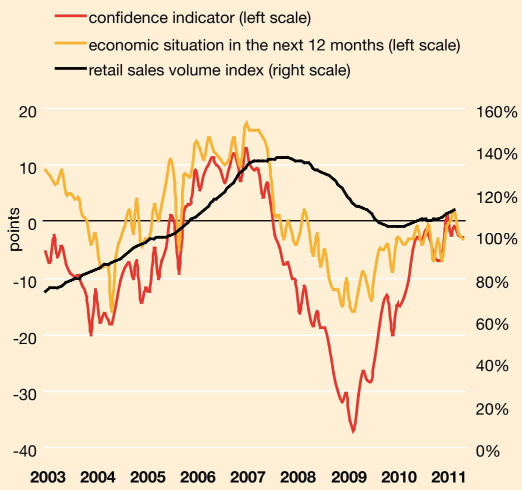
Applications for corporate loan guarantees by KredEx

Source: KredEx

The economic situation of households

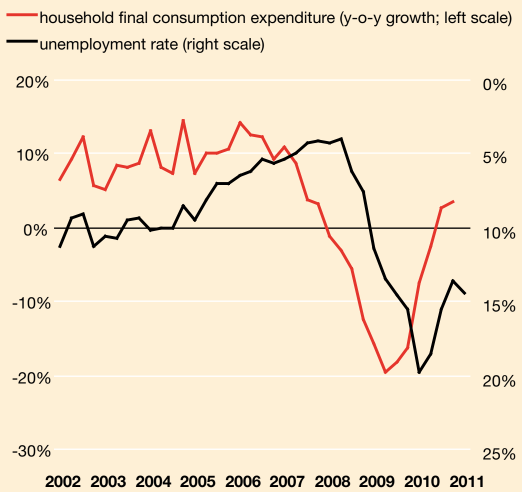
The pessimism of households is abating. Confidence has mainly been boosted by positive developments in the labour market. Although unemployment grew to 14.4% in the first quarter of 2011 owing to seasonal factors, activity in the labour market has perked up a bit in recent months. This is confirmed by the remarkable drop in the number of the registered unemployed, the rise in employment and the number of job offers that has regained its boom-time level. Moreover, nominal wages have also started to grow. However, the real purchasing power of households has not recovered to its pre-crisis level because of the rapid rise in prices.

Against the backdrop of economic recovery, the estimates of households regarding their economic situation in the next 12 months have slightly improved, and so their high propensity to save, which increased considerably during the recession, is on the wane. This is reflected in consumption, which started to improve gradually at the end of the third quarter of 2011. In the fourth quarter of 2010, household consumption expenditure grew by 3.5% year-on-year. Nevertheless, households remain cautious about their consumption and investment decisions owing to the recent crisis experience, and consumption currently remains at the level of 2006. Purchase of durables is expected to grow relatively modestly, as consumers sense the rapid rise in the cost of living. Furthermore, the fall in real incomes has been accompanied by an increase in share of inescapable expenses (expenditure on housing and food) in household budgets by 5 percentage points to 45% over the last three years[1]. This means that less money is available for other expenses. However, borrowing for making the necessary purchases is not so common and households prefer to use their savings and existing assets for that purpose.



Household confidence indicators and domestic consumption

Sources: Estonian Institute of Economic Research, Statistics Estonia



Unemployment and household consumption expenditure

Source: Statistics Estonia

[1] Source: Statistics Estonia, Household Budget Survey 2010.

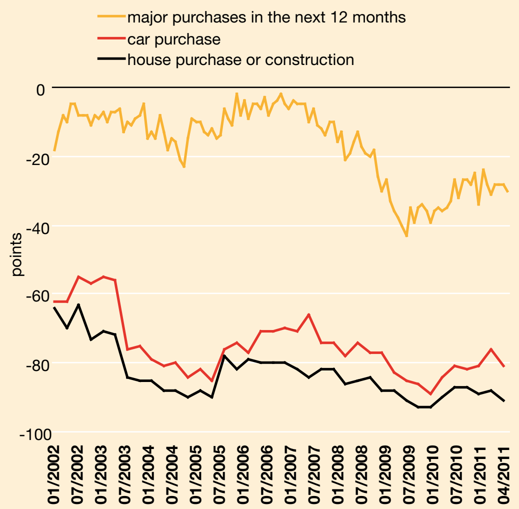
In 2010, households decreased their financial liabilities by repaying part of their loans, which helped improve their financial position considerably as shown by the financial account data. The financial assets of households grew by around 3%, largely owing to the price rise in stock markets and payments into life and pension insurance. The stock of household deposits has increased too. Households presumably continue saving despite the low interest rates and recovering consumption, albeit at a smaller scale than during the recession.

