EESTI PANK

FINANCIAL STABILITY REVIEW

May 2005

The Financial Stability Review is published twice a year by Eesti Pank. Each issue of the Review refers to the time the analysis was completed, not to the period it handles. The Review includes the latest available data at the time of each issue's preparation.

The Review is available at: http://www.bankofestonia.info

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The Review is free of charge to subscribers.

ISSN 1736-1281
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Printed in Tallinna Raamatutrükikoda

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SUMMARY

Macroeconomic and External Environment

Global economic activity decelerated in 2004 and no signs of recovery appeared in the first months of 2005. For the Estonian economy that meant continuously favourable interest rate environment and the **expected rise in the growth cycle of the euro area deferred to early 2006**. Apart from fairly constrained external demand, which was caused by a slowdown in global economic activity, another external risk for the Estonian financial environment to be pointed out is the volatility of international financial markets and exchange rates, primarily caused by vast problems with the external balance in the US.

Estonian economic growth remained fairly strong thanks to higher exports and reached 6% in real terms in the second half of 2004. In the positive light of joining the EU companies also have optimistic expectations of future growth. Relatively high sales figures and profits of the previous year provide a good starting point for these outlooks. Real estate and other business service companies had on average better results in 2004, as well as in 2003. However, a notable rise in expenses occurred in the corporate sector as a whole, which had a negative impact on profitability indicators.

Despite growing inflation expectations in the second half-year of 2004, household confidence remained high. Positive labour market developments and improved savings contributed to that as well. Accession to the European Union accelerates economic convergence and will definitely have a positive long-term impact on households' income growth. **However, there is still a short-term risk that current consumption decisions overestimate future income growth potential.**

Corporate Financial Behaviour and Risks

Corporate **debt burden** grew in 2004 mainly in terms of domestic loans and leasing, while foreign borrowing increased more modestly compared to previous years. Such a shift in financing confirms favourable loan conditions with margins of the local loan market reflecting a risk level fairly similar to that used in assessing companies in the developed European countries. All in all, the debt growth of companies operating in Estonia did not increase in 2004, remaining at a below 20% rate comparable to the previous year.

Rapid developments in the real estate market are reflected in higher than average debt growth indicators of that sector. Such allocation of financial resources is a logical reaction to high profitability in the real estate sector over the last years. Since the economic cycle might not provide similar support over the following periods, financiers should bear in mind that high profit margins might decline fast. In the case of Estonia, the small size of the market and low debt capacity of the population should be taken into account as well.

Estonian companies are characterised by large financial leverage and rather small net financial assets, compared to other European companies. Therefore it is important that companies properly assess their profit outlook so that excessive debt burden did not obstruct flexible reorganisation of business, should the economic environment significantly deteriorate.

Financial Behaviour of Households and Their Risks

The main determinants of households' financial behaviour include low key interest rates with extremely low interest margins arising from banks' loan marketing campaigns. Savings, which were modest over the last 18 months, slightly increased in early 2005 but could not balance the deterioration in net financial assets. At the end of March 2005 households' financial liabilities to banks exceeded financial assets by 8.2 billion kroons.

The **savings rate** of Estonian households is remarkably lower compared to respective indicators of the developed European countries. Cash and deposits dominate the structure of financial assets, even though the share of long-term savings instruments is increasing as the result of successful launch of the pension reform.

The **growth in household debt** accelerated at the beginning of 2005 and was close to 42% by the end of March, whereas the growth in housing loans exceeded the 50% level again. Households' loan demand will probably remain at its previous level throughout 2005, should expected favourable economic environment be maintained. Real estate developers also follow the suit and continue active residential construction in the light of sufficiently high demand for new flats. Since the market volume is limited, sales periods of older flats are likely to prolong.

The fact that banks are extending their operations to the consumer credit market, which has so far been considered conservative, reveals that the number of potential housing loan customers evidently cannot rise fast much longer. Banks foresee better growth outlooks also on the credit card segment.

The fairly good quality of household loans shows that no major problems have occurred with loan servicing as yet. Due to a decrease in interest rates households who had taken a loan previously have (temporarily) benefited from lowered interest burden. New loan customers who enter the market at the lower end of the interest cycle must be even more considerate as to their actual capabilities as well as past and future developments of the real estate market.

Banking Sector

Tight competition in the banking sector manifests itself in lowered interest margins and aggressive loan campaigns. From the point of view of financial stability it is important that banks would not loosen loan conditions under tight competition but would maintain appropriate LTV ratios as well as fairly conservative evaluation of customer's future solvency.

The share of household loans is increasing in the structure of loan portfolios, which mainly arises from rapid growth in residential real estate loans. Mortgage or pledge of building secure about 75% of household and corporate loans.

Quality indicators of the loan portfolios of banks have remained high under favourable economic environment. However, banks have reduced their reserves for covering loan losses due to changes in the financial accounting principles. In case freed capital is not maintained in the own funds or additional risks are taken on its account, banks will become more vulnerable to the potential future loan losses.

While income earned on foreign markets further support profits of **banks and banking groups** and net interest margin continues the downward trend, the ability to earn income depends on the expansion of loan and leasing portfolios. On the one hand, the average profitability of loans and leasing facilities is rapidly declining; on the other hand, foreign funding and the growing importance of market-based resources caused a rise in the average interest expenses of funds borrowed. The opportunities for a reduction in funding prices are limited which is seen when comparing the low rate of interest paid on liabilities and respective expenses of banks in the old EU countries. Although a decline in interest income accompanying the expected stabilisation of the growth in loan and leasing portfolios is balanced by a rise in fee and commission income, banks find it ever more complicated to retain their current profitability.

Fast growth in risk assets is reflected in the declining **capital adequacy** indicators, even though major banks decided not to pay dividends and retain last year's profit in their own funds. Continuous decrease in net interest margins raises doubts about banks' ability to retain their current level of capitalisation, should risk assets maintain current growth rate.

Securities Market and Other Financial Intermediaries

Bond market developments were characterised by the slightly revived primary market and moderate turnovers on the secondary market. Growth of the primary market was mainly supported by issuance of bonds by local non-financial[1] sector companies.

The fast price rise of securities on the **Tallinn Stock Exchange**, which started in autumn 2004 and which was provoked by Swedbank's takeover bid for Hansapank's shares, continued throughout the first half of 2005 with index TALSE growing by 68%. As a result, the market value of traded shares increased to 69% of GDP, which currently places Estonia at the respective level of the old EU countries in 2003, and outpaces all new Member States.

The yield of **investment funds** and changes in the value of their assets have mainly been influenced by changes in the key interest rate and the dynamics of stock markets of the developing countries. Despite the multiplication of the value of stock fund assets over the last year, the growth of the total value of investment funds was still slower than a year ago. The value of second pillar pension funds, which have been increasing steadily, rose to nearly 3 billion kroons by spring 2005. Besides investments into the second pillar pension funds, payments into supplementary funded pension funds form an increasing share in household savings. Total pension savings amount to approximately 13% of households' financial savings.

Positive developments in the **insurance** market arose from the increasing domestic demand and the spread of voluntary pension insurance. The life insurance sector was more successful as for the growth in insurance premiums, whereas the doubled total profit of non-life insurance companies in 2004 compared to 2003 shows the success of the non-life insurance sector.

Payment Systems

No major changes had occurred in the payment environment in Estonia by the end of the first quarter of 2005, indicating a fairly mature market. Merchants are adopting mobile phone payments at the POS as a new alternative payment method – the number of payments tripled over the year. The use of direct debits and card payments as convenient payment methods has increased at a rate comparable to the previous period (about 20% and 35% a year, respectively).

The use of payment cards among the new EU Member States is most popular in Malta, Slovenia and Estonia. These countries also have an extensive network of ATMs and POS for servicing payment cards.

The main reasons for the popularity of card payments in Estonia are convenience and absence of transactions fees for the card holder. The custom in payment intermediation is that the originator of the payment covers the transaction fees, which are 0.5–3.0% of the payment value. A large share of fees (interchange fees) is further paid to international card associations and to the service providers of the card payment infrastructure. The amount of the fee charged for servicing card payments could only decrease in the future at the expense of lower interchange fees charged by international card associations.

Summary and Financial Stability Risks

Optimistic future expectations of companies and households reflect the positive impact of the EU accession. Income growth is expected to accelerate, which together with sustained low interest rate environment

[1] Here and below the non-financial sector refers to households and non-financial corporations, excluding general government.

encourage consumption and investments on the account of future income. However, as household and corporate debt ratios have reached relatively high levels at their respective volume of financial assets, the **vulnerability of the Estonian economy** has increased. High debt burden might aggravate flexible reorganisation of corporate business or family budget in case of potential major economic drawbacks.

Households' loan demand will stay at previous years' levels, supported by interest rates that are expected to remain low this year. As the number of new housing loan customers fails to grow significantly because of low income levels, the wealth effect caused by surging real estate prices has a slight impact on growing loan volumes. New borrowing decisions made by borrowers at overly optimistic assumptions indicate the accumulation of potential loan servicing problems in the future.

Accelerated deposit growth is a positive trend to be noted, reflecting greater propensity to save, but the difference with debt level growth is still vast.

Extremely low interest margins limit banks' opportunities to earn income on the domestic market. Banks are willing to take more risks in order to maintain their market share and extend the income base. They are seeking new growth opportunities and have started active sales on the consumer credit market, which is currently fairly unengaged. Incomes are sufficient to meet regulative capital requirements today but, unfortunately, their weak growth outlook is not in line with the forecast increase in risk assets. In order to minimise potential risks it is vital that banks did not loosen their loan standards during low interest margin campaigns and maintained a sufficiently conservative approach towards requiring collaterals or assessing the customer's future solvency.

I
GLOBAL ECONOMY AND ESTONIAN ECONOMY

External Environment

Global Economic Cycle

Global economic activity slowed down at the end of 2004, largely owing to a rapidly increasing price of oil. In the fourth quarter, **economic growth** was the year's weakest in several major economic areas, and even negative in some major countries (Germany, Italy, the Netherlands). The slowdown in economic activity continued at the beginning of 2005; the year-on-year growth of industrial production decreased to below 4% in the United States, below 3% in the euro area, and below 1% in Japan (see Figure 1.1). Retail indicators and various economic activity and confidence indices also showed a continuous decrease in the economic growth at the beginning of the year.

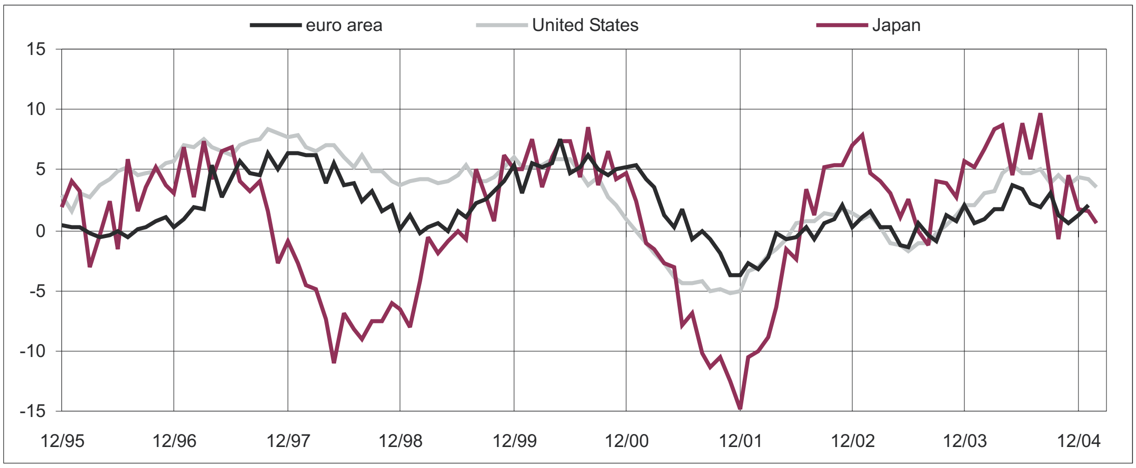

Figure 1.1. Annual growth in the industrial production of the euro area, the United States and Japan (%)

Source: EcoWin

The **labour market situation** in the euro area did not change over the review period due to persistent low growth – the unemployment rate fluctuated in the high range of 8.8–8.9%. Unemployment decreased a little in the US, ranging at 5.2–5.4%. However, the falling unemployment rate in the US was caused by a rising share of economically inactive people; the growth rate of employment did not accelerate. The unemployment rate in Japan fell to the lowest level in the last five years (4.5%) by the end of 2004 but slightly rose again in February.

Government budget deficit in the US and the euro area remained roughly unchanged, compared to 2003. The US government budget deficit of the last 12 months stayed over 3.3–3.5% of GDP in the second half of 2004 and early 2005. As for the euro area countries, Germany, Greece and France outpaced the 3% limit established by the Stability and Growth Pact in the 2004 fiscal year. Despite the depreciation of the dollar, the US goods and services account continued to deteriorate and the current account deficit increased to 6.3% of GDP in the fourth quarter of 2004.

Inflationary pressures also increased at the end of 2004 and early 2005, mostly driven by a rising oil price. The year-on-year growth rate of US consumer prices rose to 3.0–3.5% and that of the core consumer price index (CPI, excl. food and energy) reached 2.4% in February (see Figure 1.2). The US Federal Reserve Open Market Committee also noted the growing inflationary pressures in its statements on raising the key interest rate. In the euro area, the impact of the oil price rise was to some extent compensated by the declining dollar and sustained weak domestic demand; the year-on-year growth rate of consumer prices rose to 2.4% at the end of 2004 but declined again in early 2005 to 1.9–2.1%. In Japan, the rise in oil prices brought about positive year-on-year growth in consumer prices in the last quarter of 2004 after a 5-year deflation, but at the beginning of the year the growth rate again turned negative.

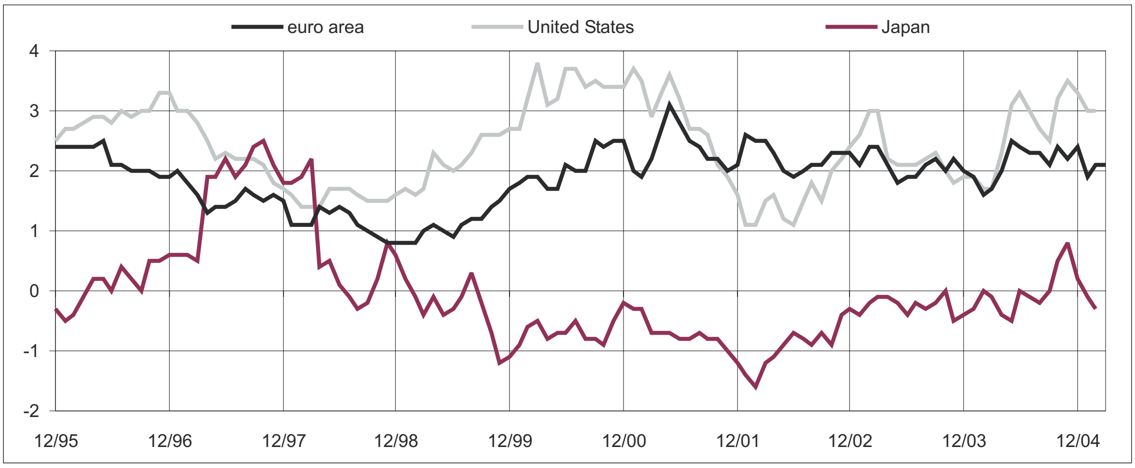

Figure 1.2. Consumer prices in the euro area, the United States and Japan (%)

Source: EcoWin

Economic growth in **Finland** and **Sweden** outpaced that of the euro area almost at a double rate in 2004 and was based on high households' willingness to consume. Investments in fixed assets started growing in both countries and, apparently, Finland and Sweden have recovered from the setback in the industrial sector in 2003. Consumer price inflation slowed down again at the beginning of 2005. Some deflation took place in Finland in January but prices started to increase again in February because of a rise in rent expenses and food prices.

According to preliminary estimates, the Finnish economy grew by 4.3% in the fourth quarter and 3.7% on annual basis[1] but in January 2005 rapid growth decelerated to 1.7% on a yearly basis. Major industrial sectors continued upward trend.

All in all, the Finnish industrial sector seems to have overcome the low of three previous years and the year-on-year growth of industrial production was 4.8% in 2004 (see Figure 1.3). The growth was broad-based, which may be considered especially positive: in addition to the electricity and electronics sector, which expanded their volume recently, the metal and chemical industry and wood and paper industry made a positive contribution.

The households' willingness to consume was supported by a 4.6% real growth in disposable income in 2004 and increased dividend income by 26%. However, such willingness may be reduced by persistently high unemployment level, which still stood at seasonally adjusted 8.9% at the end of the year.

The Swedish economy grew by 3.5% in 2004 with support from the external sector and domestic demand. Net exports supported GDP growth by 2 percentage points and final consumption of households by 0.9 percentage points. The last quarter was the weakest of the whole year: the fourth quarter GDP adjusted for working days increased by merely 2%, year-on-year, but it did not have a significant impact on the general outcome.

The scarcity of new orders over previous months caused a negative result in output volumes at the end of 2004, which declined by 3.7% in December, year-on-year. In early 2005 the situation in manufacturing

[1] Source: Finnish Statistical Office.

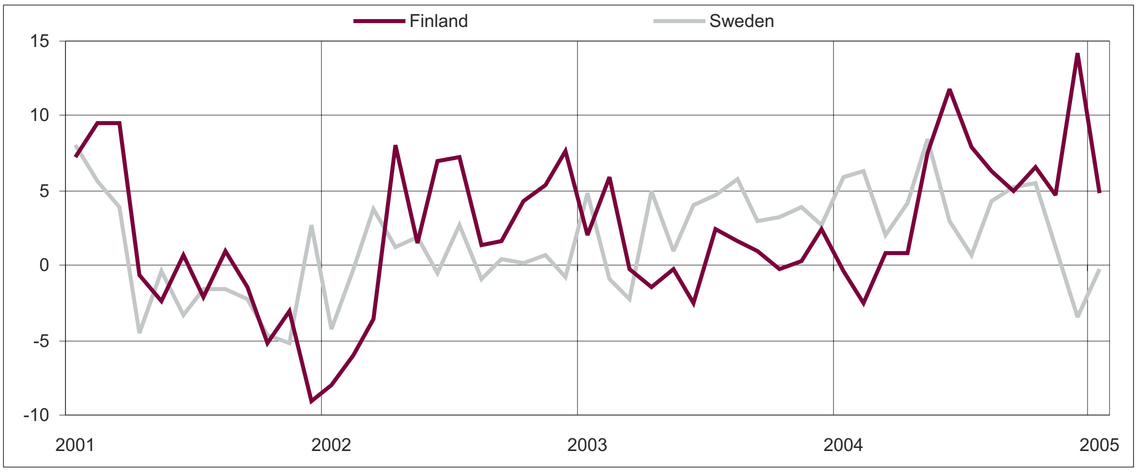

Figure 1.3. Annual growth in the industrial production of Finland and Sweden (%)

Source: EcoWin

recovered thanks to new orders received in the fourth quarter. As new orders from both export and domestic markets rose at the beginning of the year, the growth of industrial production is expected to revive soon on annual basis too.

Both in Finland and Sweden the growth rate of the harmonised index of consumer prices slightly declined in December, compared to previous months, reaching 0.9%. Prices started to rise mostly because of food prices and leisure costs, while the rise was inhibited by prices of electricity, fuel and motor vehicles. At the beginning of the year the growth rate of harmonised consumer prices accelerated again and the annual inflation reached 1.2% in February.

International Financial Markets

The upward trend on the **stock markets** continued in the fourth quarter of 2004 and the first quarter of 2005.[2] Even though economic growth decelerated over the last six months and the rising oil price caused some uncertainty, steady global economic recovery and generally positive outlook supported growth. Stock indices in the euro area and Finland grew by nearly 14% over the period, in Sweden a little less (12%; see Figure 1.4). Prices rose more modestly on the US market (about 7%); according to some estimates, stock prices there are nearer their economically justified value than, for instance, in the euro area or Japan. Rising interest rates also inhibited rise in the US stock market.

Movements in interest rates were also regionally different on **government bond markets**. The largest change occurred in the US where the central bank raised the key interest rate on five occasions, that is from 1.5% to 2.75 %, thus continuing the upward cycle started at the end of July 2004. Earlier the central bank raised the key interest rate in order to reduce monetary policy stimulus because of economic recovery, but in March the central bank pointed to the threat of potential inflation growth. Both the euro area and the Swedish central bank kept the key interest rate unchanged at 2% level and consequently the 3-month interest rates did not change within six months (see Figure 1.5).

Long-term (10-year) interest rates of US government bonds rose by 24 basis points against the backdrop of the upward cycle of key interest rates; in the euro area and Sweden the rates dropped by 45 and 64 basis points, respectively (see Figure 1.6). While low economic activity was behind the fall in the euro area interest rates, in Sweden low inflation played a major role: inflation remained below 1% over the review period and even declined to zero in January 2005.

[2] The review covers the period from 30 September 2004 to 12 April 2005.

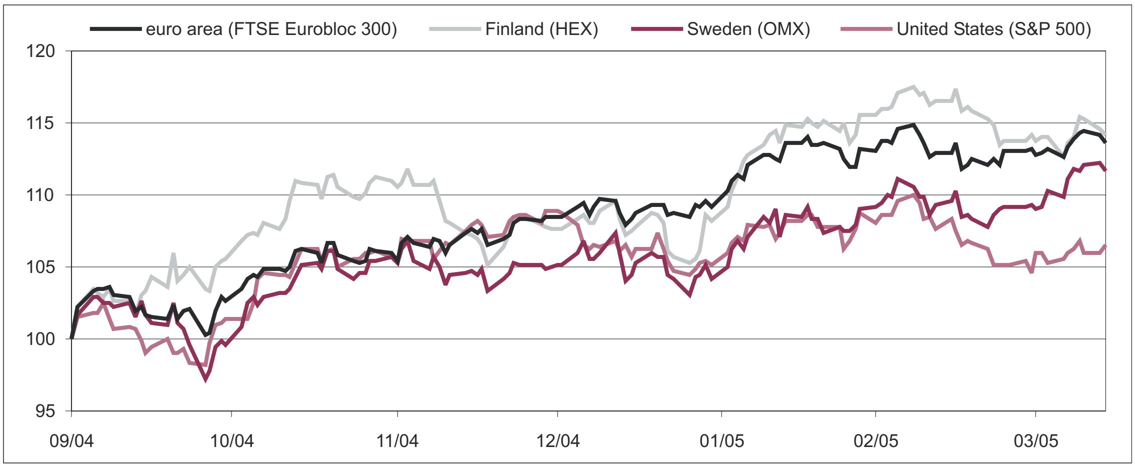

Figure 1.4. Stock indices in the United States, the euro area, Sweden and Finland (30 September 2004 = 100)

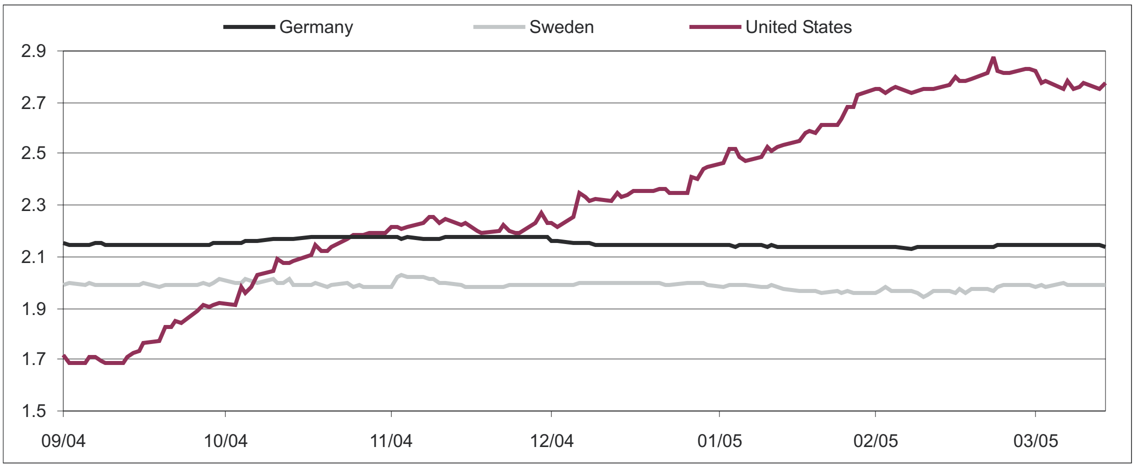

Figure 1.5. 3-month interest rates in Germany, Sweden and the United States (%)

Source: EcoWin

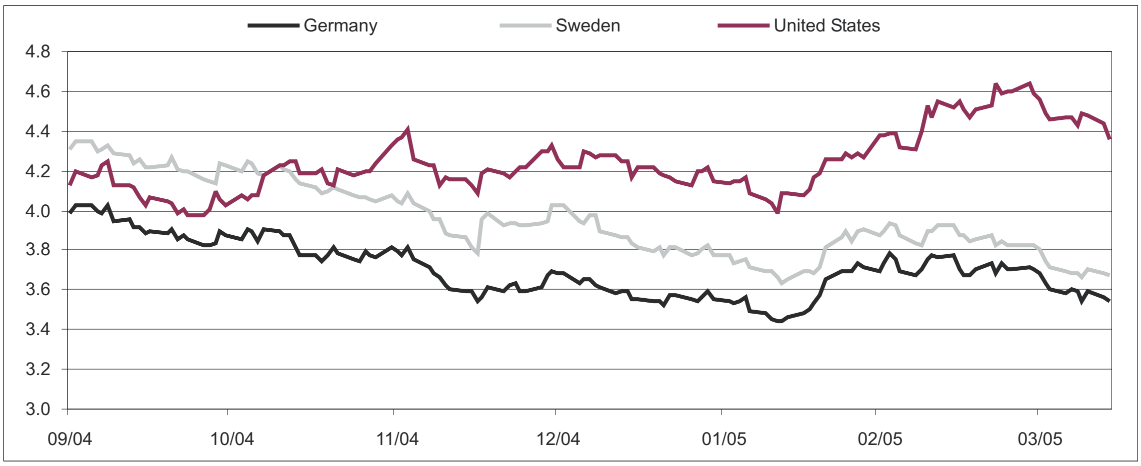

Figure 1.6. 10-year interest rates in Germany, Sweden and the United States (%)

Source: EcoWin

On **currency markets** two periods could be distinguished. In the fourth quarter of 2004 the dollar continued to depreciate against other major currencies, which caused the euro exchange rate to reach a historic high at the end of the year (1.365 dollars per euro; see Figure 1.7). The main reason behind the dollar's depreciation was the US current account deficit that reached over 6% of GDP. The beginning of 2005 brought a rather sharp turn of the trend, resulting in the euro rate trading between 1.27–1.35 against the dollar. The dollar was significantly supported by rising interest rates in the US and improving economic indicators. As a result, the euro appreciated by 4% over the period, closing at 1.2964 at the end of the first quarter.