The financial behaviour of households

The financial position of households has improved, as their financial liabilities – mainly long-term loans – have shrunk by 4% with the year. At the end of the first quarter of 2011, the ratio of household debt to GDP stood at 50% and the ratio of debt to disposable income was 91%. Although the level of debt is decreasing, it is still high and curbs households' desire to borrow. As households remain cautious in their financial behaviour, the volume of private consumer credit will probably be smaller in the current economic cycle than it was in the previous cycle, and total financial liabilities will also contract this year.

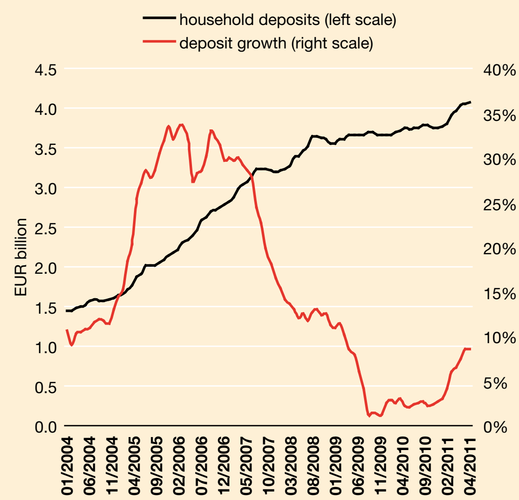
The majority of Estonian households have their own housing, with 17%[2] of them having real-estate related financial liabilities. Thus, their wealth depends greatly on developments in the real estate market. The real estate market has been recovering more modestly than expected, which may arise from the cautious behaviour of households, but also from the loans already obtained or the scarcity of suitable real estate. There is a number new development projects on the market and the number of offers is generally rising, but the data of the Tallinn apartment market show that the transaction activity was almost 10% lower in the first four months of 2011

[2] TNS EMOR's survey "F-monitor: Financial Behaviour of Estonian Households, September-October 2010".



Expected purchases by households

Source: Estonian Institute of Economic Research

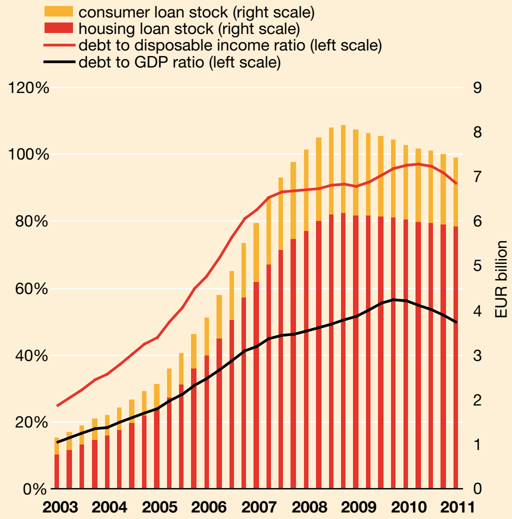


Household deposits

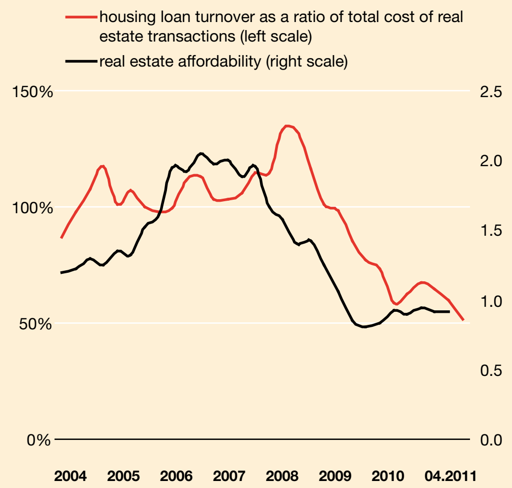
than it was a year earlier. The structure of real estate transactions has changed and transactions are mostly performed with new apartments or apartments in good condition, which partially explains the rise in real estate prices. As for the price level, the market remains at the level of 2005, and the affordability of real estate for the residents of Tallinn who earn average wages is still good. In the first quarter of 2011, the affordability indicator was 0.91, which is lower than the long-term average. Given that prices are at levels recorded six years ago, the value of the collateral real estate of a third of the borrowers is currently smaller than the loan amount, which inhibits their activity on the real estate and loan markets.