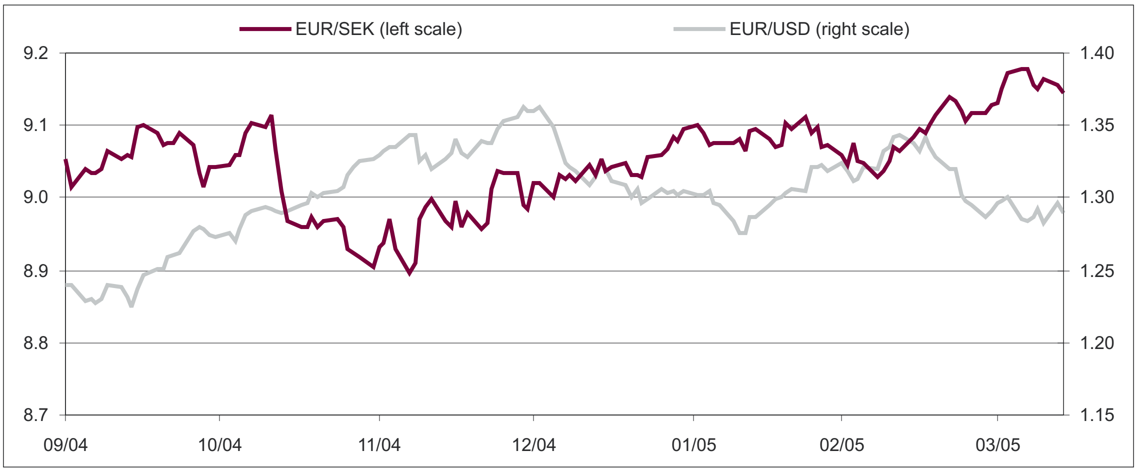

Figure 1.7. Exchange rate of the euro against the Swedish krona and the US dollar

Sources: EcoWin

The Swedish krona depreciated by 1% against the euro in the review period. The krona appreciated until early December and started to depreciate gradually thereafter, partly as a result of low inflation and a decreasing difference in the long-term interest rates with the euro area. At the end of March the EUR/SEK exchange rate stood at 9.17 kronas thus moving back to previous long-term trading range. Since 2002 the exchange rate of the Swedish krona against the euro has remained within a fairly limited trading range (9.0–9.3).

Estonian Economy and Macroeconomic Risks

Economic Growth, External Balance and Inflation

The Estonian economy continued rather rapid growth in the second half of 2004. **GDP growth** reached 6.0% and thus Estonian economic growth outpaced the respective euro area indicator in the given period by about 4 percentage points, reflecting continuous and relatively fast convergence (see Figure 1.8).

The structure of economic growth improved significantly as the share of domestic demand, which had meanwhile expanded too quickly, decreased and that of net exports increased. The Estonian trade exports showed a considerably stronger growth (20.1% according to foreign trade statistics) compared to the main target markets, which means that Estonia's economic competitiveness may have improved further thanks to the EU accession and integration.

The year-on-year growth of **domestic demand** slowed down and thus external balance improved as well in the second half of 2004 with the deficit of goods and services accounts decreasing to 6.1% of GDP of that period (in the first six months it stood at 9.0%). The balance of both goods and services improved, which resulted in more balanced economy.

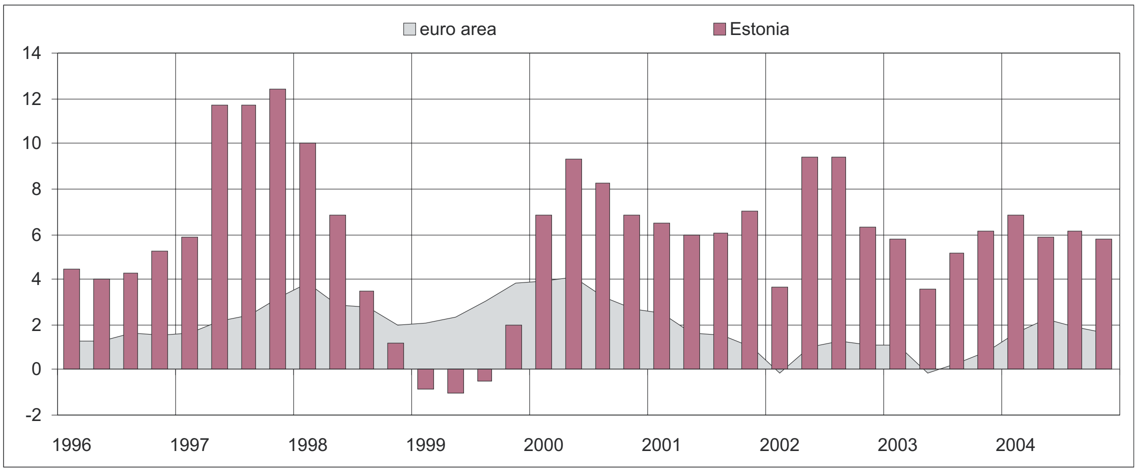

Figure 1.8. Real growth of GDP by quarters (%)

Sources: Statistical Office of Estonia; Eurostat

Domestic demand growth and increasing stocks prior to the EU accession led to a short-term setback in the external balance in the first half-year, which was enhanced by a temporary reduction in savings arising from uncertainty. In the second half of the year, however, private sector savings grew in line with confidence in the Estonian economy, and near-potential growth rate was achieved with a smaller share of imports. The four quarter average of Estonia's **current account deficit** decreased to 12.6% of GDP, marking a 0.5 percentage points lower level than in 2003 (see Figure 1.9).

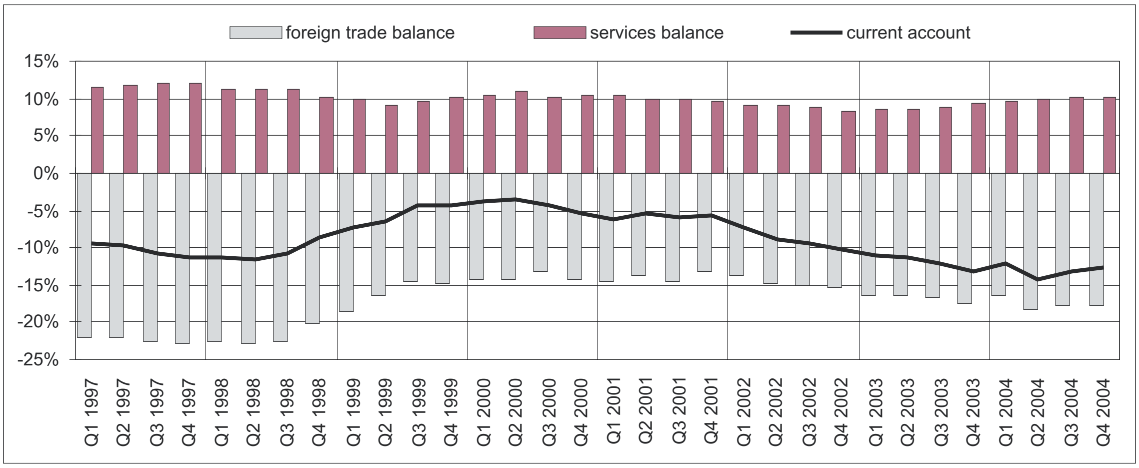

Figure 1.9. Foreign trade balance, services balance, and current account balance in ratio to GDP (4-quarter average)

The income account deficit continued to increase in 2004 and amounted to 9.1 billion kroons, i.e. 6.6% of the expected GDP. Debit turnover of the income account, i.e. the income earned by foreign investors in Estonia, increased by a fourth, whereas the income earned by Estonian investors abroad (credit turnover) increased by nearly 50%. Excluding from the income account the reinvested earnings, in case of which no actual flow of funds occurs, the net outflow of income amounted to 1.5 billion kroons.

The domestic demand growth peaked in the second quarter of 2004 due to stocks increasing in the fear of disruptions in the operation of the established supply chains and possible price rises. During the months subsequent to the accession the imports of product articles “purchased in advance“ were extraordinarily low and the growth in stocks ceased to increase that fast.

The growth of investments into fixed assets relied in the second half-year above all on new business projects, including residential construction. Most of the companies already operating on the market invested more modestly or in equal volumes compared to the year before. Residential construction was brisker thanks to the increase in the availability of bank loans to households, supported also by declining interest rates. Year-on-year, the share of investments (including changes in stocks) grew to 31.3% of GDP in current prices and was thus a major demand-side growth component.

As expected, the growth in **private consumption** slowed down in the second half of 2004. The slowdown in real income growth inhibited private consumption: although nominal wage growth continued at a fairly fast rate, rapid consumer price growth led to a slowdown in real income growth. Another factor inhibiting consumption growth was an increase in private sector savings, which reflected strengthening confidence of households.

In the second half of 2004 **consumer price inflation** picked up as expected. After a low in 2003, caused by temporary decline in external price pressures (particularly as regards food and fuel) and the relative scarcity of regulated prices, annual consumer price growth accelerated gradually throughout 2004 (see Figure 1.10).

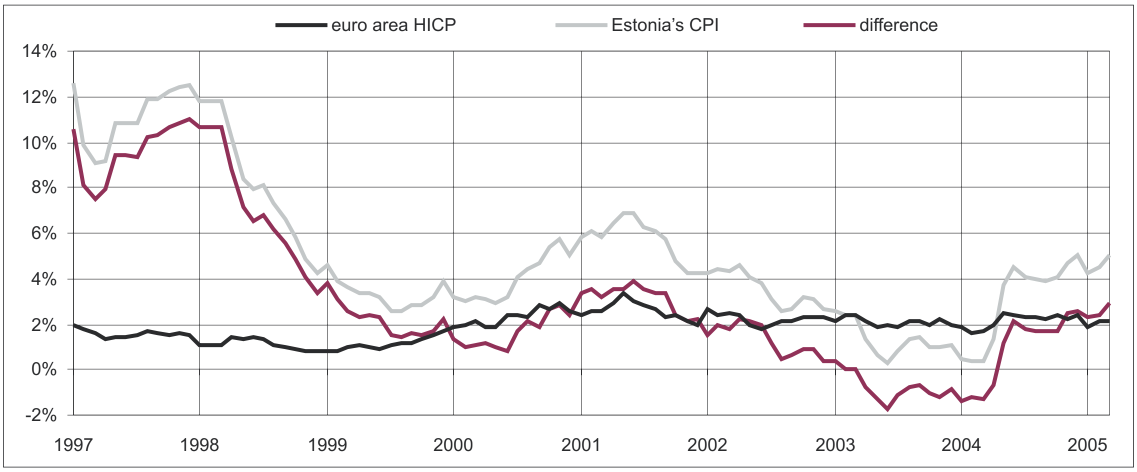

Figure 1.10. Annual growth of consumer prices in Estonia and the euro area

Source: Statistical Office of Estonia; Eurostat

The price increase in April 2004 was a one-off event, which was brought about by the implementation of common customs tariffs set for the moment of the EU accession as well as the harmonisation of fuel excise duties. Estonia's inflation accelerated mostly because of a decreasing base effect in the following months. Inflation was also spurred by rising oil prices in the global market. Domestic pressures reflected in consumer price index rather weakly compared to the previous year and the increase in regulated prices remained stable at the previous year's level. Growth of inflationary pressures was noticeable perhaps in other indicators – construction and real estate prices.

The core inflation rate decreased and the annual average price rise was 1.4% (2.3% in 2003). Estonia's indicator usually exceeds that of the euro area (which is a normal feature of current price convergence) but in 2004 it remained 0.4 percentage points below the respective euro area indicator.

Corporate Business Situation

Confidence

According to the Estonian Institute of Economic Research, estimates of Estonian companies were on average more optimistic in 2004 compared to the previous year. Business optimism increased also in early 2005 (see Figure 1.11).

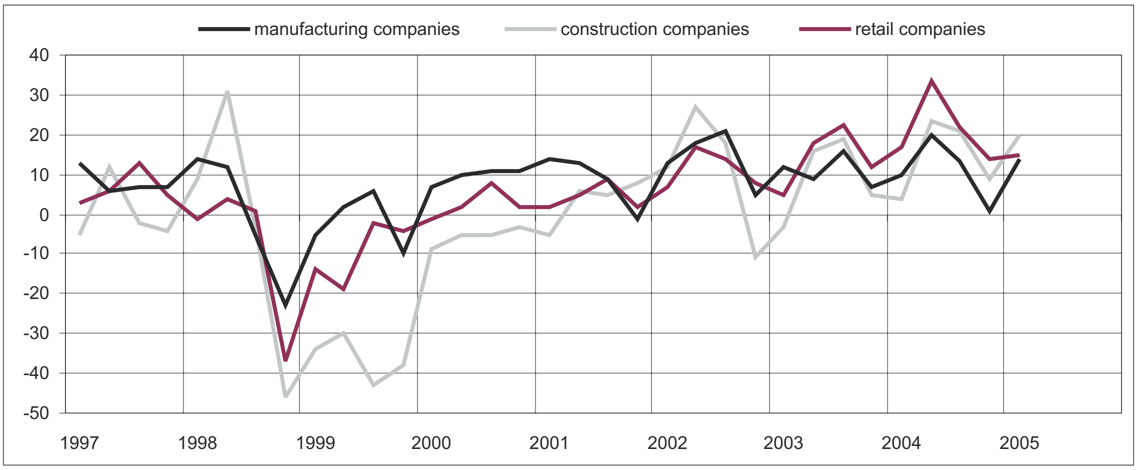

Figure 1.11. Confidence indicators of Estonian enterprises

Source: Estonian Institute of Economic Research

Construction and retail trade confidence indicators increased the most, year-on-year, while industrial confidence indicators remained slightly lower. Improving confidence of **retail trade enterprises** was supported by the addition of new retail space as well as growth in the number of foreign tourists. The optimistic estimates of **construction companies** were based on strong growth in demand.

The estimates of **manufacturing companies** improved in the early months of 2005 mainly thanks to positive estimates concerning the opportunities to market the output of the coming months (see Figure 1.12). Improvement of external demand has only been evident in a few fields of activity, whereas for some fields tighter competition and loss of current economic contacts caused severe problems. For instance, some companies encounter difficulties in finding highly qualified workforce on the labour market.

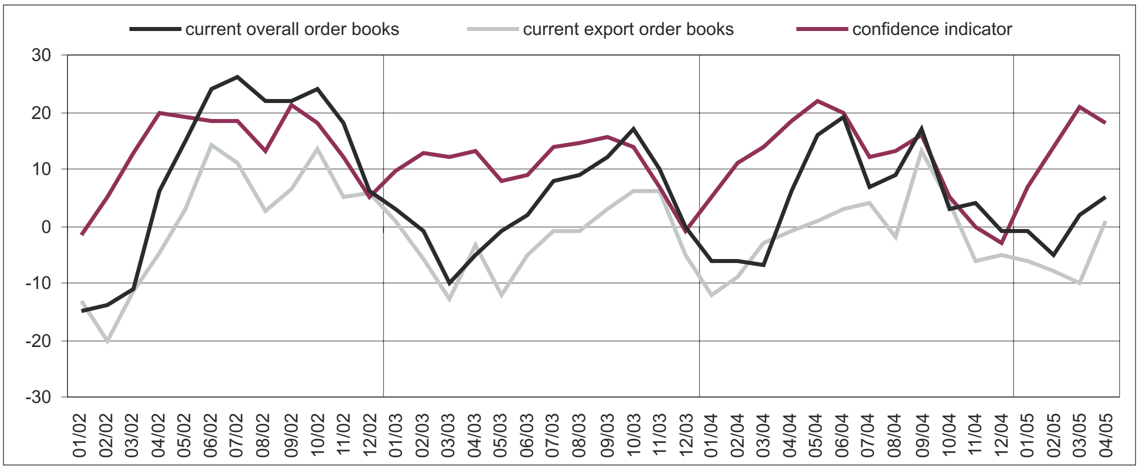

Figure 1.12. Production demand of manufacturing companies and the confidence indicator

Source: Estonian Institute of Economic Research

Industrial Sales and Investments

In the second half of 2004 the demand-side conditions were fairly favourable for both the export sector and for local providers. The euro area interest rates remained at a low level and the global economic growth stabilised remaining, however, still uneven across countries and product groups.

According to foreign trade statistics Estonia's goods exports significantly outpaced economic growth of the main target markets (20.1%) in the second half of 2004. Goods exports were positively affected by recovering global technology sector, which substantially supported growth in subcontracting exports (see Figure 1.13). In 2003 the main source of export growth was chemical and metallurgical industry. In the first half of 2004 the situation of dairy and timber industry improved too but the manufacturing of electrical machinery and radio and communication devices were the main driving forces behind export growth in the second half. The exports of textile and fish products and clothing, footwear and headgear did not grow much.

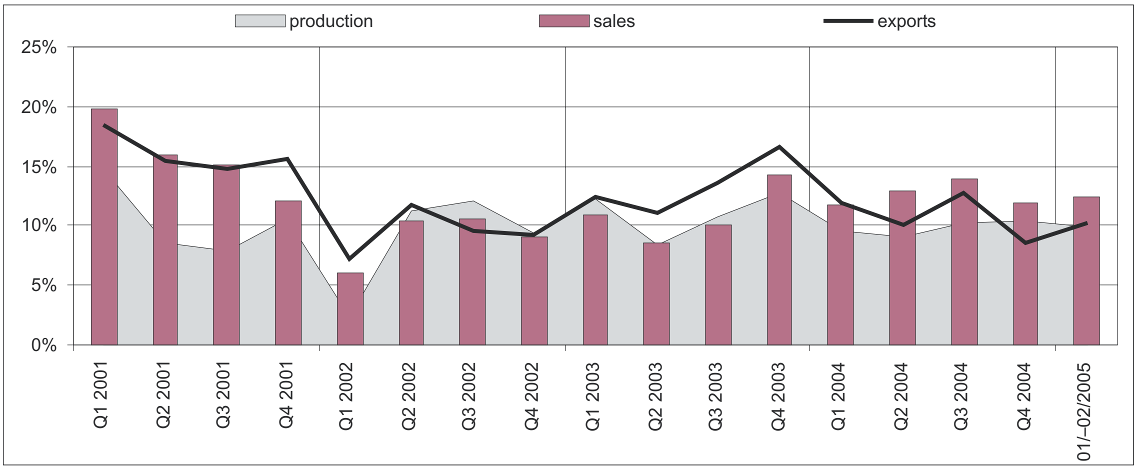

Figure 1.13. Production and sales indices of manufacturing

Source: Statistical Office of Estonia

Statistics of corporate investments show that in the second half of 2004 investments in manufacturing, construction and real estate improved, year-on-year (see Figure 1.14). Investments made by transport, storage and communications companies were smaller than in the previous year.

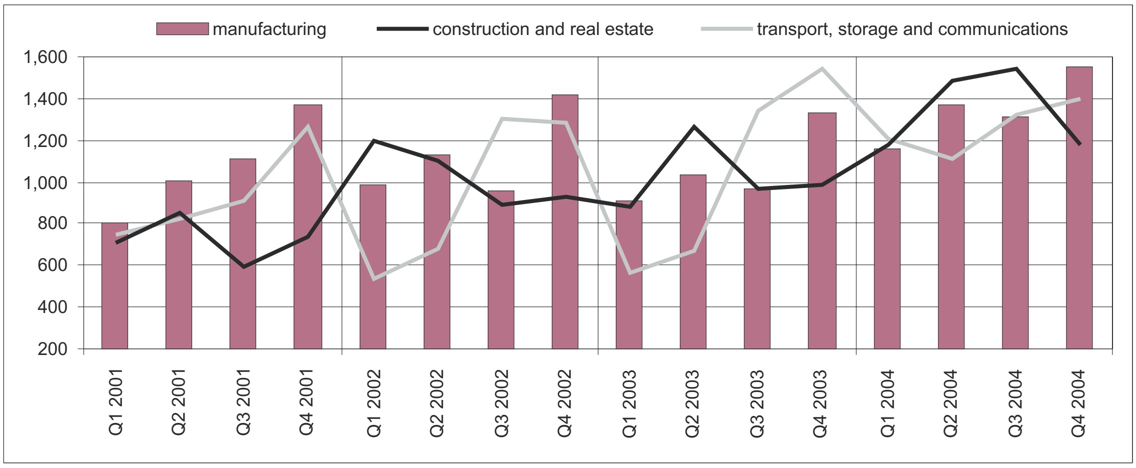

Figure 1.14. Investments in tangible fixed assets (EEK m)

Source: Statistical Office of Estonia

New Companies and Bankruptcies

The **number of companies going bankrupt** within a month declined abruptly from the relatively high levels of early 2004, stabilising by the end of the year and by early 2005 at the level of a long-term average indicator

(16–20 bankruptcies a month; see Figure 1.15). 252 companies went bankrupt in 2004, i.e. 14 companies more than in 2003. By industries there were most bankruptcies in absolute terms in the wholesale and retail trade sector (over a third of all bankruptcies). As in 2003, bankruptcies were, in ratio to the total number of companies active in the respective industry, slightly more frequent than average in construction and manufacturing.

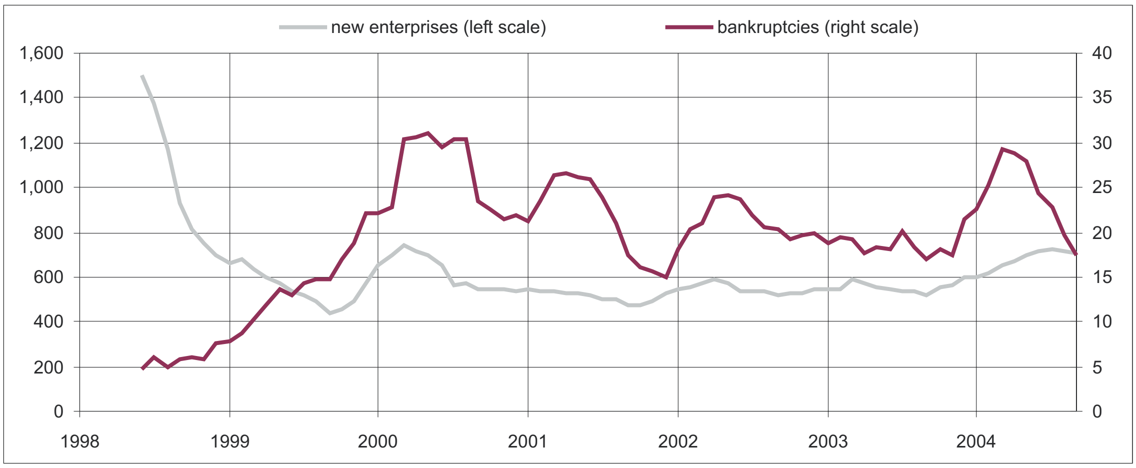

Figure 1.15. New enterprises entered in the commercial register within a month and bankruptcies (6-months moving average)

Source: Estonian Enterprises Register

Economic revival and positive outlooks were reflected in the larger number of **new companies** entered in the commercial register. 8,203 new companies were registered in 2004 (over 20% more than in 2003). Active registration continued also in the early months of 2005. Half of the new companies were set up in the wholesale and retail trade sector in 2004; a considerable number of companies were established in real estate and other business services.

Corporate Profitability

According to the business statistics of the Estonian Statistical Office the **net sales of enterprises** increased from 8.4% in 2003 to 13.7% in 2004 (see Figure 1.16). The growth rate of total profit slowed down to 0.8%, resulting in a lower **total profitability** indicator.

Figure 1.16. Growth of net sales by fields of activity

Source: Statistical Office of Estonia

The main reason for modest profitability growth was a rise in **total expenses** that outpaced the growth in turnover. With a rising turnover more attention should also be paid to more effective corporate cost management in order to gain an increase in profitability. With low interest rates current profitability may suffice to service loans but regarding fairly high financial leverage of Estonian companies drawbacks arising from potential deterioration of the environment should be taken into account as well.

By **fields of activity** a decrease in profits (or even a loss) should be pointed out in transport, storage and communications, particularly in water transport companies. Although the number of passengers has risen, the surplus of transport services has declined, which was also affected by the abandoning of duty free trade on means of transport after the EU accession. As expected, real estate had the highest profitability as demand remained high throughout the year, supported by favourable loan conditions (see Figure 1.17). High margins in the real estate development induce oversaturation of the sector but also reflect buffers required to manage potential difficulties (insufficient demand causing price pressures).

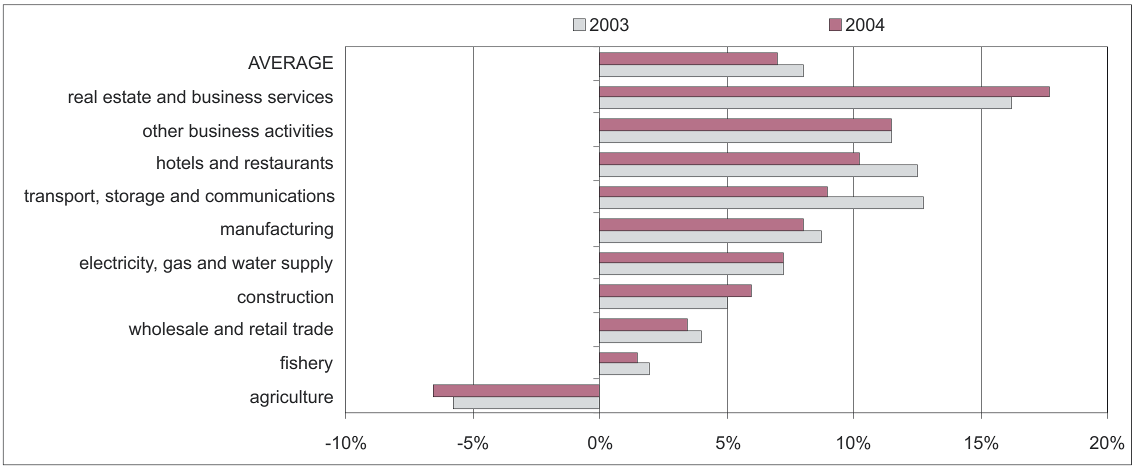

Figure 1.17. Total profit to net sales by fields of activity

Source: Statistical Office of Estonia, short-term statistics

While profit growth in the business sector as a whole remained rather modest, **foreign-owned companies** achieved remarkably high profit rates. Compared to 2003, revenue per company rose significantly in most sectors. Better results occurred in domestic demand oriented sectors, whereas the annual revenue per company on average was smaller in fishery.

Economic Situation of Households

Labour Market

The year 2004 was characterised by a fall in unemployment, which, unlike in previous years, was not accompanied by a rise in employment (see Figure 1.18). The average annual **number of the unemployed** shrank by 3.9% year-on-year; the **unemployment rate** fell below 10%, standing at 9.7%. However, unemployment declined due to a short-term recovery, whereas the number of people unemployed over 12 months grew to 9.2% and their share in the unemployed reached 52% (46% in 2003).

Employment is usually at its highest in the third quarter owing to seasonal employment but in 2004 growth remained insignificant because of poor weather. Growth in the first half-year and decline in the second half balanced each other as a four-quarter average, and employment rose by 0.2%, i.e. by 1,200 persons, year-on-year. Development varied across fields of activity – employment grew in fishery and manufacturing, while it fell in the field of transport, storage and communications.

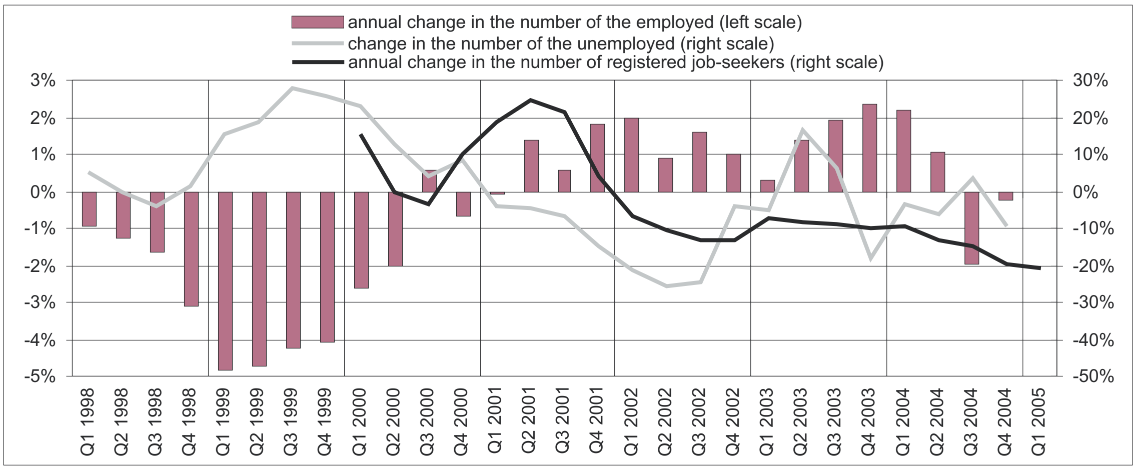

Figure 1.18. Annual change in the number of the employed and the unemployed and registered job-seekers

Source: Statistical Office of Estonia

The growth rate of **average gross monthly wages** slowed down from 9.4% in 2003 to 7.8% in 2004 and that of gross hourly wages from 10.7% to 7.1% (see Figure 1.19). Faster growth in monthly wages as compared to hourly wages was largely caused by an increase in remuneration for time not worked, which was especially characteristic of the public and financial sectors. At the same time, the rise in net monthly wages was almost equal to that in 2003 because of a rise in the non-taxable income threshold.

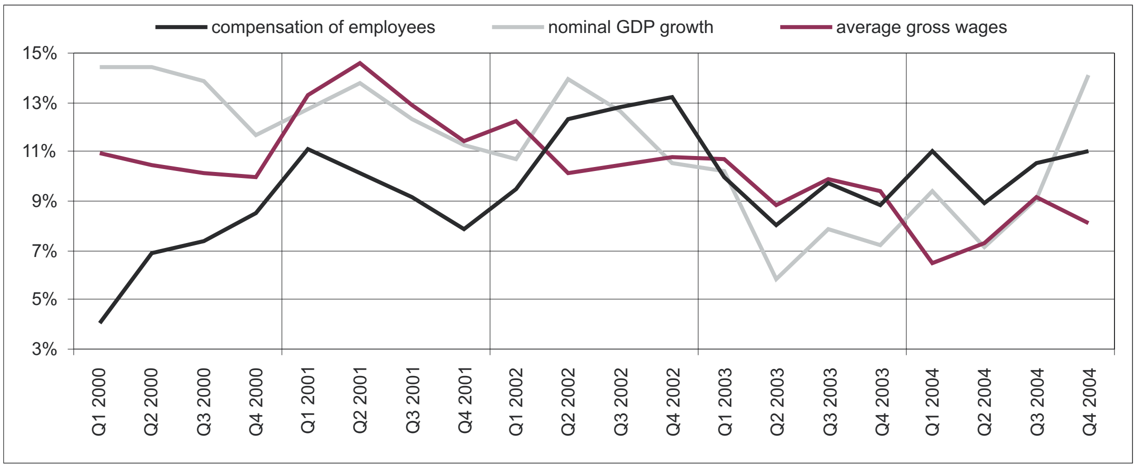

Figure 1.19. Annual growth of average wages, compensation of employees and nominal GDP growth

Source: Statistical Office of Estonia

The fastest wage growth in the sectors with less employees occurred in forestry and agriculture, which was partly influenced by increasing transfers from the EU funds. Higher than average wage growth also occurred in real estate, renting and business activities, and construction, which may be related to rapidly growing volumes of real estate loans.

Confidence and Household Budget Surveys

The downward trend of the **household confidence indicator** before the EU accession caused by fears of a price rise turned upward in May 2004 (see Figure 1.20). The number of households expecting a price rise in 12 months following the accession decreased rapidly but rose again in December 2004 and January 2005, primarily due to a planned rise in energy and fuel prices. At the same time, estimates concerning saving have risen and the fear of unemployment has remained low.

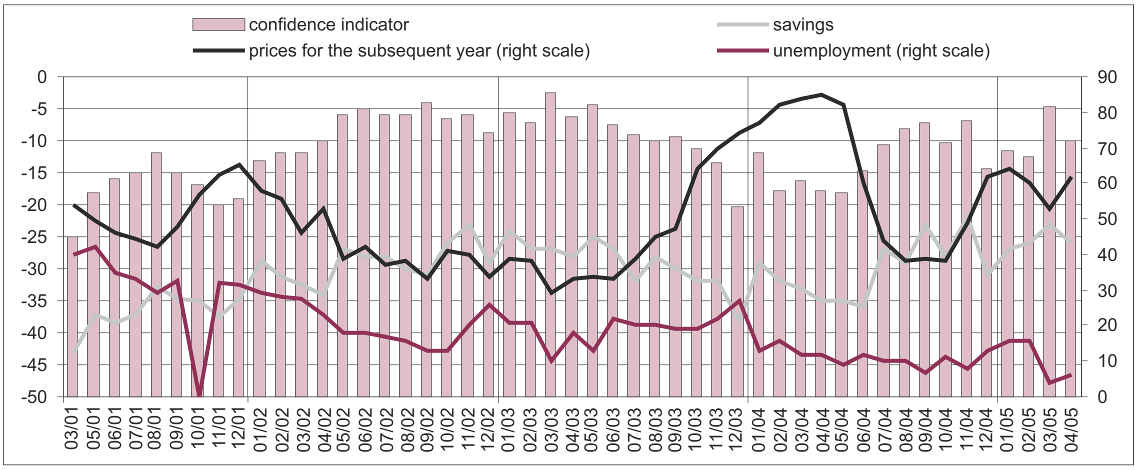

Figure 1.20. Consumer confidence indicators

Source: Estonian Institute of Economic Research

In 2004 the growth in confidence was also underpinned by reduced fears of becoming unemployed. The fear of unemployment declined to its historical low in March 2005. Households' estimates of their ability to save have also improved.

Favourable conditions of the housing loan and consumer loan market did not reflect in households' **intentions to make major purchases and investments** (buying a car; buying, building or renovating a house or an apartment), according to the estimates of the consumer barometer of the Estonian Institute of Economic Research. The renovation index picked up in the first quarter of 2005 but a few surveys are not sufficient to make far-reaching conclusions on demand growth (see Figure 1.21).

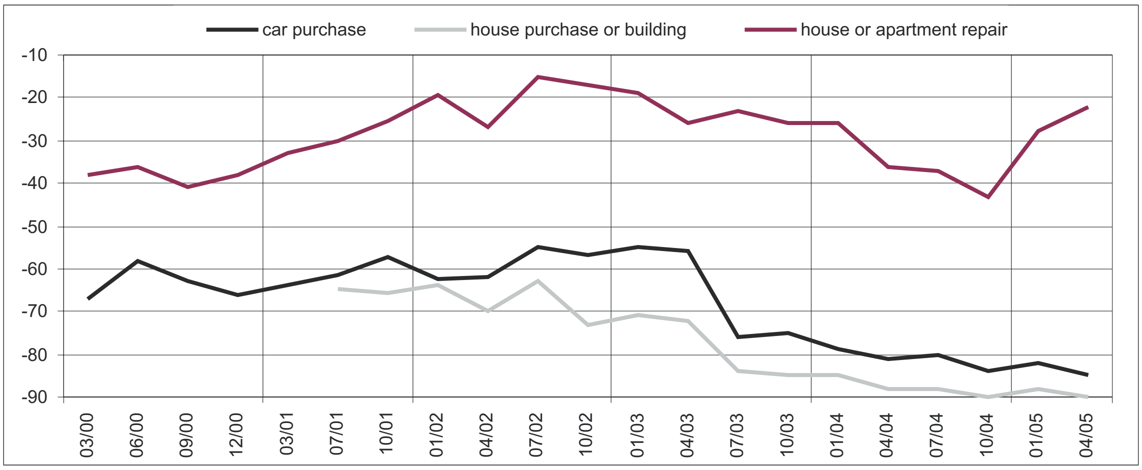

Figure 1.21. Households' cost estimates

Source: Estonian Institute of Economic Research

According to a survey of the Estonian Statistical Office on household budget, the growth of expenses per household member slowed down to 10.2% in 2004 and that of net income to 8.6%. The difference between income and expenses has decreased: in 2003 average income exceeded expenses by 9.8% but only by 8.2% in 2004. Food and non-alcoholic beverages still account for the largest share in expenses even though it has decreased over time. For instance, in 1996 they accounted for 41% of total expenses but for only 28% in 2004. Compared to the previous year the share of food expenses declined most and that of transport grew most, by 1.4 and 2.8 percentage points respectively.

Structure of Financial Intermediation and Financial Deepening

The most important factor in Estonian financial sector development over the last years has been an increase in **banks' assets**, which is based on active lending arising from low interest rates. The growth in banks' assets has been over 30% for the fourth quarter in a row and has exceeded the historical average growth rate of financial deepening by about twice. The growth of the second segment of the lending market – **leasing market** – has been slower, reflecting preference given to loan products in the bank portfolio (see Figure 1.22).

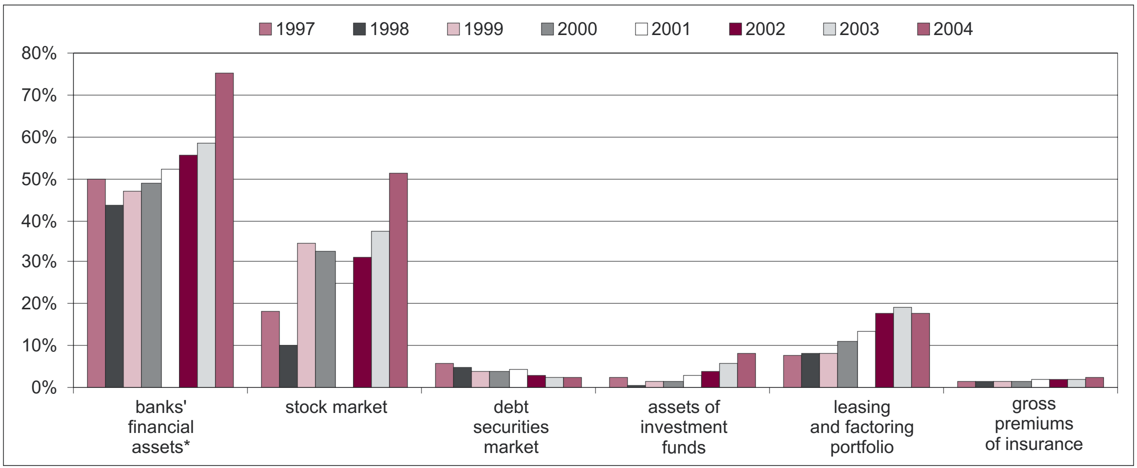

Figure 1.22. Structure of financial intermediaries (% of GDP)

* except loans issued to financial institutions (mostly leasing companies)

The **stock market** has also grown fast with an over 74% increase in market capitalisation. Rapid growth of the last years is, on the one hand, related to the increasing interest of investors in the shares of Estonian companies due to the accession to the EU and, on the other hand, to a rise in the share prices arising from the takeover of Hansapank. Therefore the growth in stock market prices and capitalisation should slow down in the future and be more reliant on change in corporate profits. The growth in the other segment of securities market – **bond market** – has been considerably slower, even though slight increase in issuance values and market capitalisation could be observed (see Figure 1.23).

The growth in **investment funds' assets** has been fairly rapid for several years now – an average of 65% a year over the last three years. Similar to the trends of previous years, this market has mainly grown thanks to stock and pension funds. The i**nsurance market** is characterised by an increase in the value of insurance premiums that outpaces nominal economic growth but is much slower compared to the other segments of the financial sector – the three-year average is 23% a year.

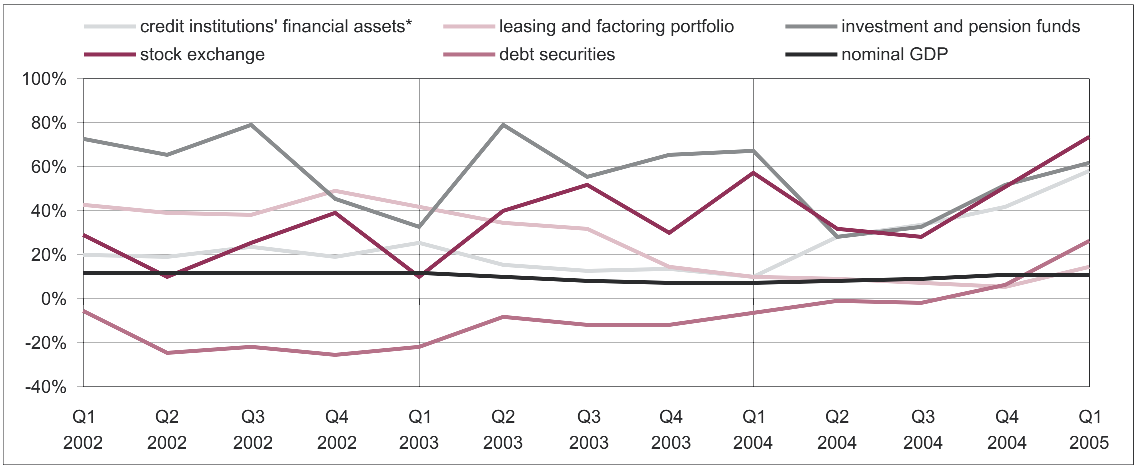

Figure 1.23. Annual growth of financial markets and nominal GDP

* except loans issued to financial institutions (mostly leasing companies)

II
FINANCIAL BEHAVIOUR OF COMPANIES AND HOUSEHOLDS AND THEIR RISKS

Companies

Financial Position and Saving

Corporate financial liabilities continued to outpace financial assets, supported by a rather strong loan demand at the end of 2004 and early 2005. All in all, it pointed to weaker financial position (see Figure 2.1). Compared to several other EU members the deficit of **net financial assets** of Estonian companies was quite large which may reflect a bigger share of fixed assets in the balance sheets of Estonian companies (see Figure 2.2).

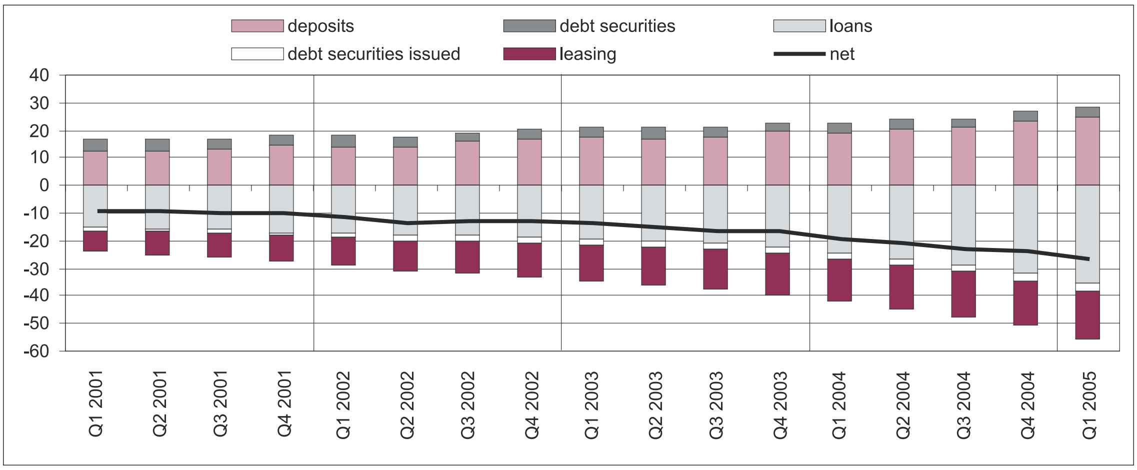

Figure 2.1. Corporate financial assets and liabilities to domestic banks and leasing companies (EEK bn)

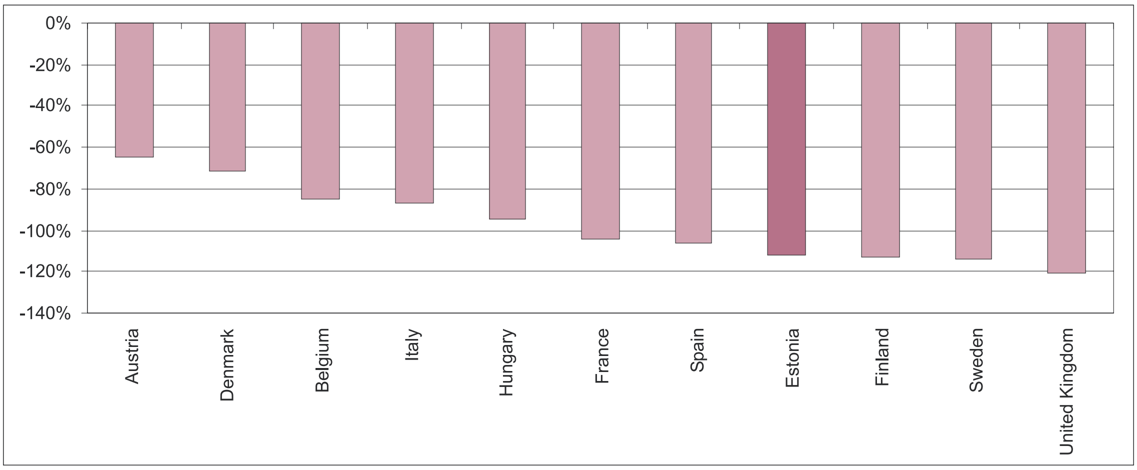

Figure 2.2. Net financial assets of non-financial companies (% of GDP) in selected EU countries (as at 30/6/2004)

Source: quarterly financial accounts

The stable and rapid **deposit** growth in 2004 can mainly be attributed to fairly positive economic results of companies. Accelerated growth over the second half of 2004 continued in early 2005, reaching 30% by late March, year-on-year. Deposits of resident companies grew by 3.7 billion kroons in 2004, exceeding previous year's growth by over one billion kroons. In the first quarter of 2005 deposits increased by 1.3 billion kroons, which is a very good result considering seasonality. Extraordinary growth probably reflected withdrawal from investment funds that had provided insufficient yield. The assumption is further assured by growth in time deposits whose share rose to 30% of the total volume of corporate deposits by the end of March.

The share of stock, fund and bond investments and issued loans in corporate financial assets is three times as big as bank deposits. Comparing the **structure of financial assets** of various EU countries, significant differences can be detected (see Figure 2.3). Swedish, Austrian and Spanish companies have invested more money in shares and investment funds; Finnish, Belgian and Hungarian companies make active use of debt instruments (loans and bonds). Companies operating in the United Kingdom prefer liquid holding (in cash and bank deposits) of their assets.

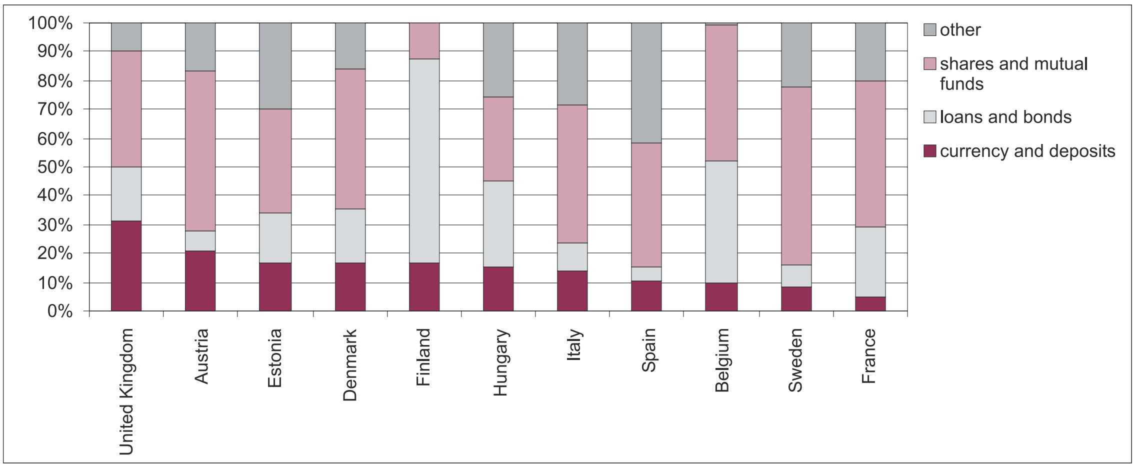

Figure 2.3. Structure of financial assets of non-financial companies in selected EU countries (as at 30/6/2004)

Source: quarterly financial accounts

Corporate Debt

Corporate debt growth was less prominent in 2004 than the year before, amounting to about 18% at the end of the year. Financing through domestic loans and leasing facilities grew considerably faster already in the first half of 2004, reaching 28% at the end of the year (see Figure 2.4). Foreign borrowing was most modest of the recent years but its share in corporate debt remains large at approximately 50%. Intra-group loans account for 44% of that (see Figure 2.5).

By **fields of activity** real estate and construction companies were most active to attract debt capital in 2004 with debt increasing by nearly 36% compared to the end of 2003 (see Figure 2.6). The funding pattern varied remarkably across fields of activity. Real estate and transport companies relied more on domestic loan and leasing in 2004, while manufacturing companies used their internal funding structure where intra-group loans have historically a major stake.

Corporate debt, which accounted for 72% of GDP at the end of the year, was almost half as big as the respective indicators of e.g. Sweden or Belgium but is still comparable to that of most EU Member States (see Figure 2.7). It should be noted that financing of the Estonian companies is largely based on debt, which makes the companies more vulnerable should the terms of financing deteriorate.