Borrowing by households is still modest. Although in April the volume of new housing loans was 16% higher than it was a year ago due to the low reference base, 7% fewer loan contracts were concluded. The forecast of Eesti Pank expects the recovery of the housing loan market to continue and the turnover of housing loans to rise by approximately 7% in 2011, but will nonetheless only reach the level of 2003. As the volume of new housing loans has been smaller than amortisation of the existing loan stock, the total stock of housing loans has dropped by 2.2% over the year. Considering the low borrowing activity, the loan portfolio of banks will shrink also in 2012.

Private consumption is financed mainly with savings, as indicated by the fact that the stock of short-term household loans in the loan portfolio has shrunk by 9% over the year. In April, the monthly turnover of consumer credit was still lower than last year, having decreased by 5% year-on-year. Only the car lease market has bounced back: twice as many vehicles were sold in the first four months of 2011 than in the same period last year. Consequently, the lease turnover had increased by 83% in April 2011 from a year earlier, though not reaching the pre-crisis levels yet. Consumer credit still mostly consists of overdraft facility and credit

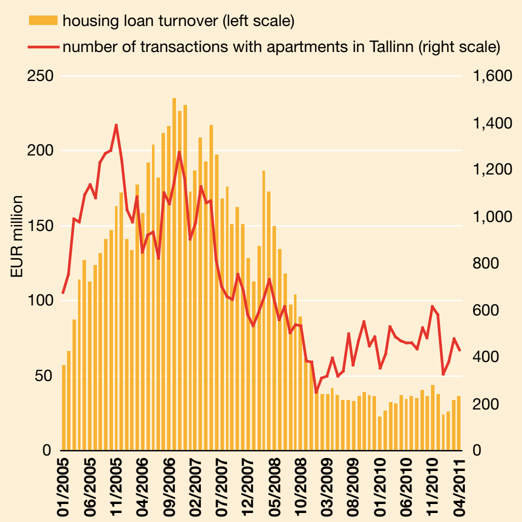


Household debt



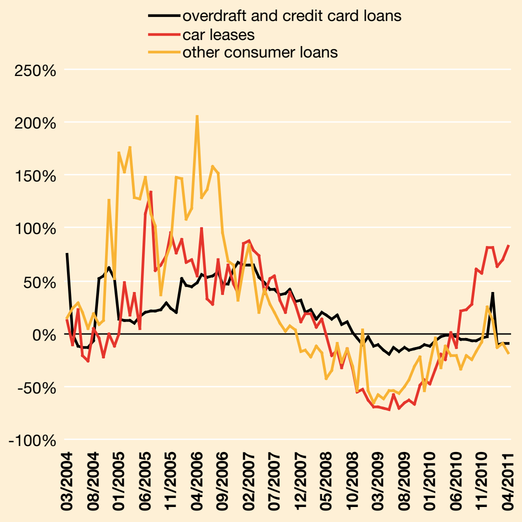
Affordability and financing of real estate

Sources: Land Board, Statistics Estonia, Eesti Pank



Household activity on the loan and real estate market

Sources: Land Board, Eesti Pank



Year-on-year growth in new consumer loans

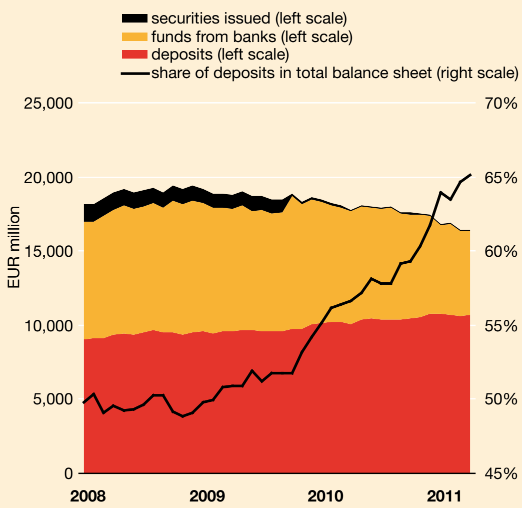
card loans that comprised approximately two thirds of the 70 million euro turnover in April. Considering that households' propensity to save is abating and consumption is picking up, growth in the turnover of consumer credit is expected to recover by the end of 2011. However, as the amortisation of earlier loans is fast, the portfolio of consumer credit will shrink further this year.