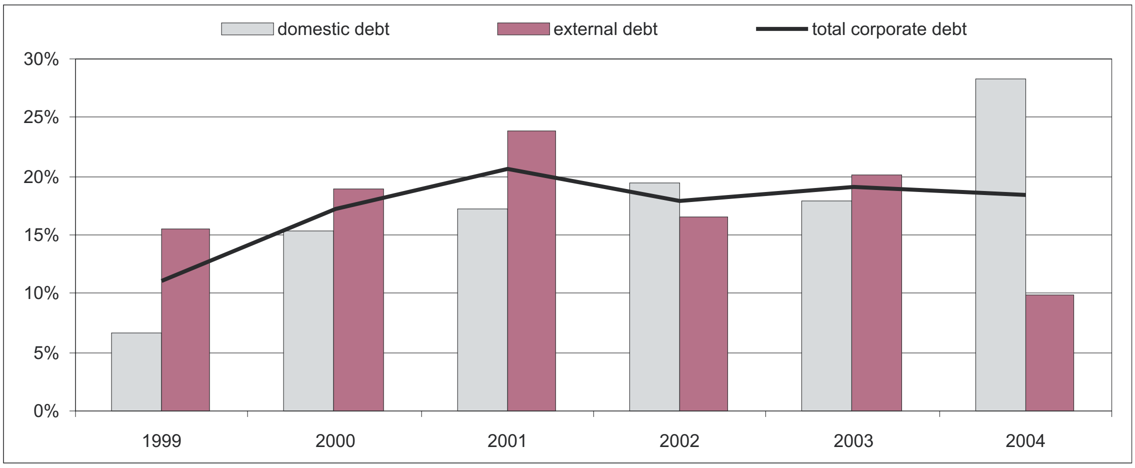

Figure 2.4. Corporate debt growth

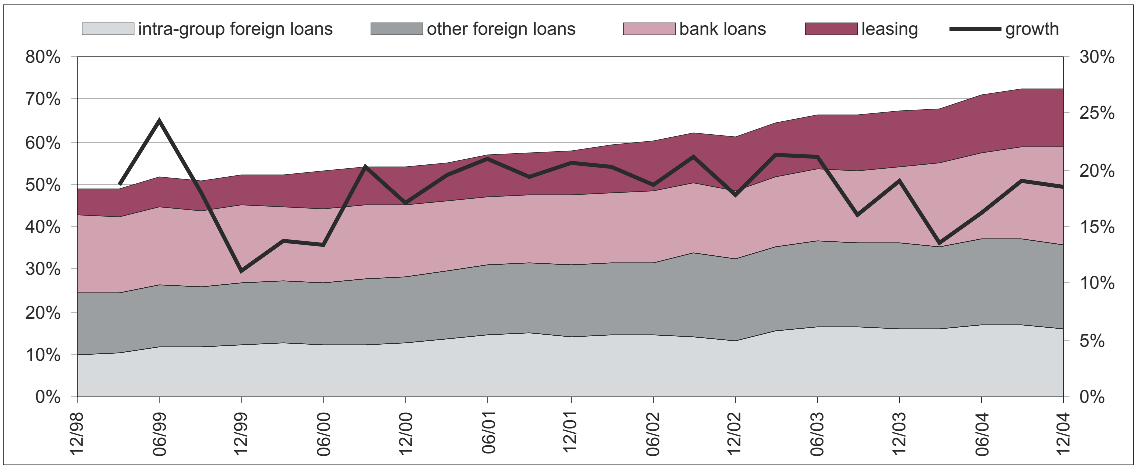

Figure 2.5. Corporate debt (% of GDP; left scale) and growth rate (right scale)

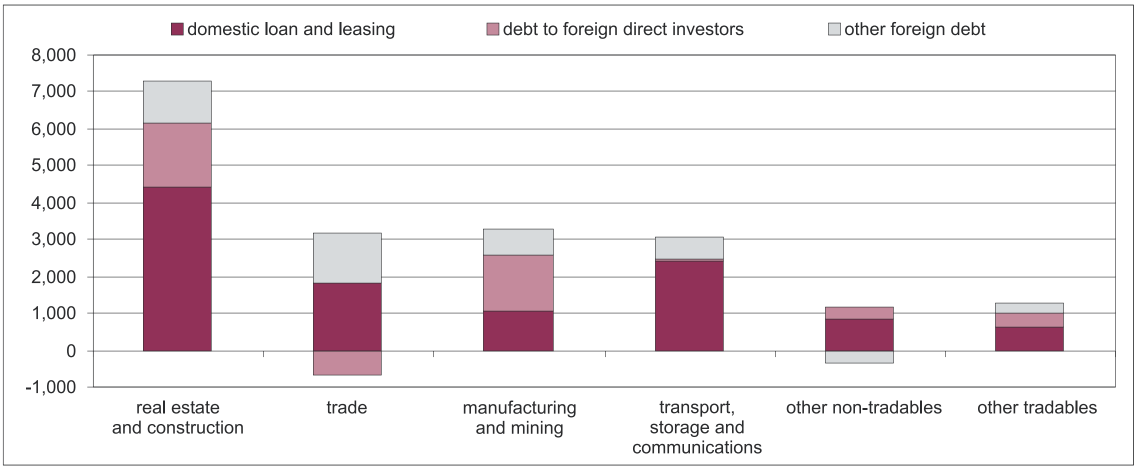

Figure 2.6. Net borrowing of corporate sector in 2004 by fields of activity (EEK m)

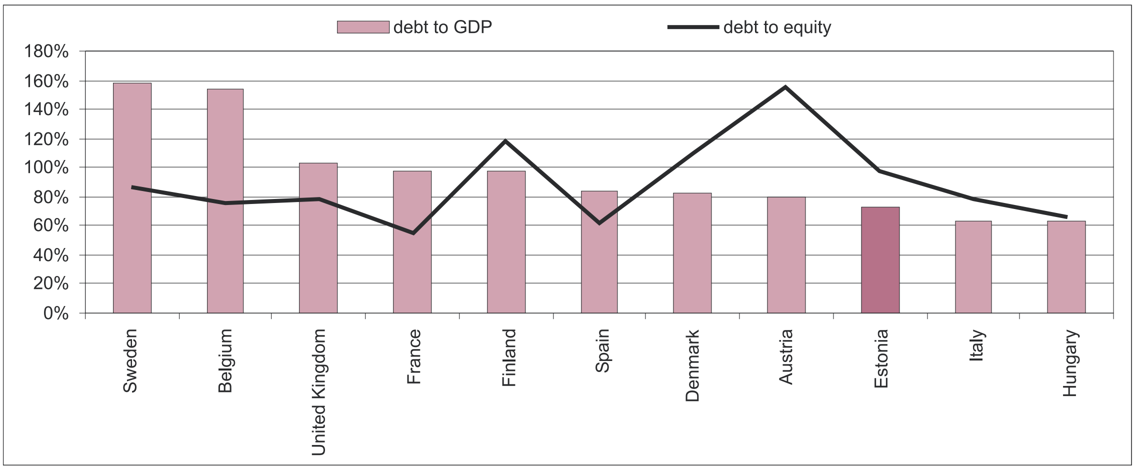

Figure 2.7. Corporate indebtedness and debt-to-equity ratio in selected EU countries (as at 30/6/2004)

Source: quarterly financial accounts

Debt Intermediated by Domestic Financial Sector

Debt intermediated by the Estonian local banking and leasing sector continued to grow fast also in the first quarter of 2005. The extremely high growth indicators of the transport sector slightly stabilised, year-on-year (the growth rate decelerated from 93% in November 2004 to 47.5% in March 2005)[1], whereas loan demand activated considerably in all other main industries. Taking into consideration favourable growth outlook for the Estonian economy and companies' optimistic forecasts, sustained growth in domestic loan demand at a much higher than 20% level is expected for the entire business sector.

This is supported by continuous favourable interest environment. Long-term corporate **loan interest rates** have stayed below 5% on average from the second half of 2004, denoting an interest level which is by about 30 basis points lower in March 2005 than a year ago (see Figure 2.8). Interest rates fell by 70 basis points in the real estate sector which displayed faster growth. It is rather difficult to find opportunities to further reduce interest margins at the current rate. Even though according to the estimates the average interest rate on long-term loans issued to non-financial companies in the euro area was 30–50 basis points lower at the end of 2004, it should be noted that in the EU context most of Estonian companies are actually small and medium-sized enterprises to whom higher risk margins are usually applied.

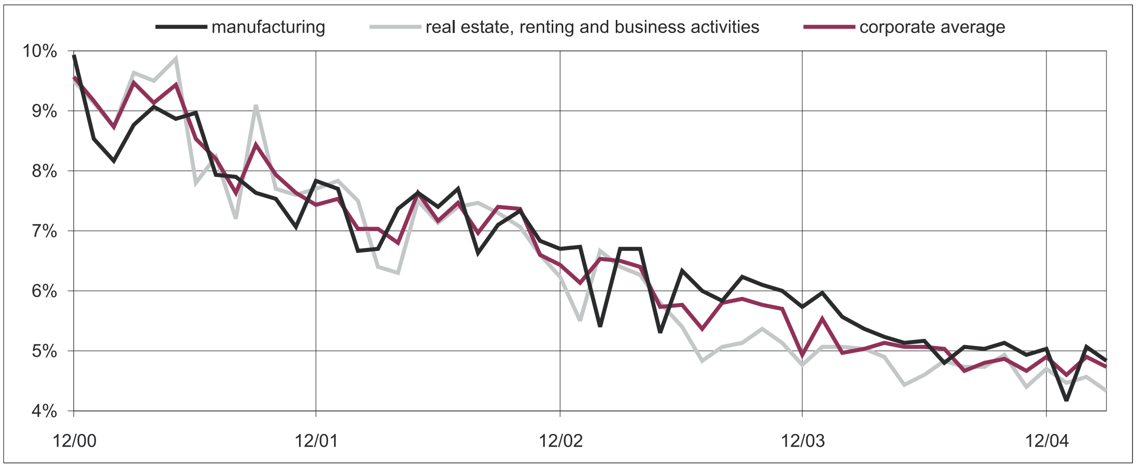

Figure 2.8. Long-term corporate interest rates

[1] The low base effect, which had caused rapid growth of the transport sector throughout the year, receded in December 2004.

It is also debatable whether rapid growth of corporate loans is in line with companies' medium-term profit expectations. The high growth rate of domestic bank loans partly reflects a substitution effect (domestic bank loans and leasing outpacing foreign borrowing) but in some segments excessive optimism may bring about over-borrowing which in case of unpredictable negative developments would inhibit flexible reorganisation of operations. For instance, financing of real estate developments increased abruptly over the past year but it must be noted that with the limited size of domestic market the profit margins need not necessarily remain at their current high level. While profit margins decrease at a similar risk level, for the banking sector it would still mean a higher risk.

Households

Financial Position and Saving

Although the growth rate of households' deposits started to increase again after modest saving at the end of 2003 and the beginning of 2005, it could not curb the continuous deterioration of the **net position of financial assets and liabilities**. Households' financial liabilities outweighed financial assets against the domestic banking and leasing sector by more than 8.2 billion kroons at the end of March 2005 (see Figure 2.9).[2]

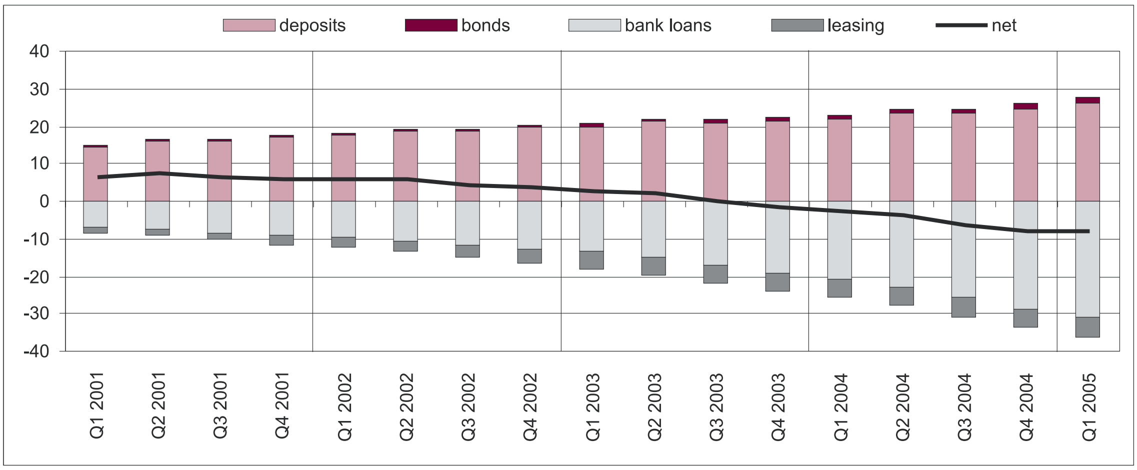

Figure 2.9. Financial assets and liabilities of households to domestic banks and leasing companies (EEK bn)

Since real estate purchases are the main factor behind the growth in financial liabilities, the wealth of households has increased against the background of surging real estate prices. Households become more vulnerable to external risks: should the potential rise in the interest rate increase costs on loan servicing and trigger price correction on the real estate market, the "unexpected wealth" gained in recent years might vanish quickly. Such risks underline the need to save also in case interest rates fail to look attractive for saving.

Households' confidence indicators expressing optimism about their improved ability to save led to the accelerated deposit growth rate that reached over 20% by the end of March 2005, year-on-year (see Figure 2.10). The **deposit growth rate** remaining above the 20% level throughout 2005 should be regarded "a minimum programme" that could support financial stability at the micro level and minimise imbalances at the macro level.

[2] It should be mentioned that thanks to the fairly large volume of financial assets held outside the banking sector (incl. mainly stock and mutual fund investments), the net financial position of households has remained positive although based on the financial accounts of the last quarters it has slightly weakened.

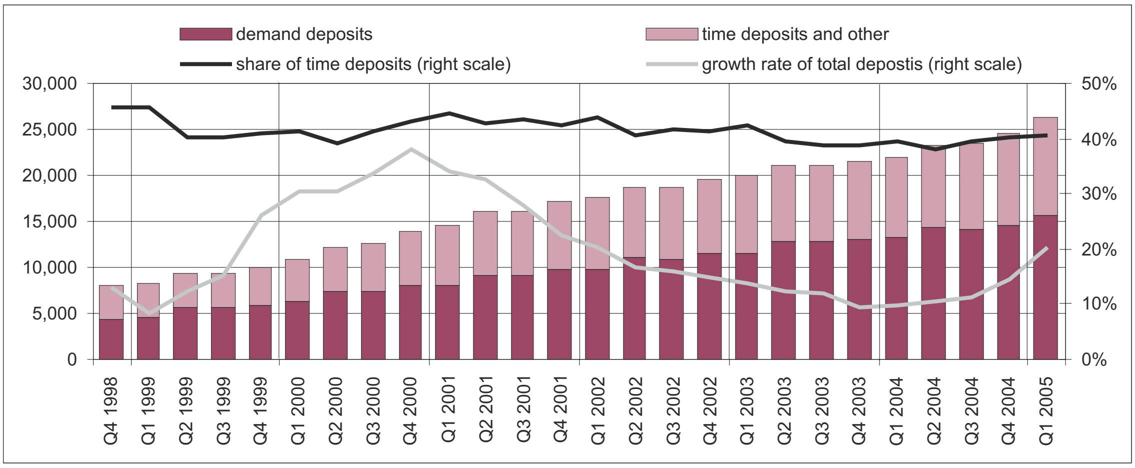

Figure 2.10. Households' deposits in domestic banks (EEK m) and deposit growth

Despite the fact that deposit rates have remained unchanged from mid-2003 (2.0–2.5% on average, depending on the term), time deposits grew faster over the past nine months, which resulted in the share of time deposits in households' deposits reaching over 40% again. Saving campaigns have played a certain role in the process, which under the favourable interest rate environment was a somewhat surprising strategy to attract new customers.

Comparing various indicators of financial deepening and volumes of deposits in other EU countries, the **volume of deposits** in Estonia still remains modest (see Figure 2.11). Along with the new EU Member States, the Nordic countries also stand out for their more moderate saving behaviour, while Central European countries prefer to hold their assets in cash and deposits. The new EU Member States differ from the old ones by a lower share of insurance assets; the United Kingdom has by far the highest figure here (over 50% of households' financial assets).

Arising from the successful launch of the pension reform, the **structure of households' financial assets** is changing in long-term perspective. Pension savings amounted to 4.1 billion kroons at the end of March 2005 and grew by 97%, year-on-year (see Chapter V: *Pension Funds and Insurance*).

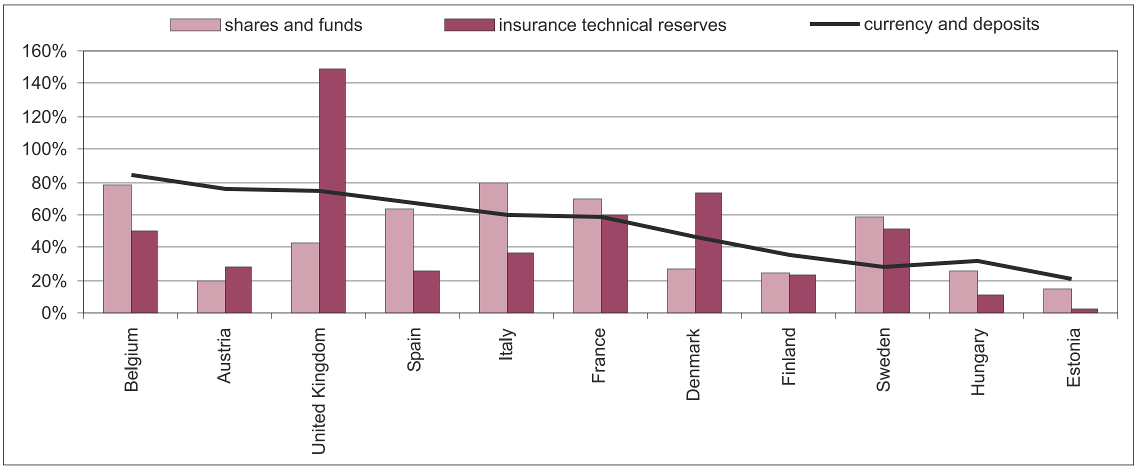

Figure 2.11. Households' financial assets in ratio to GDP in selected EU countries (as at 30/6/2004)

Source: quarterly financial accounts

Household Debt and Loan-Servicing Ability

Level and Growth of Debt

Households' strong loan demand showed practically no backslides in the early months of the year when usual development is modest due to seasonality. Thus, the **loan growth rate** slightly accelerated, reaching close to 42% by the end of March (see Figure 2.12). Rapid loan growth is still related to the demand for housing loans (growth rate exceeds 50%), whereas annual growth in other loans and leasing has decreased[3].

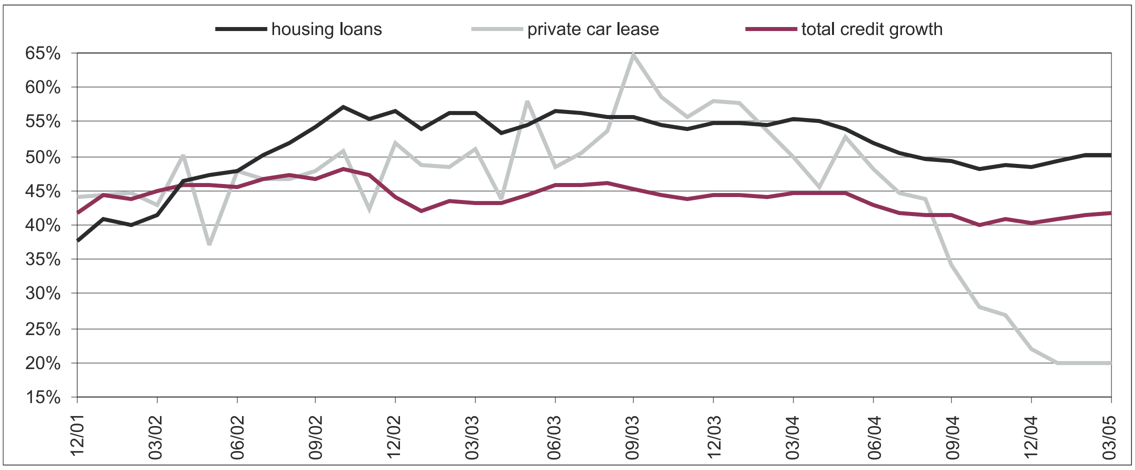

Figure 2.12. Annual growth of domestic credit to households

Households' liabilities to the domestic banking and leasing sector increased by 9.7 billion kroons in 2004, i.e. to nearly 34 billion kroons. The **stock of housing loans** amounted to 86% of growth, i.e. 8.4 billion kroons, reaching over 27 billion kroons at the end of March 2005 (see Figure 2.13). In the coming months the demand for housing loans will evidently be shaped by loan customers' desire to amend their loan contracts so as to benefit from more favourable loan terms. Even if the number of new loan customers fails to grow significantly in the near future because of low income levels, the wealth effect caused by soaring real estate prices creates good opportunities for present customers for the maximum application of the mortgage value.

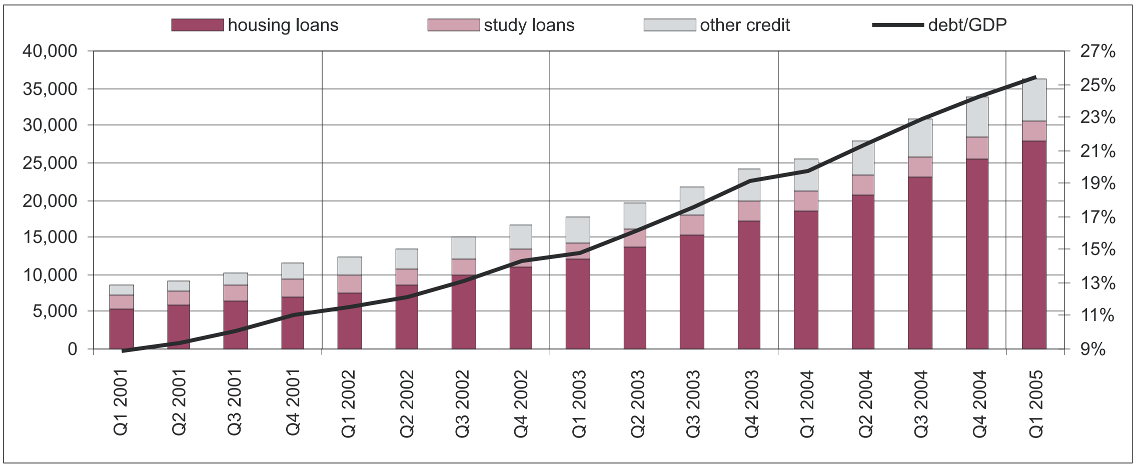

Figure 2.13. Domestic credit to households (EEK m) and debt-to-GDP ratio (right scale)

[3] In March 2004 the annual average growth rate of other loans (study loans, car leasing, other consumer credit and business loans) was 22% (20% in March 2005).

Low loan interest rates had a major role in active housing loan market. According to the November issue of the Financial Stability Review housing loan interest rates had not yet decreased to the lowest level in autumn 2004. Interest margins continued to decline, facilitated by competition. The average margin of the banking sector reached close to 1 percentage point against the EURIBOR (see Figure 2.14).[4] The average nominal interest rate on housing loans declined to 3.3% in March 2005. In the light of accelerating inflation, which followed the EU accession, the real interest rates have remained negative over the past six months (see Figure 2.15).

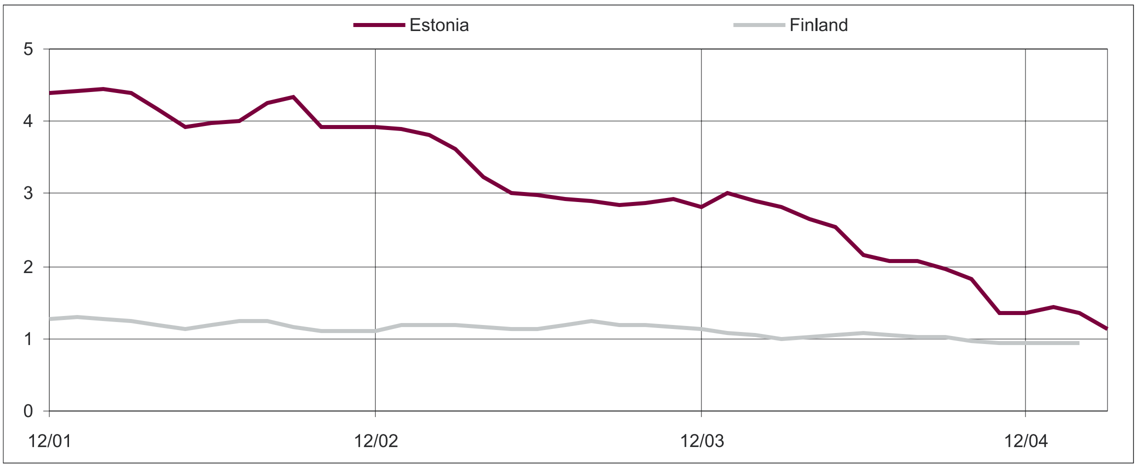

Figure 2.14. Housing loan margins in Estonia and Finland (calculations based on 6-month EURIBOR; percentage points)

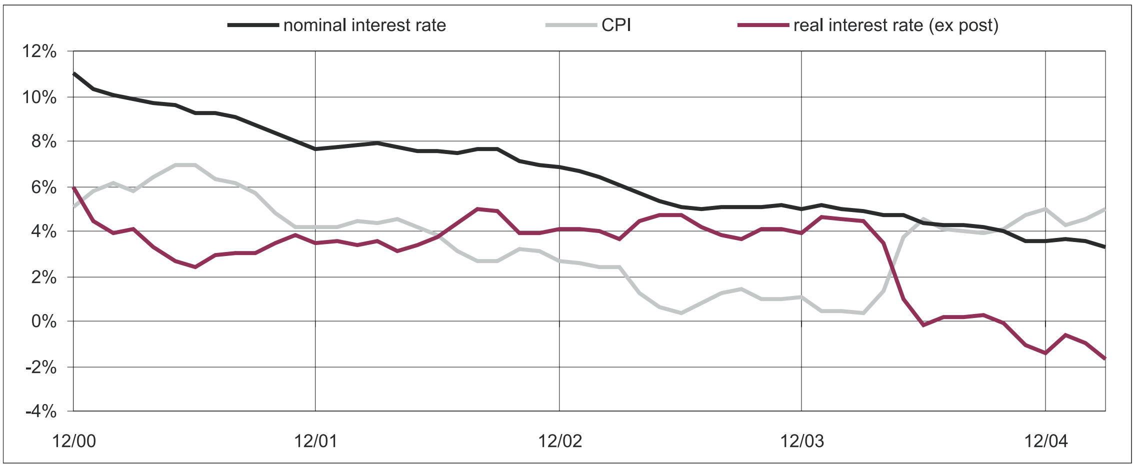

Figure 2.15. Nominal and real interest rates on housing loans and the consumer price index

Favourable loan terms of banks have diminished the role of **KredEx**[5] on the housing loan market although the provision of loan guarantees was partly affected also by the exhaustion of the limit provided to KredEx by law in autumn 2004. In conclusion, the growth rate of the stock of KredEx's loan guarantees in 2004 amounted to just a half of that of housing loans.[6]

[4] While the reduced margin was often fixed for a short period (up to one year) in campaigns, some reverse pressures might occur on the downward trend of the average loan margin.
[5] The Estonian Credit and Export Guarantee Fund KredEx is a self-sustaining fund in the jurisdiction of the Ministry of Economic Affairs and Communications, whose goal is to support the development of enterprises, exports and housing (source: KredEx).
[6] The stock of housing loan guarantees of KredEx amounted to 663 million kroons at the end of 2004 and to 527 million kroons in 2003 (source: KredEx).

Loans not directly related to financing housing formed 23% of the household debt at the end of March 2005; a quarter of them comprise car leasing (see Figure 2.16). Although the activity of the consumer credit market has slightly increased from mid-2004, there are no signs of faster growth rate – it is two times slower than the housing loan growth rate. The 20% decrease in car leasing was the main factor behind the inhibited growth in consumer credit. The usage of credit cards has intensified, year-on-year (38% at the end of March 2005).

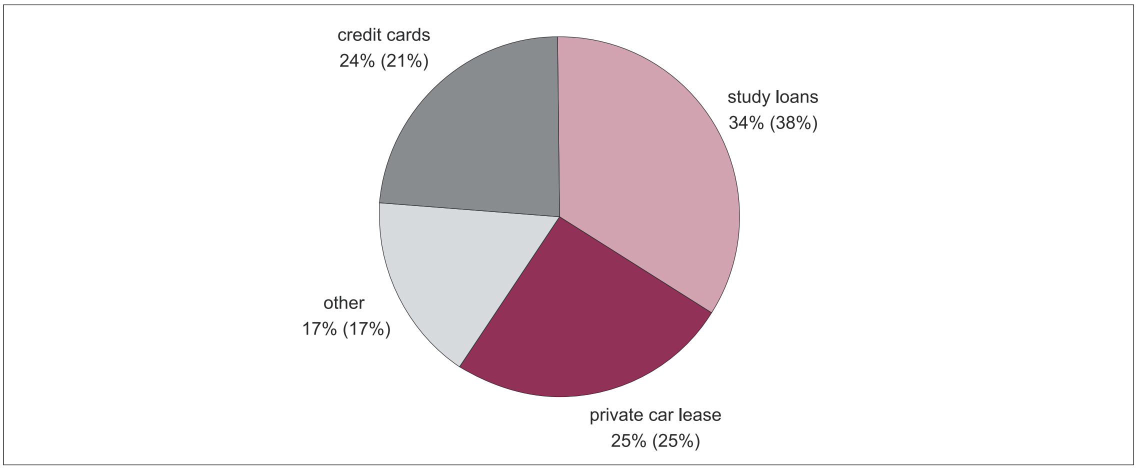

Figure 2.16. Structure of non-housing household loans (as at 31/3/2005; as at 31/4/2004 in brackets)

The average interest rate on consumer credit has remained high (about 12–13%), failing to encourage demand. Moreover, a 1–2 percentage point rise in the interest margin could be observed in the last half-year. Although high margins might indicate more conservative loan estimates of banks, they mainly reflect the particular nature of relevant loan products. For example, the average interest rate on operating leasing and financial leases in households' leasing contracts was over 5% in March 2005, having decreased by 1.2 percentage points, year-on-year (see Figure 2.17).