Funding resources

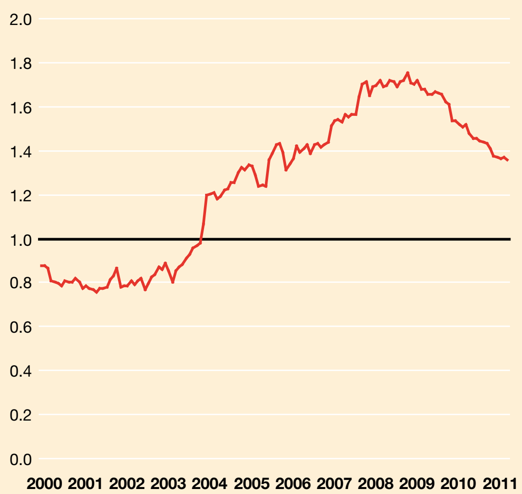
The liabilities of banks operating in Estonia mainly consist of non-financial sector **deposits**, which totalled almost 11 billion euros as at the end of April 2011. In recent years, the volume of deposits has been growing relatively rapidly due to the cautious financial behaviour of households and companies. The volume of loans and leases of the non-financial sector has declined by 15% since the autumn of 2008, while the volume of deposits has increased by nearly 13%. This development has enabled banks to repay funds obtained from their parent banks. At the end of April, the share of deposits in banks' debt liabilities had increased by 9 percentage points to 65% from a year ago.

The loan-deposit ratio that had climbed to 1.75 by autumn 2008 abated to 1.4 by the end of April 2011. Despite a relatively quick drop in the banks' financial leverage, the loan-deposit ratio in Estonia is still quite high compared to similar indicators in other European countries. These large discrepancies across countries stem from the difference in the countries' financial sector structure, for instance different housing financing schemes. After the recession and increased vulnerability in market-based funding, retail deposits have gained more importance as a stable funding resource all over Europe. However, the level of loan-deposit ratio need not, in every single case, reflect banks' need or desire to change their existing funding structure considerably or to urgently reduce reliance on markets. Consequently, the strategies of parent bank groups are not concerned with the current indicators of their Estonian subsidiaries as a factor that would hinder loan portfolio growth.

However, it must be kept in mind that the banks' funding structure has become more balanced largely thanks to the decrease in the loan portfolio. Even if credit growth does not recover rapidly, the spread between loans and deposits will remain relatively large. This funding gap along with the



Structure of banks' liabilities



Loan-to-deposit ratio* in Estonia

* Includes loans and deposits of non-MFIs (households, companies, general government, financial corporations).

need to secure sufficient capital for banks makes the banks operating in Estonia highly dependent on their parent banks. The profitability and capitalisation of **parent bank groups** operating in Estonia is good compared to most other large European banks, and financial markets regard them as less risky. This has allowed the parent banks to obtain sufficient funds from financial markets at relatively stable prices.

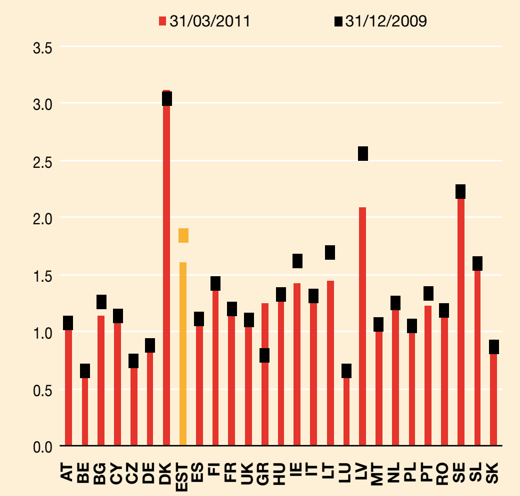
As the funding of Swedish bank groups is largely market-based and the share of retail deposits is lower than in Europe on average, the prevalent trends in financial markets play a great role in shaping the availability and cost of loan resources for banks.[1] The interest rates on the covered bonds of Swedish banks have risen from autumn 2010 owing to a change in the yield curve, but the difference with the yield of government bonds has not changed or has even shrunk a little in spring 2011, which reflects the stabilisation of risk estimates attributed to Swedish banks.

Developments in global interest rates also affect the **cost of funding** for banks operating in Estonia. The interest rate on banks' debt liabilities (including deposits and funds obtained from banks) dropped to 1.1% at the end of 2010, while at the end of April 2011 it rose by 10 basis points to 1.2% due to the cost of funds obtained from banks and the slightly higher deposit interest rate. At the same time, the Euribor that is used as the reference interest rate for most loan contracts climbed by 37 basis points. The increased interest spread helps to alleviate pressure on the interest margins on new loans.

Banks' loan supply

The average consolidated **capital adequacy ratio** of banks stood at 16.9% at the end of March 2011, with the Tier 1 ratio being 13.4%. Based on the forecast of Eesti Pank, capitalisation will

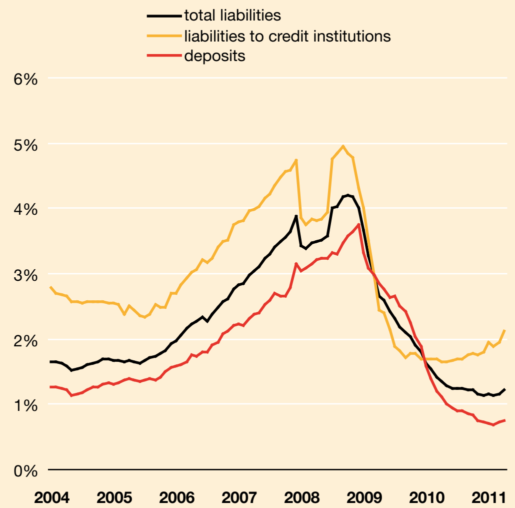
[1] For the risks of parent banks' funding see the Financial Stability Review No 1/2011.



Loan-to-deposit ratio* in EU countries

* Includes loans and deposits of non-MFIs, excluding general government.

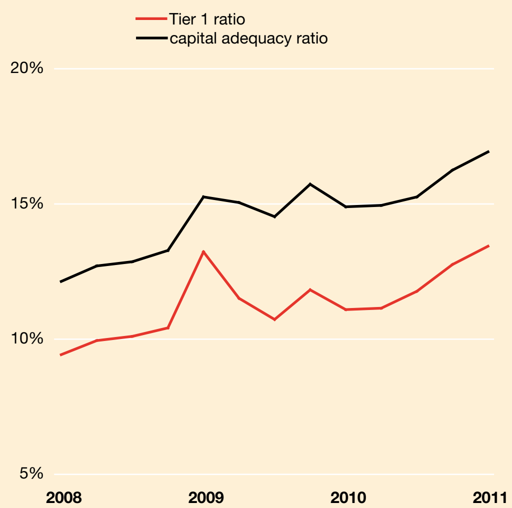
Sources: European Central Bank (MFI statistics), Eesti Pank



Avearge interest rate on banks' liabilities

strengthen as profitability grows further, while loan provisions and risk assets are decreasing.[2]

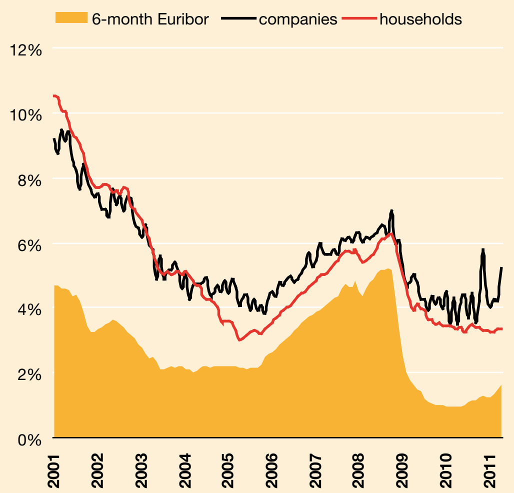
Considering the current capital buffer and the expected improvement in capitalisation, the tightening of capital regulations along with the implementation of the Basel III capital regulation will not exert great direct influence on the supply of loans by domestic banks or the branches of foreign parent banks operating in Estonia. All banks operating in Estonia were able to fulfil the minimum Basel III requirements that will be fully implemented in 2019 (total capital requirement 10.5% and Tier 1 capital requirement 8.5%)[3] at the end of the first quarter of 2011. However, higher capital requirements may affect the financing environment of banks and the local credit conditions through parent banks.