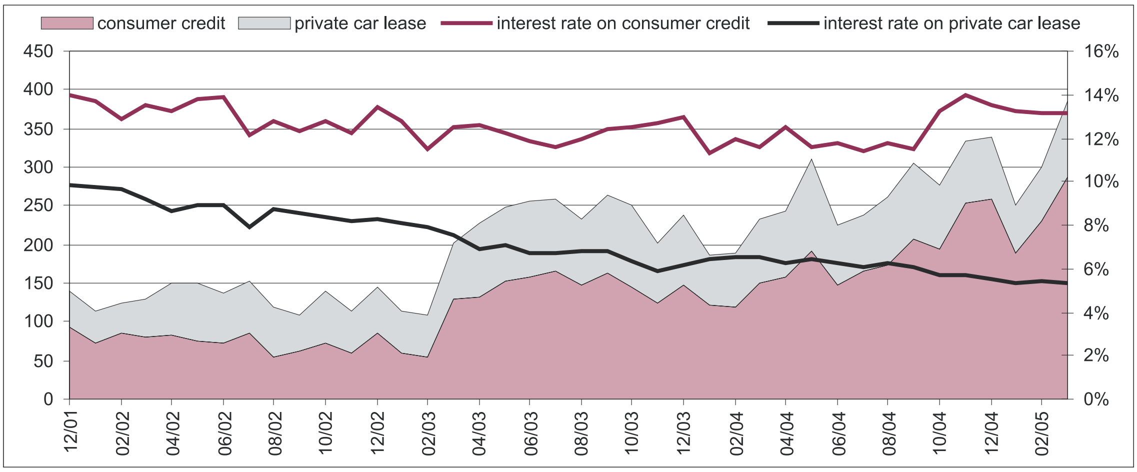

Figure 2.17. Consumer credit and private car leases issued in a month (EEK m; left scale) and the interest rate (right scale)*

* study loans excluded

Numerous consumer credit campaigns in 2005 indicate that banks are seeking additional revenue opportunities in the fairly undeveloped consumer credit segment. Should such campaigns alter the financial behaviour of households so that loans are more frequently used to pay for impulse consumption expenses, it might have a significant impact on banks' credit risk in the longer term. The loss rate of consumer credit against housing loans is considerably higher in historical comparison (see Chapter III: *Quality of Assets*). As regards risk estimates, banks should also take into account that most of the stock of consumer credit is granted without collateral[7].

The rise in mortgages accompanying rapid growth in housing loans allows banks to offer lower-margin consumer credit products.[8] However, in the light of attractive offers households should note that loan servicing costs might drastically increase along with changing market conditions, which in the worst case scenario might lead to the disposal of collateral by the bank.

Households' Loan-Servicing Ability

Loan interest rates declined throughout 2004, having yet little positive impact on households' **interest burden** in the context of fast loan growth. Households' quarterly interest payments to banks and leasing companies have been increasing since 2004. The interest burden on disposable income rose to 2.9%, which is a rather high indicator in international comparison.[9]

Summing up interest payments and principal repayments, the **total loan servicing costs** have risen even more rapidly. Both the reduced loan interest rates and extended terms of loans have contributed to sustaining the growth of total loan servicing costs below the debt growth rate (loan servicing increased 24% compared to the first quarter of 2004). Income growth that supports loan servicing was twice as small.

In the near future, fairly unproblematic loan servicing is expected for the sector on the basis of optimistic expectations of households and companies. This is possible in case of continuously low interest rates. On the other hand, putting off a rise in interest rates might indicate accumulation of problems, especially when the potential deterioration of economic environment is underestimated in the context of strong loan demand.

[7] The share of consumer credit without collateral in the stock of consumer credit (except leasing and study loans) has been growing over the past year, reaching 58% by the end of March 2005.
[8] About a fifth of consumer credit was mortgage-backed as at March 2005.
[9] The indicator stood at 4% in Sweden where debt burden is much higher compared to that of Estonian households.

III
BANKING SECTOR STABILITY AND RISKS

Strategic Development in the Banking Market

Six licensed credit institutions, and three branches of credit institutions licensed in a EU Member State were operating on the Estonian banking market on 31 March 2005; 63 foreign credit institutions had submitted applications for providing cross-border banking services and five foreign credit institutions had a representative office in Estonia.

Tough competition was characteristic of the Estonian banking market throughout 2004 and in the first quarter of 2005, which is reflected in declining loan interest margins and aggressive loan campaigns that have sustained customers' interest and brought about continuous rapid growth in loan volumes with respect to both household and corporate loans. As for households, they have primarily been new customers or those extending their loans, whereas companies now also tend to include more resources from banks operating on the domestic market instead of borrowing from abroad.

In addition to the domestic market, profits earned on foreign markets play an increasingly important role in the profitability of banking groups. Most profits earned abroad by the Estonian banking groups arise from operations on the Latvian and Lithuanian markets. Operations on the eastern market are carried out through leasing companies but on 10 March Hansapank signed also purchase documents of Kvest Bank after receiving required permits. Over medium-term perspective the Hansapank Group foresees the potential growth of the share of its operations in Russia to 10% of the group's total risk assets.

The **ownership structure of the Estonian banking sector** changed significantly in the first quarter of 2005. FöreningsSparbanken AB, the owner of the majority of the shares of the current market leader AS Hansapank, made a takeover bid on 1 March for the 40% of shares not in the ownership of FöreningsSparbanken AB yet. By the end of April 2005 FöreningsSparbanken AB had acquired over 99% of the shares of AS Hansapank.

At the end of the first quarter 97% of the total assets of the Estonian banking sector were controlled by foreign credit institutions and branches of foreign banks. Arising from the change in the ownership of Hansapank, 96% of the total assets of the Estonian banking sector belong to Nordic financial groups.[1]

Quality of Assets

Favourable interest rate environment and reduction of risk margins by banks due to competition retained customers' high interest in borrowing. The annual growth of the **aggregate portfolio of bank loans and leasing financing** continued at over 30% growth rate, taking the aggregate portfolio of domestic financing to 97 billion kroons by the end of the first quarter. Rapid loan growth is not only characteristic of Estonia but of all Baltic States: the total volume of the aggregate financing portfolios of banking groups grew 38% on annual basis, reaching over 140 billion kroons.

[1] Including the assets of subsidiaries of banks licensed in Estonia and branches of foreign credit institutions.

The share of household loans in the structure of Estonian financing portfolios[2] of banking groups continued an upward trend in the past quarters. The share of household financing in the aggregate portfolio of banks and leasing companies had risen to 38% by the end of the first quarter (see Figure 3.1). The growth arises primarily from household real estate loans whose share in the aggregate portfolio of domestic financing increased by 3 percentage points in a year, i.e. to 29%.

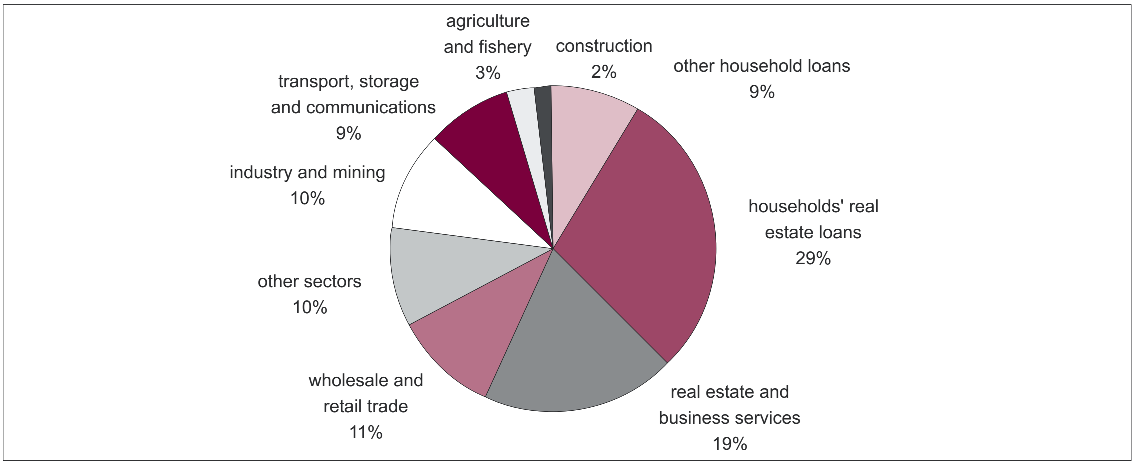

Figure 3.1. Domestic financing by banks and leasing companies (as at 31/03/2005)

As regards corporate loans, the loan stock of the commercial real estate sector accelerated again in the first quarter. The share of commercial real estate loans in the structure of the loan portfolio has risen mainly on the account of a slight decline in the share of industrial sector financing.

Fast growth of real estate loans is also reflected in the increasing share of mortgage used as collateral for bank loans. Mortgage loans formed 68% of banks' aggregate loan portfolio at the end of the first quarter, while pledge of building secured 4% of loans (see Figure 3.2). Mortgage or pledge of building secure over 80% of household loans.

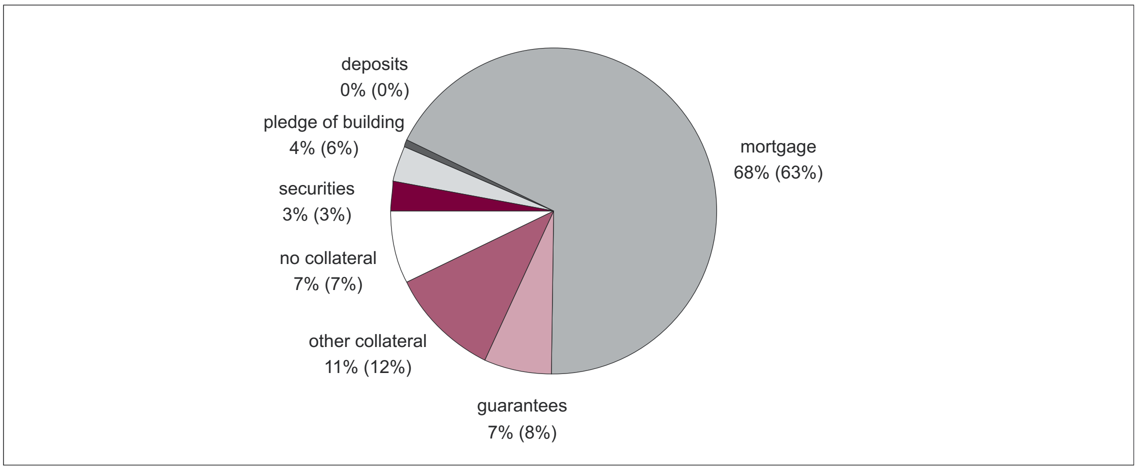

Figure 3.2. Loan collaterals by type at the end of March 2005 (in brackets at the end of March 2004)

[2] Bank loans and leasing financing.

Local government financing forms a quarter of the 7% of loans without collateral granted to the non-financial sector; a third of loans without collateral is granted to companies (mostly overdraft facilities of real estate, trading and transport companies; see Figure 3.3). While other loans without collateral saw a slight decrease in interest rates over the last periods, the risk level of household consumer credit without collateral, which form 2.4% of the aggregate loan portfolio, has not been considerably re-estimated and the average interest rate on that loan stock has remained above 15%.

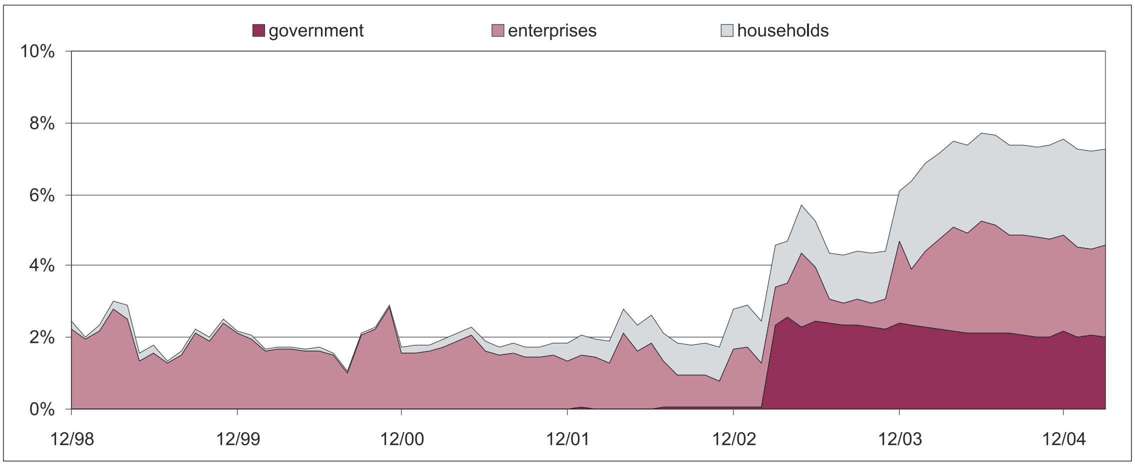

Figure 3.3. Share of uncollateralised loans in total domestic bank financing

The growth rate of the off-balance sheet liabilities of banks slightly accelerated in the first quarter of 2005 and reached 19 billion kroons by the end of the quarter. Guarantees and other similar corresponding items amounted to 6 billion kroons and other irrevocable commitments (mainly standby loans) to 10 billion kroons. The share of guarantees granted to manufacturing companies has increased over the last half-year (26% of all guarantees) while that of guarantees granted to the construction sector has slightly decreased (23%). As regards other irrevocable commitments, standby loans granted to the real estate sector form the largest share (30%).

Quality indicators of the banking sector's loan portfolio have remained quite good supported by favourable economic environment and low interest rates. On a solo basis the aggregate share of **loans overdue for more than 60 days** of all loans granted to the non-financial sector declined to 0.4% by the end of the first quarter of 2005, i.e. to a 0.2 percentage points lower level than past twelve months average (see Figure 3.4). Decrease of the share of loans overdue for more than 60 days was more significant in loans issued to export-oriented companies, mainly due to a decrease of loans overdue in the portfolio of loans granted to manufacturing companies (see Figure 3.5). At the end of the first quarter the industrial sector and trading companies accounted for about 40% of loans overdue for more than 60 days, while overdue housing loans accounted for 35%. As the share of loans overdue of the industrial sector has decreased, household consumer credit has the biggest share in all loans overdue (the share of loans overdue for more than 60 days in this portfolio is 1.3%). In the total loan portfolio consumer credit accounts, however, for less than 5%. On aggregate basis, the relatively better quality of study loans has kept the share of loans overdue for more than 60 days in other household loans at 0.8% as the quarterly average.

The ratio of **banks' provisions** to the aggregate loan portfolio declined from the end-of-year 1% level to 0.7% by the end of the first quarter, and from 1.2% to 0.9% with respect to banking groups. The decrease in the provisioning ratio arises not only from better quality of assets but also from changes in the provisioning principles[3].

[3] From 2005 onwards according to international financial reporting standards (IFRS/IAS) provisions for loan losses should be made only when there is objective evidence of loan impairment.

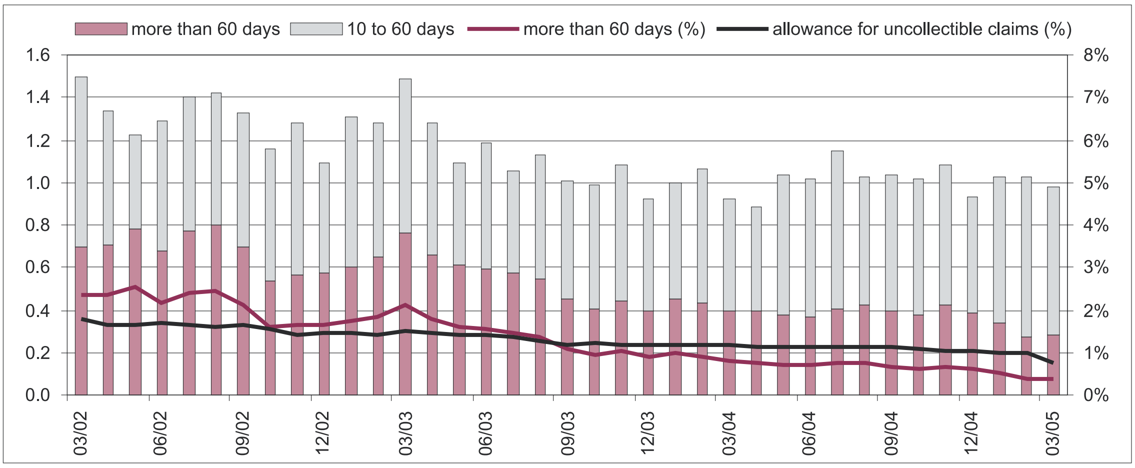

Figure 3.4. Volume of overdue loans (EEK bn; left scale) and share of overdue loans and allowance for uncollectible claims in banks' loan portfolio (right scale)

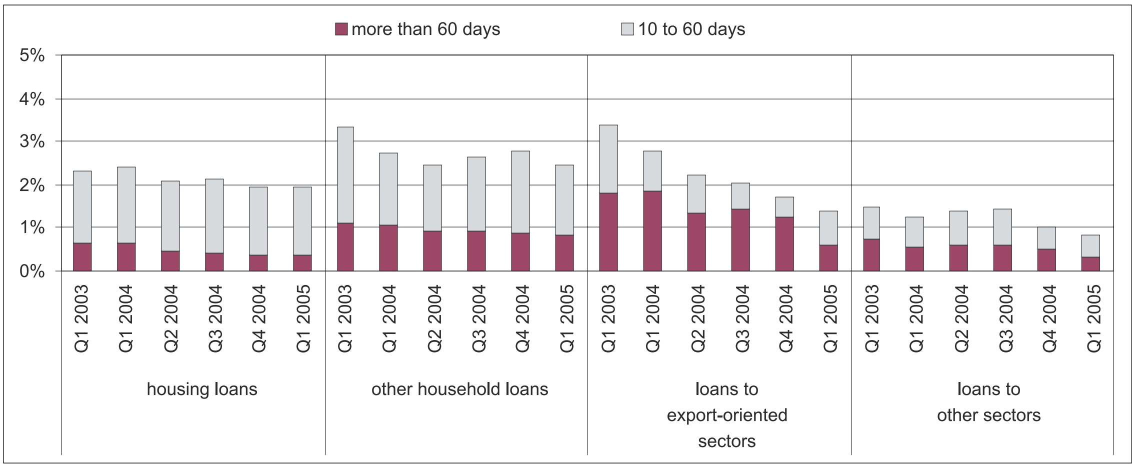

Figure 3.5. Share of overdue loans by sectors*

* 3 months average

Thus, as regards the changes in **risk levels of loan portfolios** in recent periods mainly earlier trends have continued; the share of loans collateralised by real estate has grown. As for the sustainable operations of banks it is vital that if the customer's insolvency called for disposing the collateral, the real market value of the collateral would exceed the sum owed by the customer, thus it is important that banks would retain the sufficiently conservative view on potential future changes in real estate prices, and that the requirement for a sufficient rate of self-financing would be maintained in granting loans, despite competitive pressures.

As the reduction in provisions in the first quarter of 2005 did not arise just from banks' altered estimates of customers' future solvency but to a significant degree from changes in the financial reporting principles, from the perspective of banks' ability to absorb future loan losses it is important that banks would not withdraw freed capital or increase risk positions in such a volume that would jeopardize maintaining this ability at appropriate level. Therefore the Financial Supervision Authority sent a letter to all banks in March 2005 asking them to retain freed capital in their own funds so as to guarantee bank's sufficient capitalisation and sustainable operation also under conditions less favourable than today.[4]

[4] Major banks have decided not to pay dividends in 2005.

Capital Adequacy

Although the ratio of banks' risk assets to total assets has declined over recent periods, risk assets of the banking sector increased to 97 billion kroons on **aggregate solo basis** by the end of March 2005. The structure of risk assets has not changed considerably. Credit risk weighted balance sheet items account for 86% of all risk assets, that is a slightly higher share than the EU-15 average (82%[5]). Credit risk weighted off-balance-sheet liabilities account for 7% of all risk adjusted items and trading portfolios and risk arising from foreign exchange positions form 7%.

Banks' own funds have expanded – mostly owing to the inclusion of audited profits of the previous year in the own funds – to 11.9 billion kroons on an aggregate basis by the end of the first quarter. The **banks' aggregate capital adequacy ratio on a solo basis** declined to 12.2% by the end of March, as risk assets grew rapidly (the lowest capital adequacy ratio of banks on a solo basis was 11.1% at the end of the first quarter; see Figure 3.6).

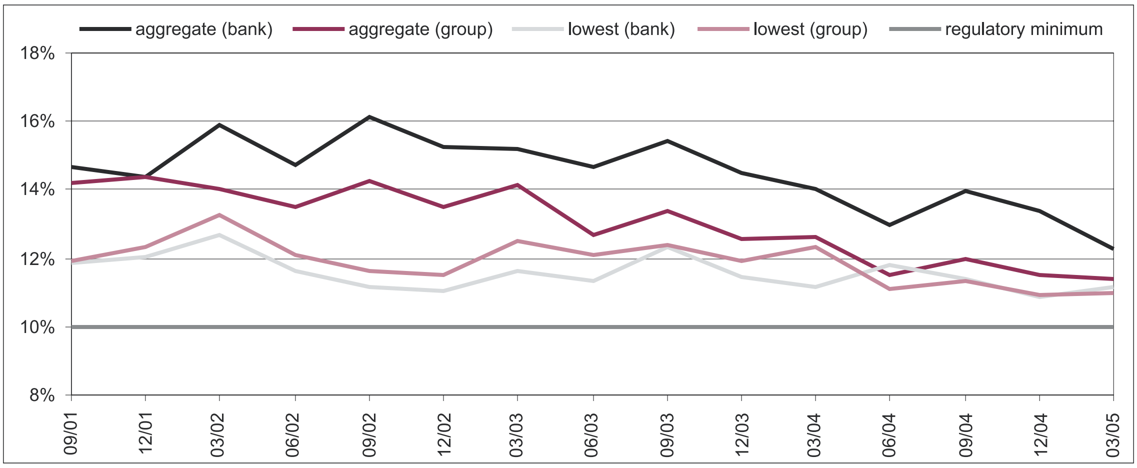

Figure 3.6. Capital adequacy

The rapid growth of loan portfolios reflects also in over 30% annual growth of risk assets of **banking groups**. As a result, the aggregate risk assets of banking groups exceeded 150 billion kroons. Credit risk weighted balance-sheet assets account for 86% of total risk assets of banking groups, over 80% of which arise from assets with a 100% risk weighting (see Figure 3.7).

The own funds of banking groups amounted to over 17 billion kroons at the end of the first quarter owing to the inclusion of last year's large profits. The aggregate capital adequacy ratio still declined, year-on-year, influenced by the rapid growth of risk assets, and reached 11.4% by the end of the first quarter (the lowest indicator was 11.0% at the end of the first quarter).

Fast growth of risk assets is reflected in the decrease of banks' capital adequacy indicators in several new EU Member States over the last periods. Upon the evaluation of banks' capital buffers it should be taken into account that, on the one hand, negative changes in the economic environment might cause a rise in loan losses but, on the other hand, a reduction in loan interest margins while banks' opportunities for the inclusion of considerably less expensive resources can be considered limited, might call in question banks' ability to retain their current profitability (see also *Efficiency and Profitability*).[6]

[5] EU banking sector stability, November 2004.
[6] According to calculations annual decline in net interest margins earned on loans and leasing (-30 percentage points) might reflect in annual decline of banks' aggregate capital adequacy ratio by about -0.2 percentage points compared to a situation where net interest margin remains at its current level.

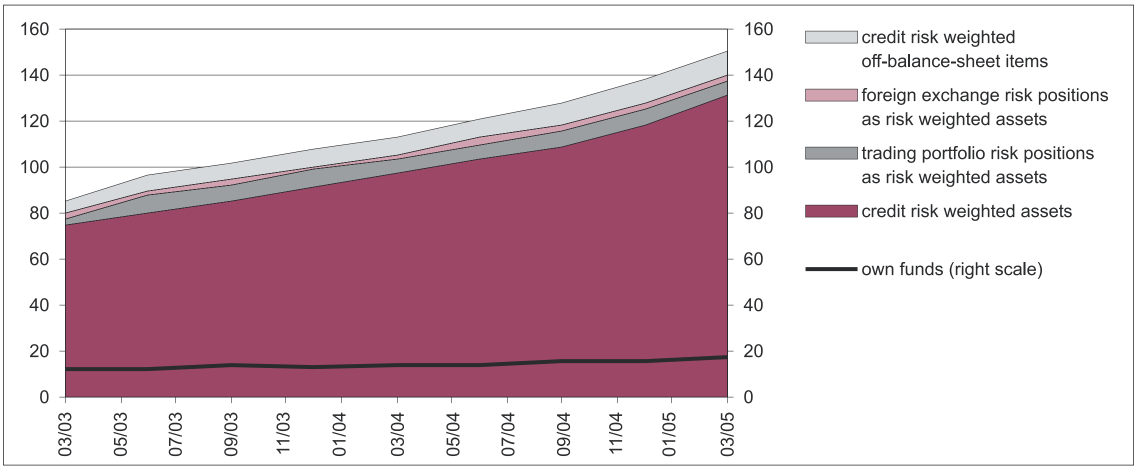

Figure 3.7. Structure of banking groups' risk assets and own funds (EEK bn)

In recent periods, annual net write-downs have remained below 0.5% of the annual average loan portfolio on aggregate basis. The last time the ratio of net write-downs exceeded 3% was in the late 1990s. In order to assess banks' current ability to absorb potential loan losses, we can calculate to which extent banks would be able to write down loans and at the same time still be able to meet the required minimum capital adequacy ratio without including capital from outside the bank.