Capital adequacy ratios of banking groups operating in Estonia

Loan interest rates

The interest rates on new loans remain favourable for borrowers owing to low key interest rates. The interest rates on long-term loans reached a historical low in 2010, even though risk margins rose against the backdrop of global economic decline. In recent quarters the key interest rates started to climb, but due to the lowered interest margins this has not transferred fully to loan interest rates yet.



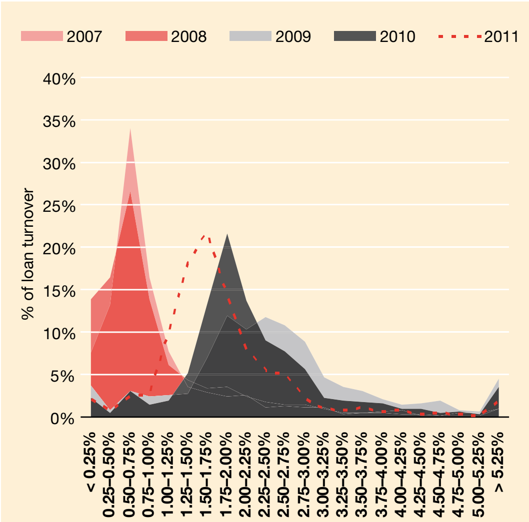
Interest rates on long-term loans and 6-month Euribor

Sources: European Central Bank, Eesti Pank

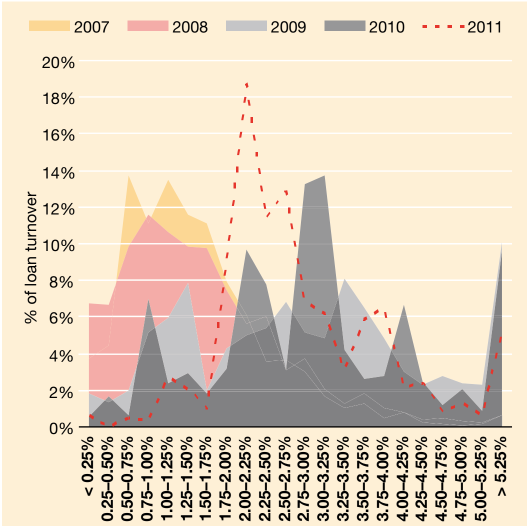
The pricing of housing loans for households increasingly resembles the rapid credit growth period. The risk premiums of new housing loans are more homogeneous than in recent years, although not as concentrated as in 2006–2008.

The margins for long-term corporate loans still point to the rather great risk-based differentiation

[2] See the Financial Stability Review No 1/2011.
[3] Both requirements include the 2.5% capital conservation buffer. However, an additional counter-cyclical buffer, ranging between 0.0–2.5% or higher, may be added depending on the economic cycle.



Housing loan margins as a ratio of 6-month Euribor

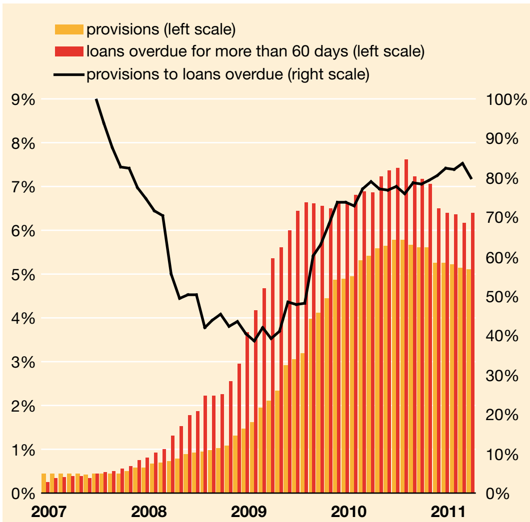


Margins for long-term corporate loans as a ratio of 6-month Euribor

among companies, as indicated by the relatively wide range of margins in 2011. Compared to 2010, however, the differences between margins have decreased somewhat and the average margin is also lower, which means that credit conditions have become slightly more favourable for companies.

Other factors affecting loan supply

The accumulation of loan repayment problems during the economic recession considerably affected the risk awareness of banks, and until the middle of 2010, banks focused on managing their existing loan portfolio. Although the quality of the loan portfolio has been on the rise since the autumn of 2010, the share of **non-performing loans** is still high. Given that loans overdue for a longer period and restructured loans are covered by sufficient provisions, the materialisation of credit risk does not set significant constraints for the volume of new loans. Meanwhile, the level and history of overdue loans should influence the risk estimates for granting new loans, which



Loans overdue for more than 60 days and provisions as a ratio of the loan portfolio

will probably be reflected in a higher interest rate margin compared to the pre-crisis period. Moreover, the level of non-performing loans will affect the rate of amortisation of the loan portfolio, as it may take quite some time to write bad loans off the balance sheet. As a result, the banks' loan portfolio may contract by 2–3% in 2011-2012.

Competition on the loan market has been on the rise since 2010, as evidenced by the smaller range of interest margins and banks' own observations regarding the loan market (see Annex 1 *The results of the Bank Lending Survey in the first quarter of 2011*). As noted by banks, competition has been especially strong on the loan market of large companies, but since the first quarter of 2011 also in the segment of loans for households and small and medium-sized companies. Compared to companies, households are a more homogeneous group of borrowers and the signs of competition in this segment are thus also more apparent. Stronger competition is reflected in shrinking housing loan margins and their convergence between banks. Banks' market shares in the supply of new housing loans are also more even since in the second half of 2010.

After a break of five years, banks launched housing loan and car lease campaigns in spring 2011 to attract new customers, which expresses banks' readiness to increase their loan volumes. Although the main goal of these campaigns is to secure a strong customer base by offering more favourable housing insurance or credit card terms, they also entail a slight easing in credit conditions, in particular a drop in interest margins.

Annex 1. The results of the Bank Lending Survey in the first quarter of 2011

The Eurosystem's Bank Lending Survey gives an overview of the changes that have occurred and may occur in loan standards and demand in the near future. The survey is conducted on a quarterly basis and the results reflect the last month of a quarter. The survey on the Estonian lending market includes qualitative estimates of four major credit institutions operating in Estonia.

The survey results **revealed a slight tightening of credit standards for euro area companies in the first quarter of 2011.** This stemmed from the banks' poorer access to funding and the deterioration of their liquidity position. The corporate credit standards for **banks operating in Estonia** generally remained the same, but credit standards for large companies were slightly loosened. This was fostered by the improved operation environment of companies, tight competition between banks and their capital and liquidity position. As for credit conditions, loan margins have dropped. The non-interest rate charges of banks have slightly decreased and the volume of the credit lines for large companies has increased somewhat.

The tightening of **household credit standards** in the euro area is related to banks' greater funding costs and balance sheet constraints. The deterioration of risk perception in the euro area contributed to the rise in interest margins. Banks operating in Estonia, however, estimate the risks to be lower and have loosened the credit standards for loans issued to **Estonian households** because of heavy competition, although there are exceptions too. Nevertheless, average credit standards have remained relatively unchanged in the Estonian loan market and housing loan conditions have eased in many cases. One bank has reduced its interest margins considerably and half of the banks have lowered the loan-to-value ratio (LTV) requirement. The terms of consumer credit did not change in the first quarter.

In the euro area, credit standards for companies and households are expected to tighten further in the second quarter of 2011. However, most banks in Estonia do not plan to change the general credit standards. The standards for long-term corporate loans may be lowered somewhat. One bank also intends to loosen housing loan standards.

In general, the **loan demand of companies** has been rising in the euro area, boosted both by the need for inventories and working capital and for funding fixed investment. In Estonia, the demand for short-term loans has improved the most. Over half of the respondents mentioned also increased borrowing by small and medium-sized companies.

Households' demand for housing loans has broadly remained the same in Estonia, while the demand for consumer credit has decreased slightly more. Housing loan demand is supported by the improved outlook for the housing market and the increasing confidence of households, but it is curbed by non-housing consumption expenditure, savings and borrowing from other banks. The demand for consumer credit and other loans has dropped as households prefer to use their savings as an alternative source of financing.

In the second quarter of 2011, corporate loan demand is expected to increase in the entire euro area. The banks operating in Estonia forecast a growth in demand mainly among small and medium-sized companies. Half of the banks presume that households' demand for both housing loans and consumer credit will pick up.