The data as at the end of the first quarter of 2005 show that, on a solo basis, the aggregate capital adequacy ratio had fallen to a regulatory minimum (10%) by an additional, over 5% one-off write-down of bank loans granted to the non-financial sector. Calculations show that the aggregate capital adequacy ratio of banking groups would have fallen below the 10% limit in case of ca 3.5% write-down of loan and leasing portfolios. However, the different capitalisation levels of banks should be taken into account: as the capitalisation varies across banks, the capital adequacy ratio of banks accounting for a large share in the total assets of the banking sector might fall to the required minimum by a significantly lower write-down of the loan portfolios than the one that would take the sector's weighted average indicator to the required minimum.

Efficiency and Profitability

Solo Profitability of Banks

Banks earned 2.6 billion kroons in **net profit** as the sum of four consecutive quarters by the end of the first quarter of 2005 which is as much as 60% higher than last year's outcome (see Figure 3.8). The return on assets is still following a downward trend owing to the strong expansion of the balance sheet total, decreasing from 2.17% in autumn 2004 to 2.06% (see Table 3.1). Profit was largely affected by income earned by subsidiaries in the second quarter of 2004, otherwise the growth in net profit would have remained below 20%. Interest income and fee and commission income, which have followed a steady upward trend, also contributed to profit growth, while fee and commission income has continued to gain importance beside interest income.

The growth rate of **interest income** has been accelerating since the second quarter of 2004, caused by an abrupt increase in the volume of the loan portfolio even though the average yield has decreased. However, the average **interest costs** of interest-bearing liabilities also began to rise in the last quarter of 2004 and the growth of interest costs was even stronger than that of interest income. Margins continued to decline along with the decreasing income on interest-earning assets and the trend persisted in the first quarter of 2005.

The growth of **net fee and commission income** has also increased under the impact of more active use of banking services and vigorous expansion of the loan portfolio. **Net profit from financial transactions**

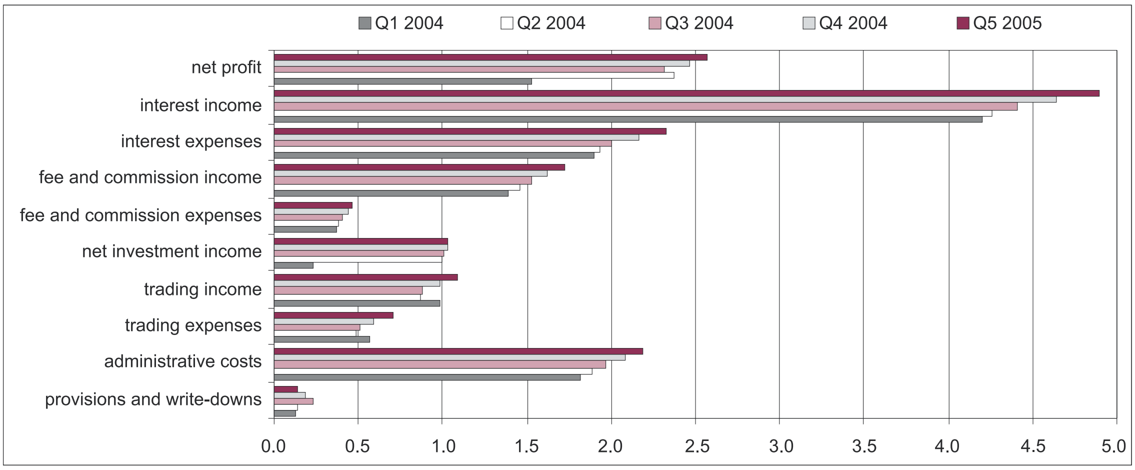

Figure 3.8. Banking sector solo profit (four-quarter moving cumulative; EEK bn)

Table 3.1. Banking sector profitability ratios

	2002	2003	Q1 2004	Q2 2004	Q3 2004	2004	Q1 2005
Return on assets	1.55%	1.70%	1.63%	2.38%	2.17%	2.14%	2.06%
Return on equity	14.7%	14.1%	13.8%	20.9%	19.6%	20.0%	20.3%
Cost-income ratio	61.6%	53.0%	52.9%	44.9%	45.3%	45.8%	46.2%
Net interest margin	3.6%	2.9%	2.8%	2.6%	2.5%	2.4%	2.3%
Spread	3.4%	2.8%	2.7%	2.5%	2.4%	2.3%	2.2%

has been decreasing since the second quarter of 2004, as banks focus on the intermediation of transactions for customers when trading in securities and keep securities for themselves in the liquidity portfolio so as to meet the minimum reserve requirement.

Wage costs have increased due to successful business expansion. On the other hand, other administrative costs have risen as well, partly in connection with higher advertising costs accompanying tougher competition. The increase in costs and the smaller impact of dividend income earned in the second quarter of 2004 caused a slight deterioration of the **cost-income ratio** – it is ever more difficult for the banks to achieve additional efficiency even though prospects are still good.

Although the robust growth of the financing portfolio caused an expected increase in the four-quarter cumulative **net write-down expenses** due to a change in the value of claims and off-balance-sheet liabilities, the indicator has decreased as a ratio to the loan portfolio compared to autumn 2004 (see also *Quality of Assets*). Arising from changes in the financial reporting principles, the nominal volume of net write-down expenses dropped considerably at the beginning of 2005. Net write-down expenses are now more closely related to the loan quality of the respective period – if the quality sustains or recovers, net write-down expenses will still remain lower than in earlier periods.

Consolidated Profitability

Banking groups earned 3.9 billion kroons in **profits** as the sum of four consecutive quarters by the end of the first quarter of 2005, outpacing the respective figure for the same period a year ago by 36% (see Figure 3.9). Both an increasingly rapid rise in interest income and continuously improving cost efficiency contributed to higher profits. Despite the robust growth in profits, banking groups have not been able to improve the return on assets due to extensively expanding balance sheet total and falling margins. While in the last quarter of 2004 the return on assets rose to 2.22%, in the first quarter of 2005 it dropped again to 2.15% where it was in the third quarter of 2004 (see Table 3.2).

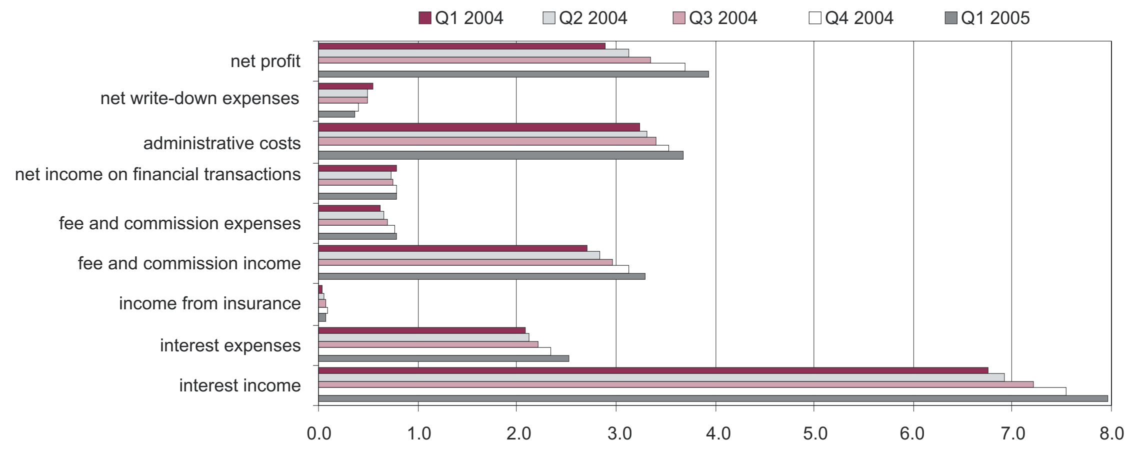

Figure 3.9. Consolidated profit of banking groups (four quarter moving cumulative; EEK bn)

Table 3.2. Profitability ratios of banking groups

	2002	2003	Q1 2004	Q2 2004	Q3 2004	2004	Q1 2005
Return on assets	2.12%	2.07%	2.13%	2.16%	2.15%	2.22%	2.15%
Return on equity	20.3%	20.0%	20.5%	21.2%	21.6%	22.8%	23.0%
Cost-income ratio	60.9%	52.3%	51.2%	51.1%	50.3%	49.7%	49.2%
Net interest margin	4.4%	3.8%	3.7%	3.5%	3.4%	3.3%	3.2%
Spread	4.6%	3.9%	3.8%	3.7%	3.5%	3.4%	3.3%

Interest income made **net interest income** of banking groups to rise fast although the interest costs are growing as well. This arises from the vast expansion of the income base – both the spread and the net interest margins continued to decline. In 2004 income from insurance also increased considerably; however it still remains marginal (about 2% of the net interest income) compared to income from banking and leasing activities.

Net fee and commission income growth remained strong but has not accelerated along with the expanding business volumes. On the basis of banking groups' public reports on 2004 fees and commissions for changing loan, leasing or warranty contracts and bank cards are the largest component in the structure of fee and commission income, whereas the former have significantly increased in the last two years. An analysis of income related to bank cards shows that the largest share of net fee and commission income related to bank cards arises from management fees and commissions. These make a stable income source for banks but as the market is well covered in Estonia as a result of banks' active sales[7], the net fee and commission income is expected to slow down in Estonia, whereas there is still growth potential in Latvia and Lithuania.

According to the public reports of banking groups, banks' fees and commissions for the management of and trading in securities have also considerably risen in 2004. Their current share in the total fee and commission income is relatively low but growth prospects are considered promising over a longer term because of an expected increase in savings and a change in the structure of savings.[8] Fee and commission income growth is also supported by the growing popularity of electronic banking channels instead of traditional ones. The former are likely to have the highest potential for use in neighbouring markets. Thus, should loan and leasing contract fees and commissions decrease in the case of stabilised loan growth, over a longer perspective it

[7] At the end of April banks had issued 1.081 million debit and 0.226 million credit cards in Estonia. Debit cards have been issued to nearly 95% of the population aged over 15 years, whereas only a fifth own a credit card. It should be noted that a part of bank cards have been issued to companies.
[8] Fees and commissions for securities are among the two most important components in the structure of Swedish and Finnish large banking groups dependent on the banking group.

might be balanced by higher fees and commissions for securities and smaller costs achieved through more extensive use of electronic channels.

The growth of management costs has been slower than that of income. This has facilitated greater cost efficiency. The **cost-income ratio** continued a stable decline from 50.3% in autumn 2004 to 49.2% in March 2005. Net write-down expenses arising from the write-down of claims and off-balance-sheet liabilities have also been significantly lower since the fourth quarter of 2004 compared to the two preceding quarters. This is largely related to changes in the financial reporting principles implemented this year (see also *Quality of Assets*).

The return on assets of the banking sector of the new EU Member States reached 0.85% in 2003 and 0.41% in the old Member States. The return on assets of the Estonian banking sector (2.2%) may thus be considered high in the European context. Although the share of net interest income in the total assets has declined, it still remained higher than the respective indicators of the new and old EU Member States (see Table 3.3). At the same time, the strikingly low share of interests paid in the total assets indicates that further opportunities for lowering the rates of funds are running short. Weaker competition pressures are not to be expected and thus it will be complicated to retain current levels of profitability.

Table 3.3. Income structure of banking groups in Estonia and the European Union

	2004	2003			2002		
	Estonia	Old Member States	New Member States	Estonia	Old Member States	New Member States	Estonia
% of total assets							
Total income	**5.5%**	**2.4%**	**4.4%**	**6.0%**	**2.4%**	**4.9%**	**6.4%**
Net interest income	**3.4%**	**1.4%**	**2.7%**	**3.8%**	**1.4%**	**2.9%**	**4.2%**
Interest receivable	4.8%	4.0%	5.5%	5.4%	4.6%	6.7%	6.4%
Interest payable	1.5%	2,6%	2.8%	1.7%	3.2%	3.8%	2.2%
Net non-interest income	**2.1%**	**1.0%**	**1.7%**	**2.2%**	**1.0%**	**1.9%**	**2.2%**
Net fees and comissions	1.5%	0.6%	1.1%	1.6%	0.7%	1.1%	1.6%
% of total income							
Net interest income	**62%**	**58%**	**62%**	**63%**	**59%**	**60%**	**66%**
Net non-interest income	**38%**	**42%**	**38%**	**37%**	**41%**	**40%**	**34%**
Net fees and comissions	28%	27%	26%	28%	28%	23%	25%

Source: EU banking sector stability 2004, ECB

Liquidity

Funding of Banks

The gap between client deposits and financing makes the banks to continue including foreign liabilities. The **loan-deposit ratio** rose to its present high (1.46) in November 2004 (see Figure 3.10). Later on the increase in the given gap has slowed down due to the fast rise in deposits (see also Chapter 2: *Financial Behaviour of Companies and Households and Their Risks*). The total volume of financing exceeded deposits by 1.42 times in March 2005.

Active institutional foreign borrowing continued – the average annual growth from October to March was 80% and the share in liabilities grew from 38% in September 2004 to 44% in March 2005. The share of foreign market-based liabilities has expanded. The prominence of market-based liabilities has been supported by direct financing of branches of resident banks on a larger scale than before by their non-resident parent banks. This has reduced the banks' need for funding from non-resident parent banks.

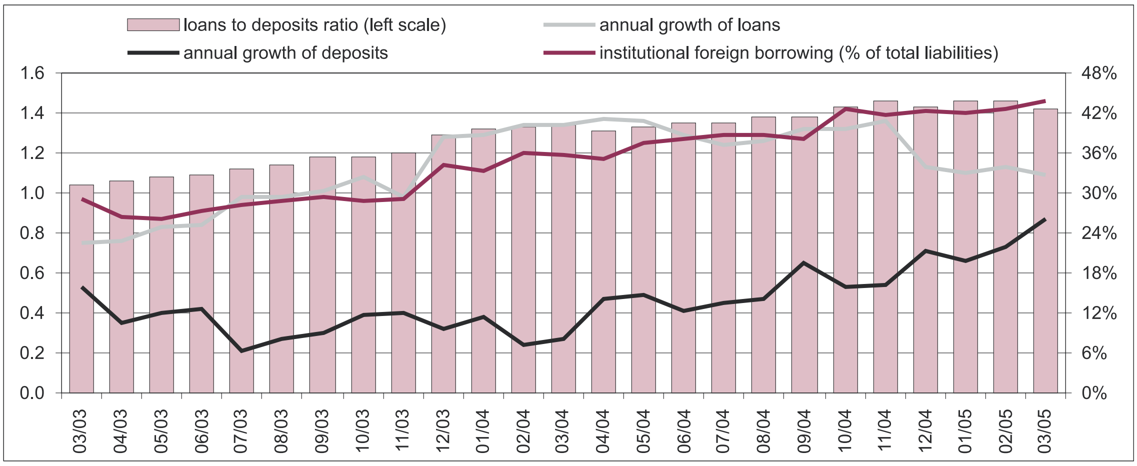

Figure 3.10. Loans to deposits ratio and dynamics

According to estimates, market-based liabilities accounted for 60% of institutional foreign borrowing at the end of March, and those received from parent banks accounted for 40%.

The shift of the funding structure in favour of market-based liabilities has directed the development of **liabilities' maturity structure** (see Figure 3.11) making it more volatile. In November 2004 the share of short-term liabilities fell sharply from 82% in September to 70% after large issuance of long-term bonds in October, but in December 2004 the indicator started to rise again due to the inclusion of short-term bonds and reached 80% of liabilities at the end of March 2005.

Faster growth of the **weighted average interest rate of liabilities**, which started in the third quarter of 2004, partly reflects changes in the funding structure and the rising share of market-based liabilities (see Figure 3.12). Further price development depends on further developments in the funding structure. Greater dependence on parent bank's funding might balance the pressure for a rise in the liabilities' price.[9]

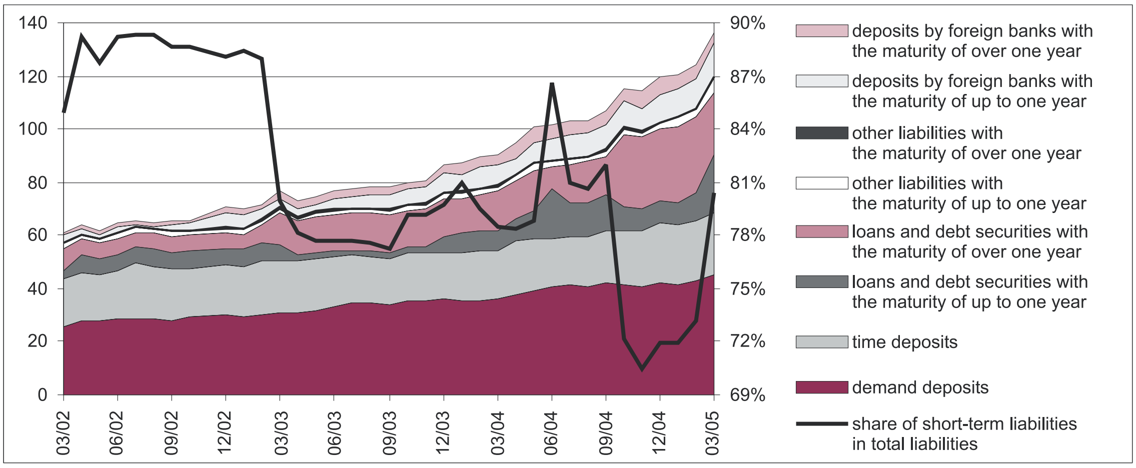

Figure 3.11. Structure of banks' liabilities (EEK bn)

[9] Arising from parent banks' higher credit ratings the price of resources received form parent banks is, as a rule, lower (up to 50 basis points, according to estimates) than the price of market-based resources. Moreover, in the case of parent bank's resources various costs (e.g. issue costs) decrease (or are absent) related to the management of assets or liabilities.

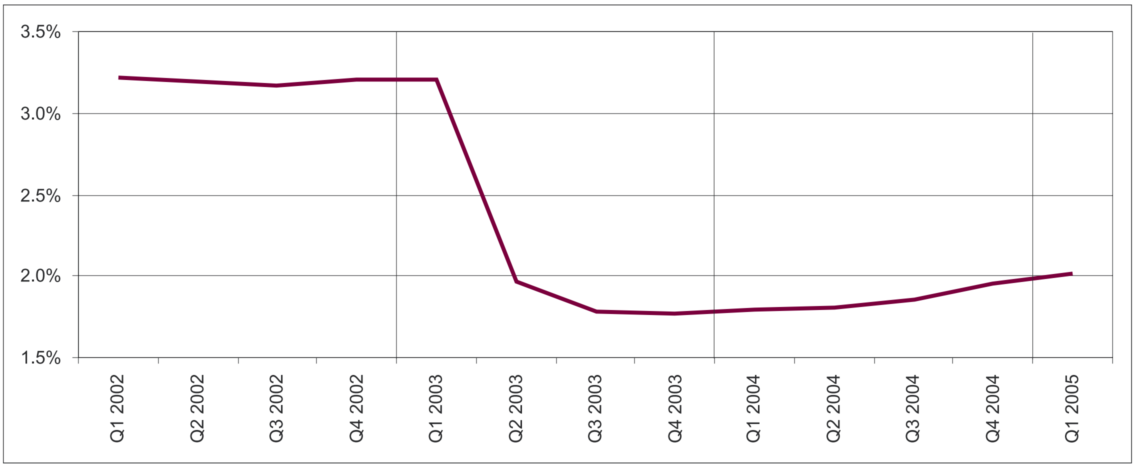

Figure 3.12. Weighted average interest rate on funds

Liquid Assets

More extensive use of market-based funding makes liquidity indicators more volatile and the banking sector more vulnerable to changes in market conditions. Banks' liquid assets covered nearly half (i.e. by 10% more than in September 2004) of the current liabilities as the six months' moving average.

The driving force behind the growing liquidity indicator is the increase in the **share of liquid assets** (accompanying the growth in market-based funding) as the six months' moving average from 20% in September 2004 to 23% (see Figure 3.13). In order to use favourable market conditions and to achieve economies of scale in issue costs, market-based liabilities are attracted more in advance as more flexible funds from parent banks, whereas deposited mainly with foreign credit institutions until lent out at more favourable conditions.

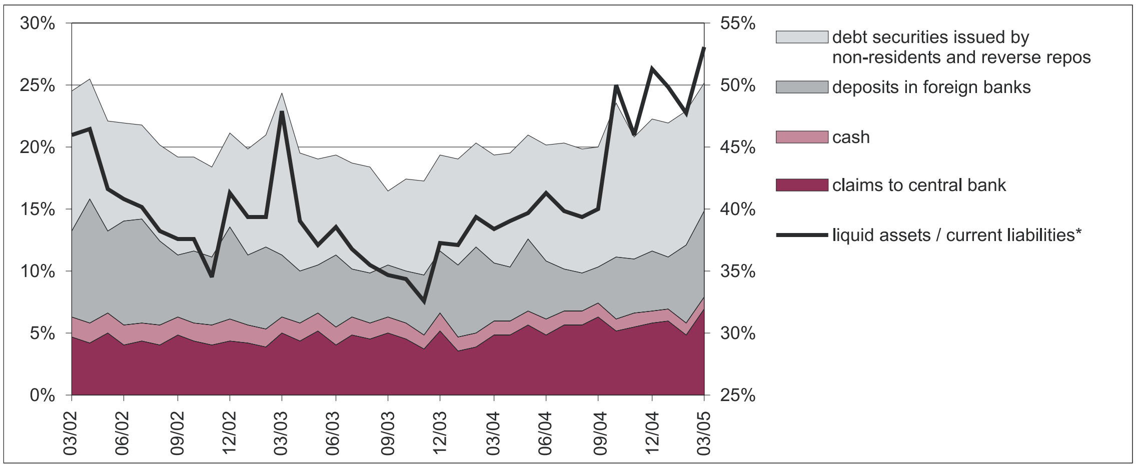

Figure 3.13. Share of liquid assets in total assets and the liquidity ratio

* current liabilities – remaining maturity of up to one month

However, the **share of current liabilities** in assets has decreased as the six months' moving average from 51% in September 2004 to 46% in March 2005, which in general may again be related to the growing share of market-based liabilities with the maturity of over one month in funding.

BACKGROUND INFORMATION

FUNDING OF BANKS AND FINANCING OF BRANCHES OPERATING ABROAD

In terms of financial stability, monitoring banks' funding structure and dynamics is vital from the aspect of banks' liquidity risk assessment. Data on banks' primary funding sources enable to assess access to funding and thus liquidity risk as well. On the other hand, in order to assess related risks it is necessary to know which assets are financed using the funds attracted. As branches of the Estonian banks are ever more active on neighbouring markets, the funds attracted by banks are not only used to raise domestic loan burden but also to finance branches operating on foreign markets. Thus the situation of Estonian banking sector depends not only on the Estonian economic environment but also on banks' position in foreign markets. The current background information takes a closer look at the banks' funding structure and dynamics and assesses the volume of funding intermediated to other countries.

Client deposits tend to be the most stable and favourable form of funding for banks and therefore deposits usually have the largest share in banks' liabilities (see Figure 3.14). Although deposits' price advantage over other resources has fallen in the course of time, at the end of 2004 client deposits accounted for 55% of liabilities of the Estonian banks with nearly two thirds being demand deposits. Growth of financing has been exceeding that of deposits since early 2002 and therefore institutional borrowing (deposits and loans, issued securities and subordinated liabilities included from other banks) plays a more important role. As the volume of funding provided by domestic institutional investors is limited, the share of foreign borrowing started to increase in the second half of 2002.

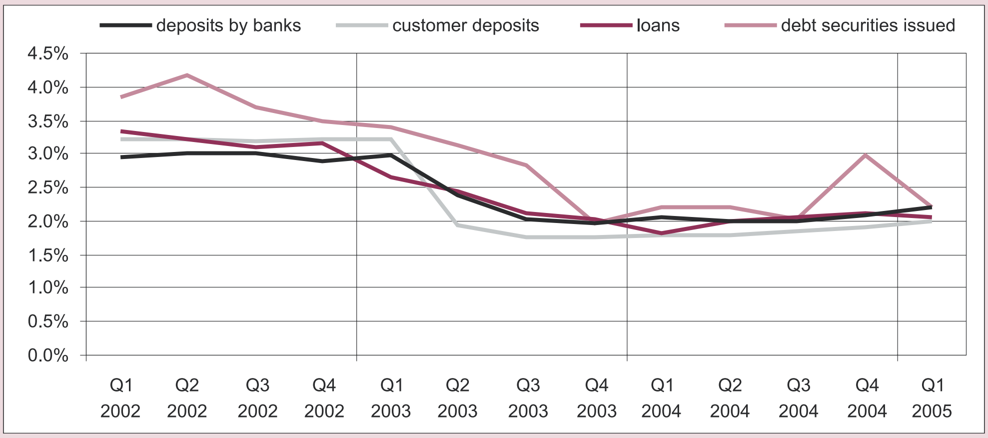

Figure 3.14. Weighted average interest rate on funds by instruments

The large owners of major Estonian banks are foreign credit institutions, which means that a substantial part of institutional foreign borrowing comes from parent banks. Liabilities received from parent banks started growing vigorously in the second half of 2001 when the restructuring in larger banks after a change in ownership was completed, and the focus shifted to improvement of the market position. The peak was reached in January 2003 when the share of liabilities received from parent banks in institutional borrowing amounted to approximately 60%. After that funding of the banking sector became more market-based and reduced parent banks' share in liabilities to nearly 40% by the end of 2004.

Parent bank funding is mostly included as deposits of which over two thirds are with the maturity of up to one year. Financing with short-term deposits gives parent banks more freedom to influence the activities of the branch either through refinancing or limiting financing.

The role of subordinated liabilities has gradually decreased in parallel with the growing volume of deposits and loans included from banks and issued securities, reaching 0.4% at the end of 2004. Subordinated liabilities are deposits or securities in case of which claims on the bank will be satisfied after claims on all other creditors' accepted claims are satisfied in the case of bank's dissolution or bankruptcy. Therefore subordinated liabilities can be, under certain conditions, included in the bank's own funds when calculating capital adequacy. As growing profits have generally supported the own funds in the course of increasing risk positions over the last years, there is less need for banks to retain or enlarge subordinated liabilities to meet the capital adequacy requirement.

Compared to the EU Member States the funding structure of the Estonian banking sector is more similar to that of the old members due to its high share of market-based resources. The larger share of client deposits in banks' funding structure of the new members arises from the fairly high price of market-based funding for the new Member States with lower ratings, and the low level of financial deepening (see Figure 3.15).

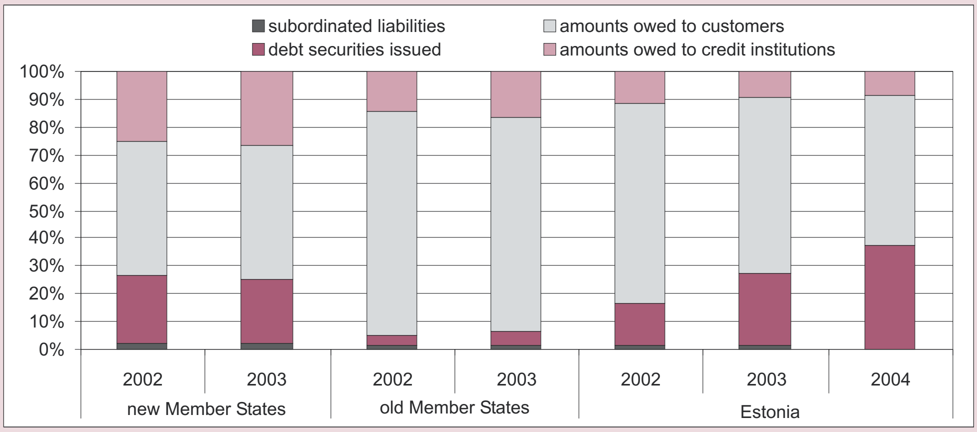

Figure 3.15. Structure of funding in Estonia and the European Union

Financing of Branches Operating Abroad

As regards operating abroad, Estonian banking groups focus on neighbouring markets (Latvia, Lithuania, Russia and Ukraine) and operate mainly through branches and leasing companies. Based on the reports of banks and leasing companies, the volume of resources intermediated through Estonian banks to their foreign branches reached an estimated 10 billion kroons, which is less than 10% of the assets of the whole banking sector. In 2004 financing of the branches operating abroad remained at a level comparable to 2002 (see Figure 3.16.). It can be attributed to internal structural changes of banking groups after which financing of non-resident branches is more based on other liabilities instead of parent bank funding operating in Estonia.

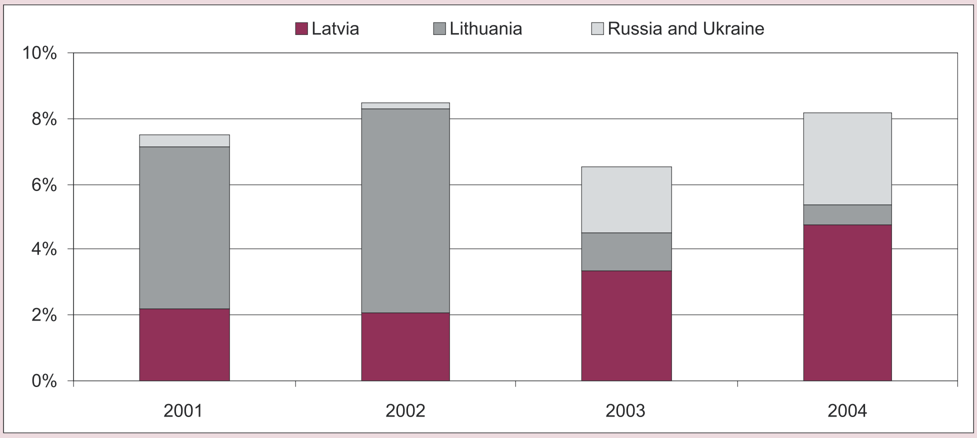

Figure 3.16. Financing of non-resident subsidiaries (% of total liabilities)

In conclusion, even though the share of deposits in the banks' structure of liabilities is decreasing, they still account for the largest component in the funding of the Estonian banks. Nevertheless, the share of funds received from foreign institutional investors continues to increase. While about two years ago parent banks played a more important role in foreign institutional borrowing, then in 2004 their share is slightly smaller than that of market-based funding. Financing of subsidiaries operating abroad (in Latvia, Lithuania, Russia and Ukraine) accounts for less than 10% of the total assets of the banking sector, according to estimates.

IV
SECURITIES AND MONEY MARKET

Money Market

The development of the Estonian money market has been stable and no major changes have occurred over the last six months. On the one hand, key interest rates of the European Central Bank have remained unchanged since mid-2003 and thus the money market interest rates of the euro area and consequently Estonian **short-term kroon interest rates** have remained at a low level. On the other hand, the turnover of the Estonian kroon money market remained basically unchanged at the average level of previous years.

The spread between the interest rates of short-term Estonian kroon loans and respective euro area interest rates has been stable, being close to 25–30 basis points in mid-April (see Figure 4.1). Participation in the exchange rate mechanism (ERM II)[1] has proceeded smoothly and no pressures on the exchange rates have occurred on the currency market. Consequently, the difference in interest quotations, which form the basis for forward difference, has continued at a low level.

Figure 4.1. Difference between money market interest rates of the Estonian kroon and the euro (percentage points)

The yield of the 5-year eurobonds issued by the Estonian Government has been moving in line with the yields of government bonds issued by other European countries (see Figure 4.2). The difference between the yield of Estonian eurobonds and German bonds with comparable maturity decreased to 14–16 basis points in the first half of 2005, while the difference with comparable Austrian bonds is just 4–5 basis points. The ongoing harmonisation of long-term interest rates with those of the euro area shows that market participants still consider Estonia's long-term credibility to be very high.

The Estonian kroon **money market turnover** remained fairly stable over the period under analysis (Quarter 4 of 2004 and Quarter 1 of 2005; see Figure 4.3). The most active segment of the money market was again the market of short-term loans in kroons whose estimated share of the total money market turnover amounted to 45%. The transactions of non-residents accounted for about 70% of the market. Swedish and Finnish banks remained the most active market participants.

[1] Estonia joined ERM II on 28 June 2004.

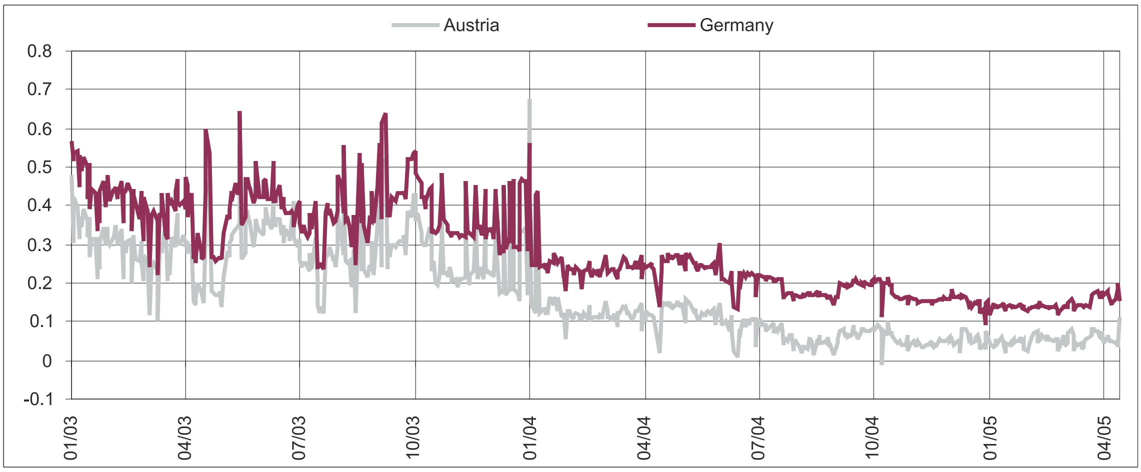

Figure 4.2. Yield spread between Estonian government bonds and respective bonds in Austria and Germany (percentage points)

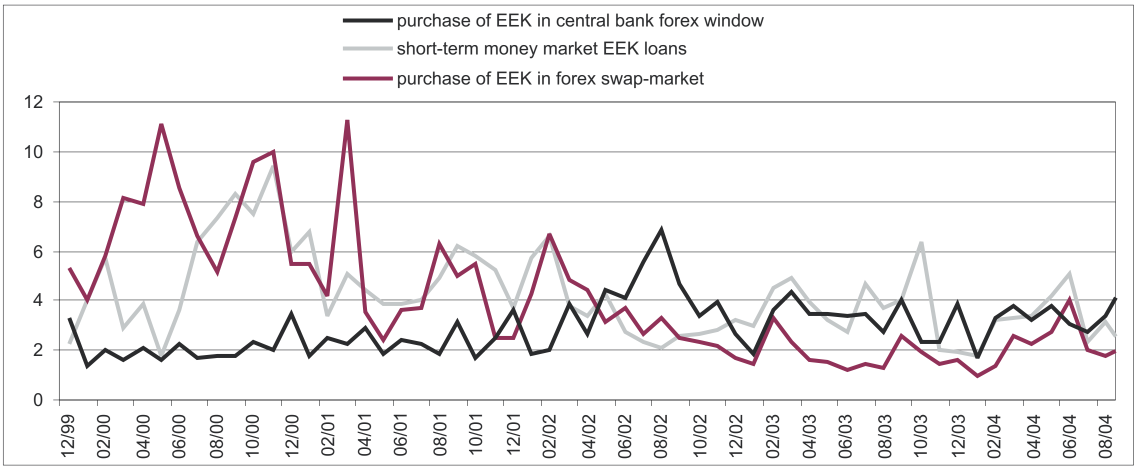

Figure 4.3. Supply of the Estonian kroon liquidity in Estonian money markets (monthly turnover; EEK bn)

At the beginning of the year, the **turnover of derivative instruments** in Estonian kroons was comparable to the last year's average and accounted for an estimated 25% of the total money market turnover. The share of derivatives in kroons has been considerably declining over the last years because of the decreasing activity of non-residents (the estimated share of non-residents accounts for 40%), and thus reflects the increasing reliability of the Estonian kroon and a decline in kroon risk margins in the light of the EU accession.

Bond Market

The domestic bond market has slightly recovered thanks to expansive liquidity environment. The **primary market** turnover grew by 15%, year-on-year (see Figure 4.4). As a result, bond market capitalisation increased by 25%, year-on-year, and reached 3.7 billion kroons (2.5% of GDP) by the end of March. The market grew because of a 34% increase in the volume of resident companies' bond emissions, whereas the volume of bonds issued by non-residents fell. The volume of bonds issued by banks decreased to 39% of the bond market capitalisation by the end of March.

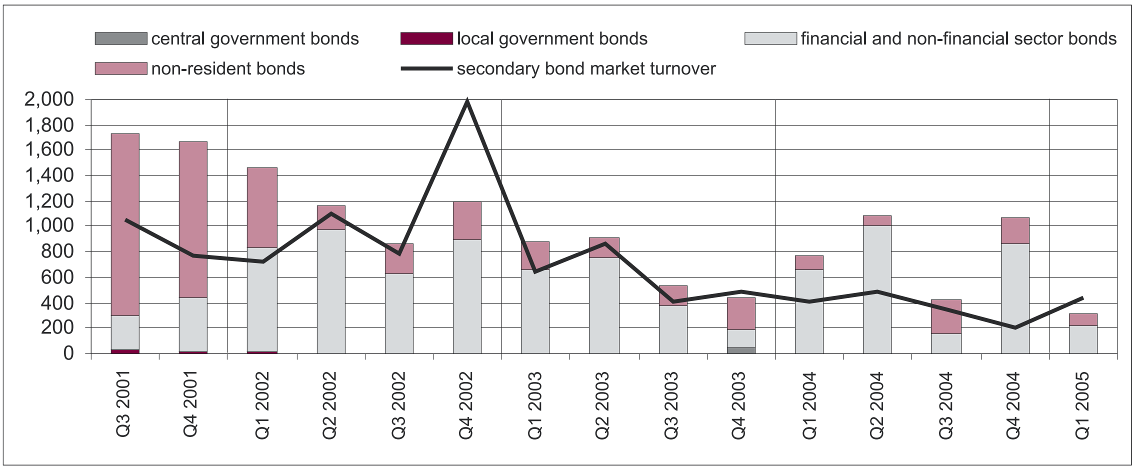

Figure 4.4. Volume of quarterly issued bonds and secondary bond market turnover (EEK m)

The interest rates of bonds with the similar credit risk showed a downward trend in conjunction with the decline of the money market interest rates. Due to favourable interest environment smaller and less known companies have entered the primary market, causing a slight rise in the average interest rate of the bond market (see Figure 4.5). A general fall in interest rates has encouraged issuance of bonds with a longer maturity. The volume of bonds with the maturity of over three years doubled and accounted for over 47% of all issues. The maturities of bonds up to one year extended and all the bonds were issued with a redemption date in more than three months.

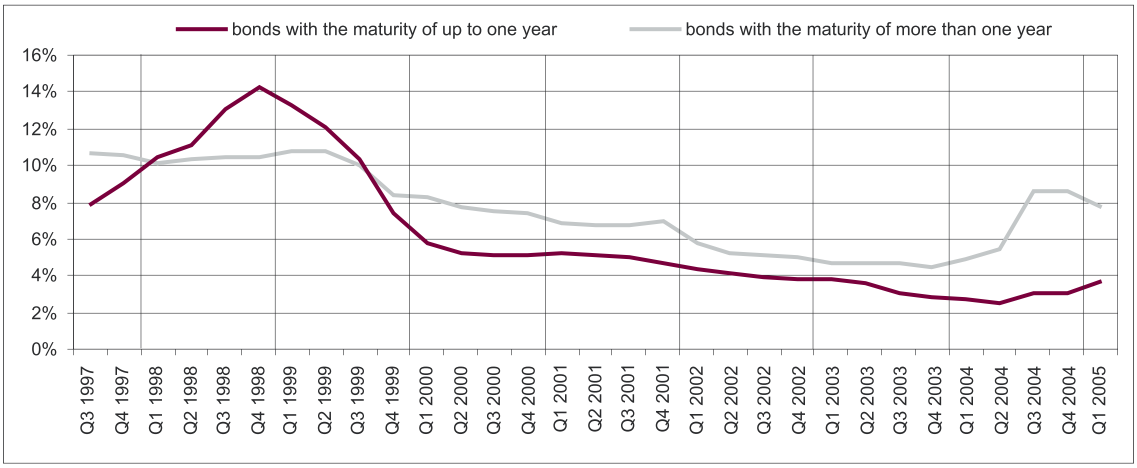

Figure 4.5. Weighted moving average interest rate on kroon-denominated bonds (%)

The **secondary market** was moderate as a large share of bonds is purchased for holding. To counterbalance the more active primary bond market the average daily turnover of the secondary market fell from 7 to 5.1 million kroons in the last six months compared to the same period last year. The bond market recovered in March when the securities market was extremely active due to events on the stock market and the turnover of the secondary bond market reached nearly 10 million kroons a day. Residents accounted for 77% of the bond investors of whom companies accounted for 64% and investment funds for 26%.

As measured by the value, most transactions were carried out with financial sector corporate bonds, even though their turnover had decreased by a third, year-on-year (see Figure 4.6). Non-residents' bonds are increasingly popular, their turnover being the only one to rise among bond transactions. Since autumn 2004 investors can trade with bonds registered in the Latvian Central Depository, whose turnover reached 10% of the total secondary market turnover in the last six months.

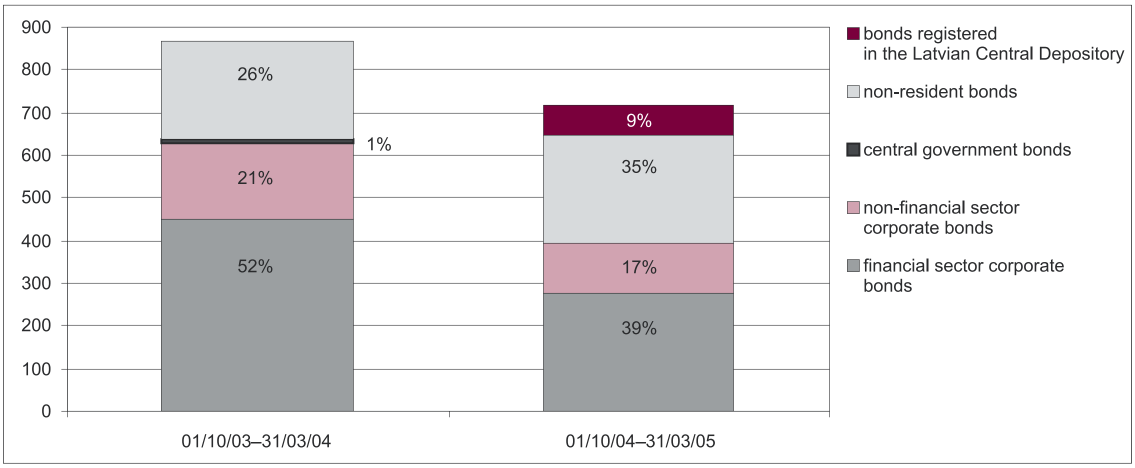

Figure 4.6. Structure of secondary bond market turnover (EEK m)

Over the last six months the bonds of Balti Investeeringute Grupp (Baltic Investment Group) and Baltika added to bonds listed on the stock exchange[2]. As a result, the market value of bonds of the six companies listed on the Tallinn Stock Exchange equalled 0.9 billion kroons at the end of March 2005, i.e. nearly a quarter of the total volume of the bond market. Despite the 82% annual growth of the capitalisation of bonds listed on the stock market, the daily turnover of bond transactions only reached 0.5 million at the end of 2004 and 1 million kroons in 2005.

Stock Market

From the beginning of 2004, but especially after joining the EU, the **price indices of shares listed on Central and Eastern European stock markets** followed an upward trend until the outflow of external funds and the withdrawal of profits in mid-March 2005 because of a rise in the interest rates of the US dollar (see Figure 4.7). Consequently, the Slovakian and Czech markets underwent a correction, as well as the Hungarian stock exchange, which generally follows the same movement as the Czech stock exchange. The fall had a smaller impact on the securities markets of Poland and Slovenia whose indices follow the euro area index[3] the most as regards Central and Eastern European stock exchanges. From the early May of 2004 the highest rise (165%) occurred in the Slovakian stock exchange, followed by the Estonian and Lithuanian stock exchanges with a 79% and 64% rise, respectively. Analysts remain positive about further rises in the Central and Eastern European as well as Baltic and Russian stock exchanges, considering the expected economic growth of these countries.

The fast growth of the **Tallinn Stock Exchange**, which had started in autumn 2004, continued from October 2004 to the end of March 2005 when the stock exchange index **TALSE** grew 68% (see Figure 4.8). Thus, the value of TALSE was 611 points at the end of March. As a result of such developments the market value of the companies listed on the Tallinn Stock Exchange increased from October 2004 to the end of March 2005 by nearly 70%, i.e. 40 billion kroons. Stock market capitalisation increased to 98 billion kroons, i.e. to 69% of GDP (48% at the end of March 2004). This indicator keeps Estonia currently at the level equal to the total level of all old EU Member States in 2003.[4] Estonia ranked first among the new EU Member States, followed by Malta and Cyprus at a level close to 35%.

[2] Bonds of Sampo Pank, Tallinna Sadam, Eesti Post, and Fenniger.
[3] FTSE Euro 100.
[4] Source: European Central Bank, “Banking Structures in the New Member States”, January 2005.

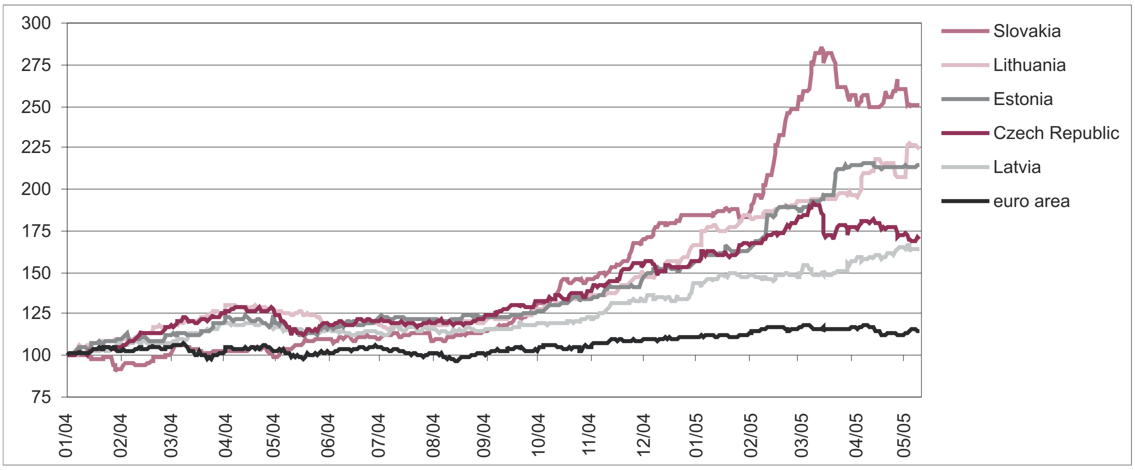

Figure 4.7. Dynamics of stock exchange indices of the new EU Member States and the euro area (points; 01/01/2004 = 100)

Source: EcoWin AB

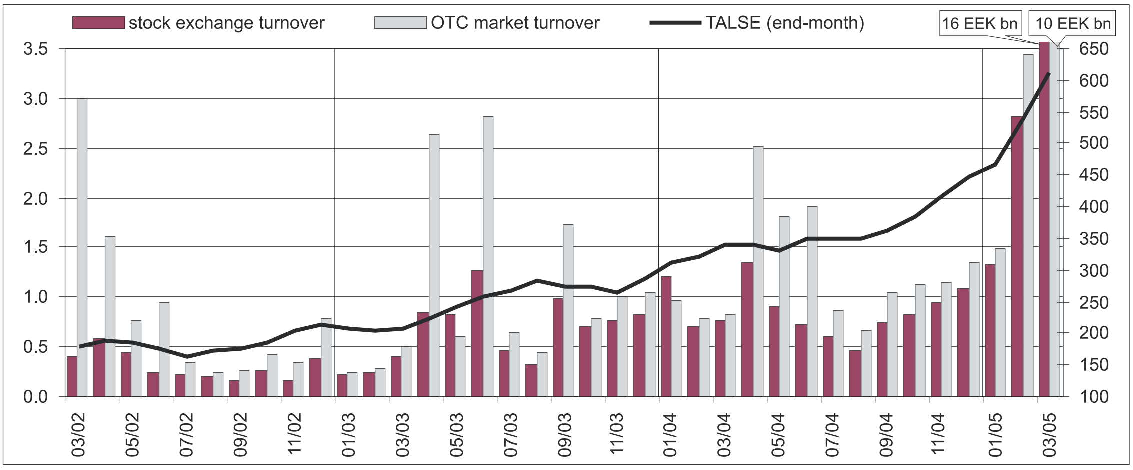

Figure 4.8. Stock turnover on the Tallinn Stock Exchange and OTC market (EEK bn; left scale) and Tallinn Stock Exchange index TALSE (points; right scale)

The market recovery was evident in the steady growth of the stock exchange turnover. The daily turnover amounted to 43 million kroons in the last months of 2004 but as a result of a ten-fold increase in the daily turnover by the end of the first quarter of 2005[5] it reached a quarterly average of 0.3 billion kroons. The main driving force behind growth was Hansapank's share whose price rise was provoked by Swedbank's takeover bid to minority shareholders of Hansapank[6]. Thus, trading in the shares of Hansapank formed 94% of the stock exchange turnover. In addition, trading in the shares of other companies listed on the stock exchange also supported growth. The prices of half of them rose more than 40% in early 2005. The main focus was on trading in Hansapank's shares but also in the shares of Eesti Telekom and Merko Ehitus where transactions yielded 5% of the total turnover of the stock exchange.

[5] In March 2005 the average daily turnover of the stock exchange was 0.7 billion kroons.
[6] Swedbank made a takeover bid to minority shareholders of Hansapank offering 11 euros per share. On 22 March Swedbank raised the offer to 13.50 euros per share. Buying up of shares following the takeover bid took place from 1 March to 4 April. At the beginning of May Swedbank owned 99% of Hansapank's shares.

The price rise of the listed shares was primarily caused by the interest of foreign institutional investors. The **share of non-residents' investments** in the stock market capitalisation rose to 85% by the end of March 2005. The largest share (77%) was still yielded by Swedish investors. Resident investors were predominantly financial and non-financial sector companies that controlled listed shares with the value of 12.4 billion kroons, i.e. 12.8% of the total stock exchange capitalisation. Retail investors held 2.6 billion kroons worth share holdings, i.e. 2.3% of the total value of listed shares. The share of second pillar pension funds that had been investing in shares since the second half of 2003 fell to a marginal 0.2% level of the total capitalisation by the end of March. The volume of retail share holdings and investment funds decreased significantly in March when Swedbank gradually acquired Hansapank's shares. While local companies have invested the free capital gained from the sales of Hansapank's shares in other shares listed on the local stock exchange, individuals and investment funds have used other methods and instruments[7] to invest the capital released in the sales of Hansapank's shares.

The excited stock market, especially the rise that had started in autumn, is reflected in the growing number of **securities accounts** holding the shares listed on the stock exchange in 2004 (see Figure 4.9). At the same time, the number of actively used accounts has been decreasing since February 2005 similar to years preceding 2004. This is related to the general internationalisation and integration processes of markets and thus investors prefer more liquid foreign markets while international investors take interest in rapidly growing markets. Therefore the number of non-residents' accounts rather follows the upward trend. On the other hand, the declining number of accounts probably arises from the transactions made by Swedbank to take over Hansapank's shares.

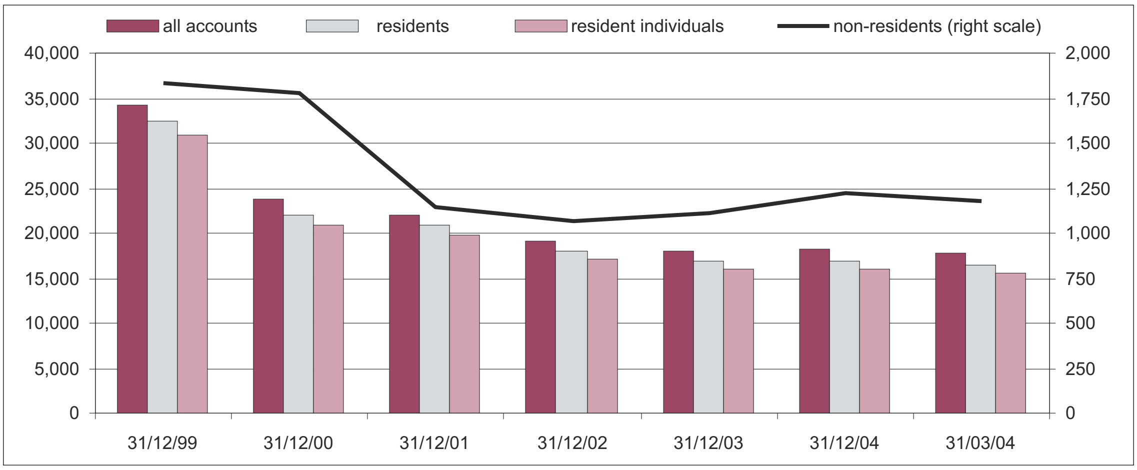

Figure 4.9. Number of securities accounts holding shares listed on the Tallinn Stock Exchange

There are 17 members of the stock exchange that may act as brokers. Three of them are currently inactive and eight members trade from abroad. 95% of the value of transactions was intermediated by Suprema Securities and Hansapank.

Because of the strategic majority stake of a few listed companies (Hansapank, Eesti Telekom) the main trend on the stock exchange for the time being is the delisting of companies from the stock exchange. The potential withdrawal of Hansapank, which covers 68% of stock capitalisation, from the stock exchange has given rise to public discussions on the future of the local stock exchange and the arrival of the new wave of listed companies. Managers of both public sector institutions and companies have hinted potential listing of several companies (e.g. AS Starman, AS Tallinna Vesi) on the stock exchange. The Tallinn Stock Exchange is likely to integrate even more closely with the infrastructures of the Nordic and Baltic securities markets.

[7] There is a possibility that individuals have invested in the stock market through companies in order to optimise taxes.

The next stage of the **integration of the Nordic and Baltic securities markets** is the launch of the common trading environment SAXESS on the Lithuanian stock exchange in May 2005. Then all stock exchanges participating in NOREX, the alliance between the Nordic and Baltic stock exchanges, would be using the common trading system[8]. By the end of the first half of 2005 a more extensive use of classification standards[9] of companies is intended. It has been used to categorise listed companies on Stockholm, Copenhagen and Oslo stock exchanges since 2001. On 1 July 2005 these standards will be introduced in the stock exchanges of the Baltic countries and Helsinki.[10] The integration process of the Baltic market indicates the updating of the cross-border settlement link between the Estonian Central Register of Securities and the Latvian Central Depository in 2004. Through the link between depositories, holders of securities accounts in Estonia can invest in securities registered in the Latvian Central Depository and vice versa (see *Securities Market*). Similar settlement links are being created with the depositories of Lithuania and Finland.

[8] The Tallinn Stock Exchange introduced SAXESS in September 2004.
[9] Global Industry Classification Standard (GICS) provides four levels of industry analysis: by sectors, industry groups, industries, and sub-industries.
[10] Source: Tallinn Stock Exchange.

V
OTHER FINANCIAL MARKETS

Investment Funds

The yield of investment funds and change in their assets from October 2004 to the end of March 2005 have mainly been characterised by changes in key interest rate levels and trends on the stock markets of developing countries. Resulting from low interest rates the yields of both money market and interest funds have been decreasing, being so far unaffected by the US Federal Reserve's decisions on raising key interest rates (see Figure 5.1). From August 2004 the yield of stock funds has rather been on the increase but in March 2005 the yield of Estonian stock funds underwent a correction because of a fall on the Eastern European markets. The yield of stock funds at the end of March stood at nearly 26% on average, remaining below the 80% annual growth of TALSE.

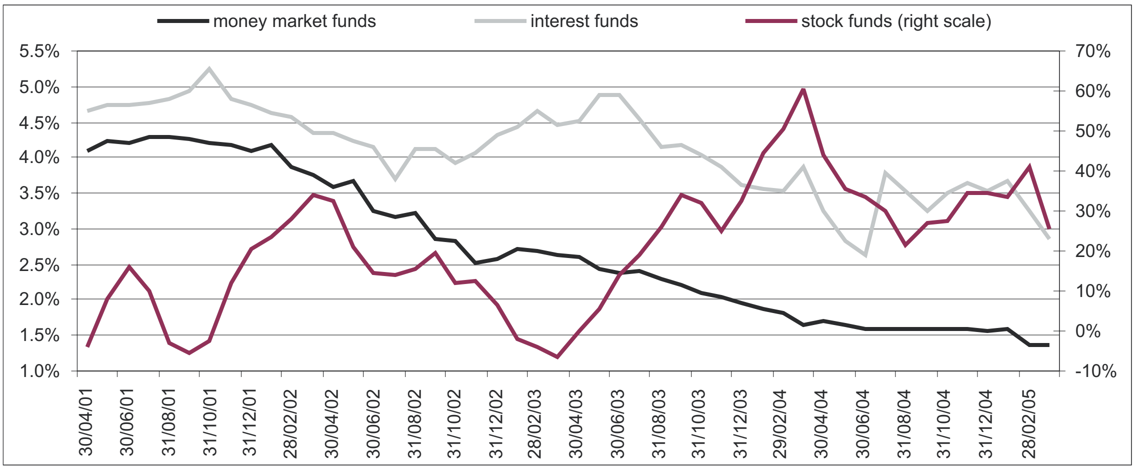

Figure 5.1. Average yield of investment funds (%)

The growth in the **volume** of investment funds over the last few years remained steady in the last six months as well but the growth rate was slower than a year before due to higher comparison basis (see Figure 5.2).

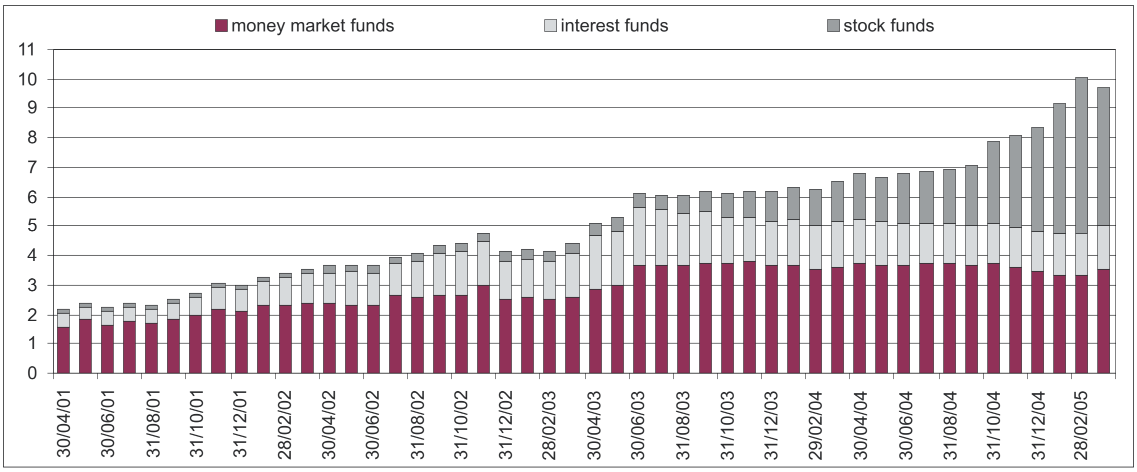

Figure 5.2. Volume of investment funds' assets (EEK bn)

Previously, investors preferred shares in the money market funds that provide more stable yields and are more liquid but until March rapid growth boosted interest in share holdings on the Central and Eastern European stock exchanges. This resulted in the multiplication of stock funds, reaching 4.7 billion kroons in late March. The volume of money market and interest funds has decreased rather, year-on-year. Both residents and non-residents invested equally in stock funds from October 2004 to the end of April 2005. While non-resident investors were predominantly companies (94%), the share of companies (52%) and individuals (45%) was almost equal among resident investors. Local investment funds hold 2% of the capitalisation of stock fund units. At the end of April, residents' capital accounted for 98% of the volume of interest funds, 75% of which belongs to companies and 25% to individuals.

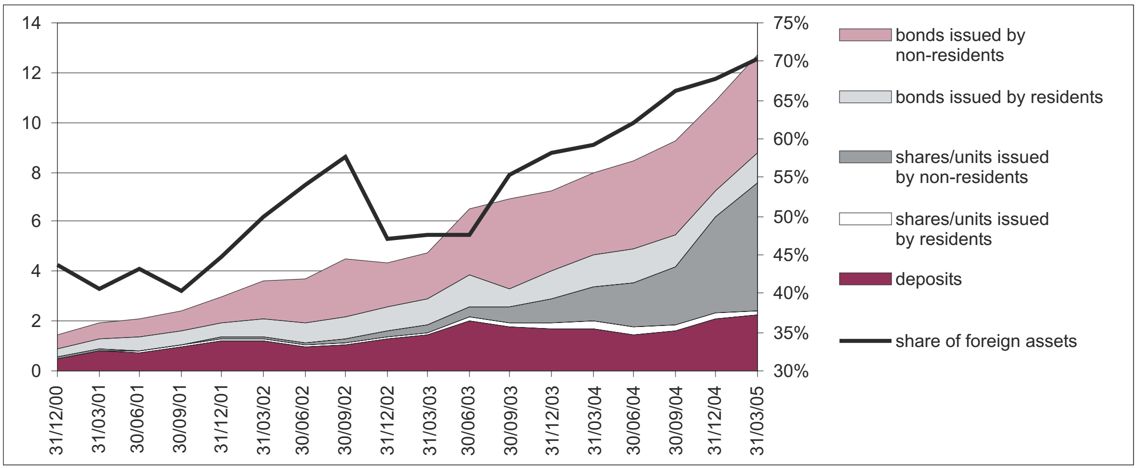

Figure 5.3. Structure of investment and pensions funds' assets (EEK bn; left scale) and share of foreign assets (%; right scale)

Since the second half of 2003 the share of foreign assets in the assets of funds has increased, amounting to over 70% by the end of March 2005 (see Figure 5.3). 68% of foreign assets are invested in the markets of the EU Member States. Markets outside the European Union attracted most investments in the last six months, most popular among them being the market of Croatia (see Figure 5.4). Investments in the US have significantly decreased in six months because of rising interest rates and a more modest growth of stock markets in comparison to other markets. Investments in domestic stock and bond markets and domestically issued units of investment funds amounted to 1.5 billion kroons (including 227 million kroons for stocks and shares), i.e. 11% of funds' assets.

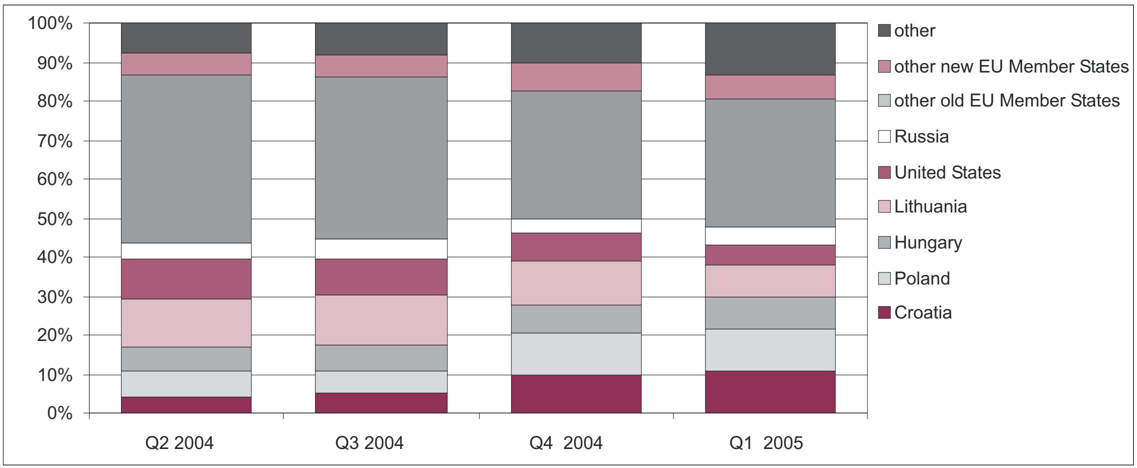

Figure 5.4. Foreign investments of investment and pension funds by residency as at end of period (%)

Pension Funds and Insurance

The number of subscribers to the second pillar of the pension system was close to 440,000 at the beginning of May 2005, which accounts for 73% of the employed. According to the data of the Pension Centre 80% of subscribers had bought shares of funds by the end of the first quarter of 2005.

The volume of the second pillar funds increased to 3 billion kroons by the end of March 2005 (see Figure 5.5). Given the average monthly growth (140 million kroons) in the second pillar pension funds, the threshold of 4.2 billion kroons (2.8% of GDP) is expected to be exceeded by the end of 2005.

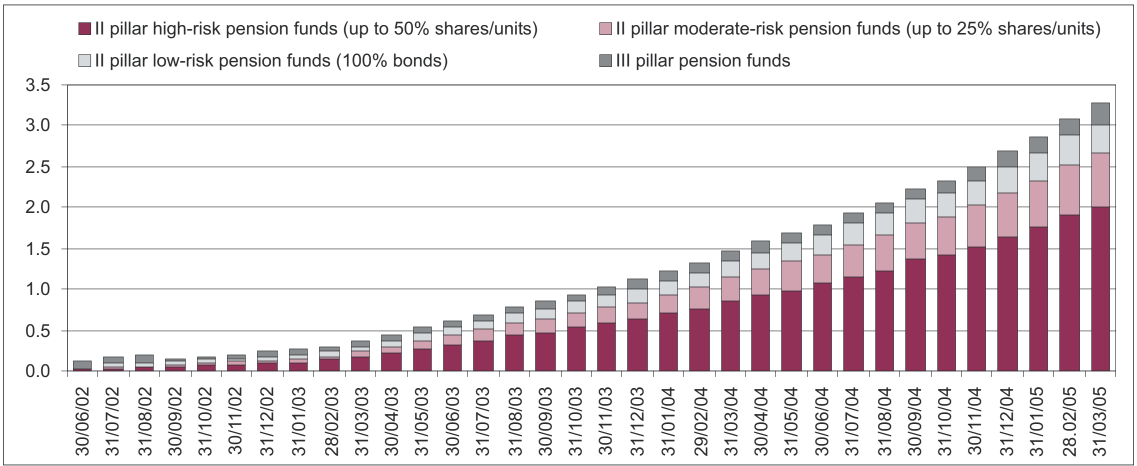

Figure 5.5. Volume of pension funds' assets (EEK bn)

82% of the assets in the second pillar pension funds have been placed into more liquid foreign markets and the volume of local stocks stands at just 149 million kroons (see Figure 5.6).

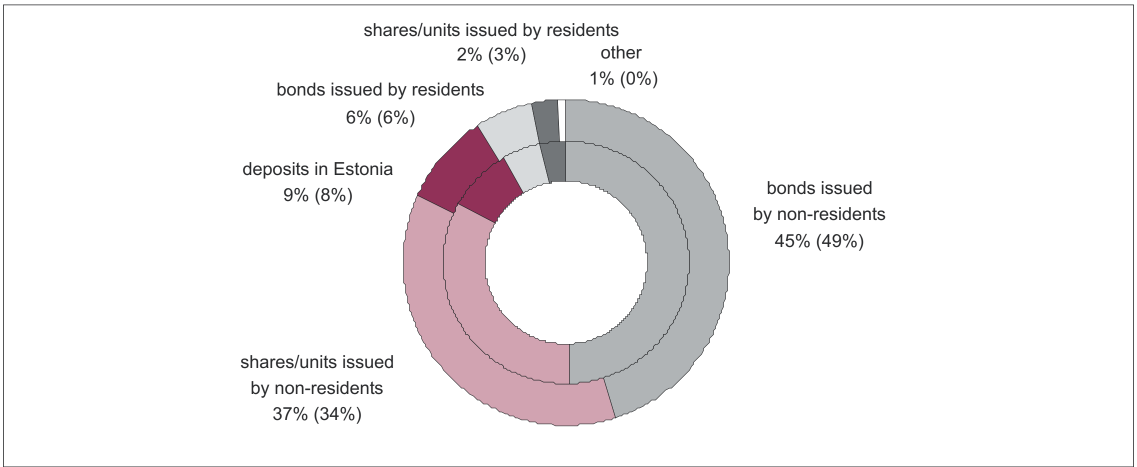

Figure 5.6. Structure of II pillar pension funds' assets as at 31 March 2005 (position on 30 September 2004 indicated in brackets)

At the end of 2004 the number of subscribers to the third pillar of the pension system was over 75,500 (12.6% of the labour force). By the end of March 2005 savings in the voluntary pension system including pension funds and insurance were over a billion kroons of which the value of the funds amounted to about a quarter.

At the end of March 2005, 68% of the assets of the third pillar funds were invested in foreign markets (see Figure 5.7). The total volume of domestic stocks, units and bonds in the investments of these funds reached 77 million kroons at the end of March. This is more than twice as high as six months ago.

The share of pension savings in the residents' financial assets in the second and third pillar of the pension system had risen to 13% by the end of March from 11% six months earlier.

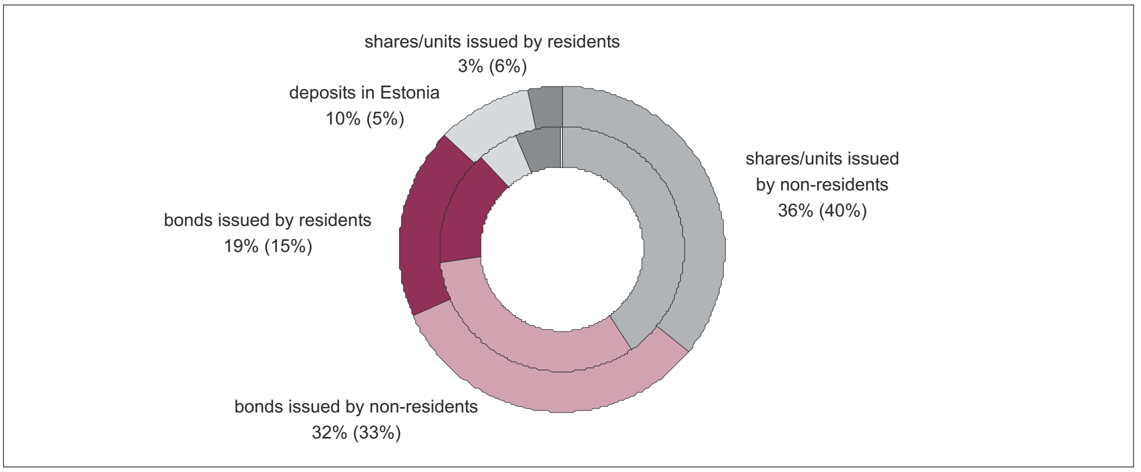

Figure 5.7. Structure of III pillar pension funds' assets as at 31 March 2005 (position on 30 September 2004 indicated in brackets)

Insurance Companies

The increasing domestic demand and the spread of voluntary pension insurance continued to impact the development of the insurance market.

The growth rate of the **life insurance market** reached an average of 40% from October 2004 to the end of March 2005, being about 20% faster year-on-year (see Figure 5.8). The total volume of premiums was mainly boosted by premiums collected under unit-linked life insurance policies, which also included premiums collected under pension insurance contracts based on income tax incentives, i.e. third-pillar pension insurance contracts. Insurance companies collected gross premiums from September to March for a total of 0.5 billion kroons with a major part coming from capital insurance of life insurance and unit-linked life insurance.

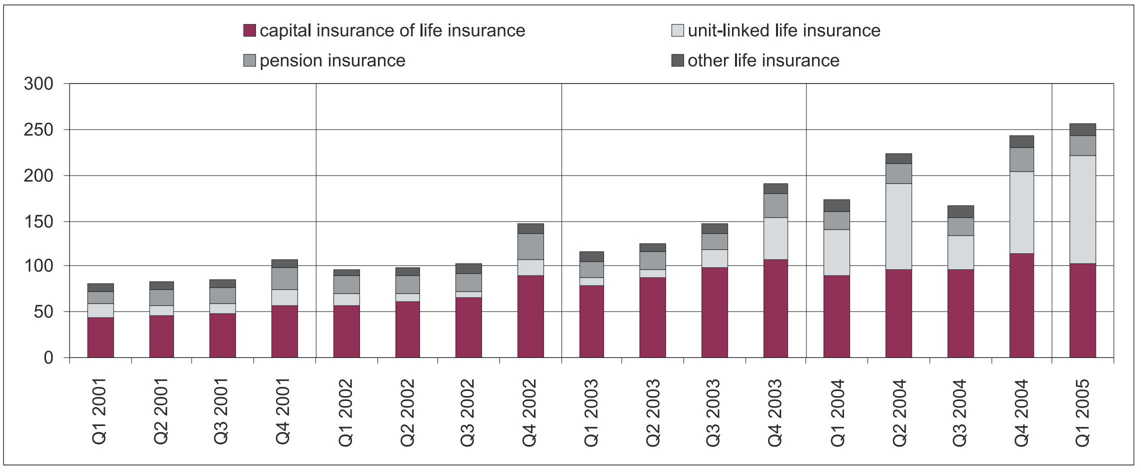

Figure 5.8. Gross premiums collected by life insurance companies (EEK m)

The **non-life insurance market** grew more modestly from September to March than over the same period last year, being 15% on average (see Figure 5.9). The major driving forces behind growth were the recovering real estate market and rise in the housing loan market. The volume of non-life insurance was also considerably increased by premiums collected under voluntary insurance for motor vehicles. The growth of premiums of voluntary motor vehicle and property insurance was therefore higher than average, 25% and 20% respectively.

Figure 5.9. Gross premiums collected by non-life insurance companies (EEK m)

While the institutional structure of the life insurance market had taken shape already a few years ago, redistribution of market shares was still evident on the non-life insurance market over the last half-year. At the end of 2004 Zürich Kindlustus Eesti, a company of Swiss origin, left the market and its portfolio was transferred to If Eesti Kindlustus. Consolidated profits of non-life insurance companies almost doubled in 2004, year-on-year, to a record 0.35 billion kroons. Unlike the profit indicators of non-life insurance companies the consolidated profit of life insurance companies grew at a much lower rate in 2004, i.e. by only a half, reaching 97 million kroons.

VI
PAYMENT SYSTEMS

Settlement System of Interbank Payments

The Estonian kroon liquidity environment has remained stable and, as a result, funds of credit institutions held with the central bank are sufficient to ensure smooth operation of the settlement system. The annual growth of the number of payments settled through the **Real Time Gross Settlement System** (**RTGS**) fell by 13 percentage points to 40% by the end of the first quarter (see Figure 6.1). An average of 170 payments were made per day. The share of customer payments remained the same, amounting to 75% of all RTGS payments.

The value of payments settled through RTGS grew by 4 percentage points by the end of the first quarter of 2005. Thus, the value increased by 8% and reached 2.3 billion kroons per day. Banks' "compulsory" payments (transactions related to the collateral account of the designated time net settlement system)

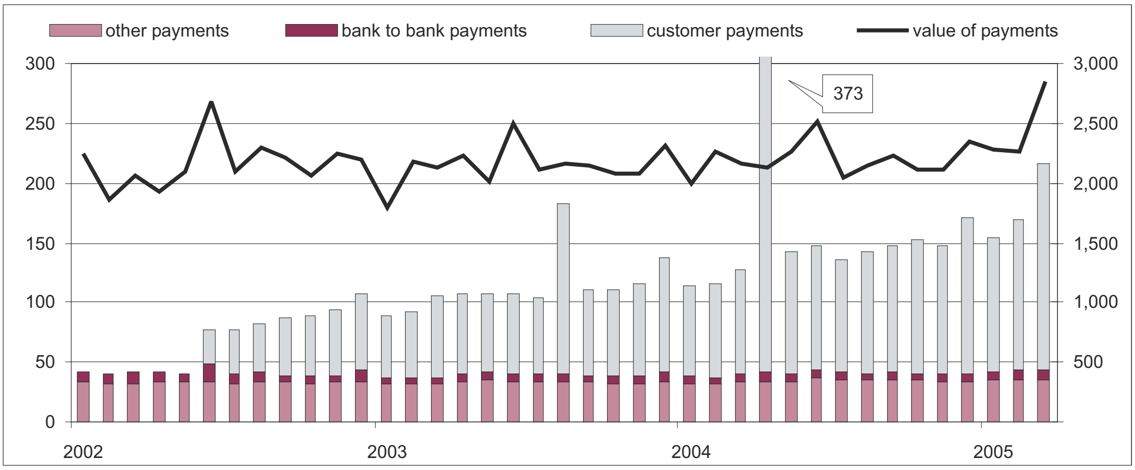

Figure 6.1. Daily number (left scale) and value (EEK m; right scale) of payments processed in the RTGS System (monthly average)

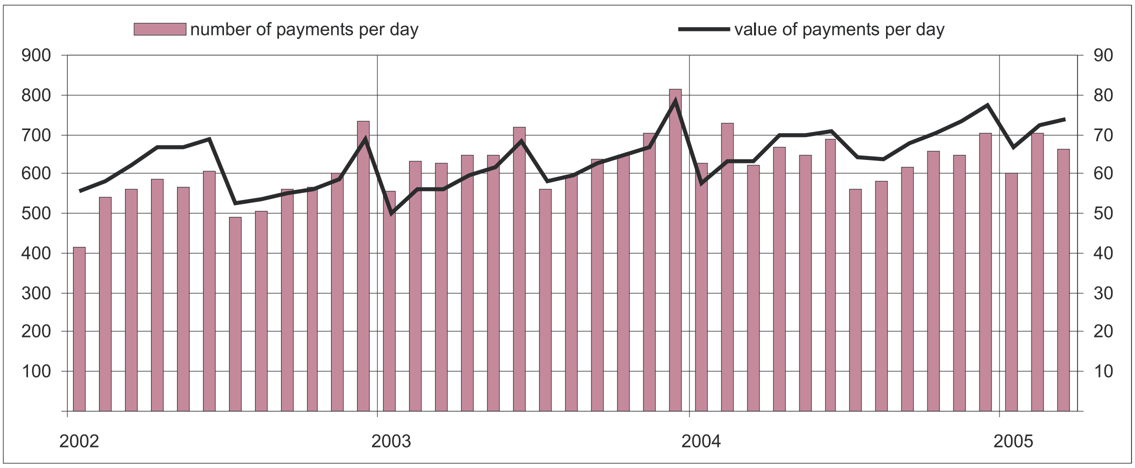

Figure 6.2. Daily number (thousands; right scale) and value (EEK m; left scale) of payments processed in the DNS System (monthly average)

accounted for most of the value (62%). The average value of customer payments continued to decrease, though at a slower rate (by 8%), declining to 2.1 million kroons. Such a tendency reflects the customers' interest in using RTGS also for the transfer of smaller but more urgent payments.

An average of 65,000 payments a day were settled through the **Designated Time Net Settlement System** (**DNS**) by the end of the first quarter of 2005 (see Figure 6.2). The number of payments decreased by 4% over the year at a slightly accelerating pace. At the same time, the annual increase in the value of DNS payments was 10%, while annual growth showed no change and the average daily value was 723 million kroons.

Payment Environment

No major changes had occurred in the payment environment in Estonia by the end of the first quarter of 2005, indicating a fairly mature market, which was affected by a seasonal increase in demand at the end of the year (see Figure 6.3).

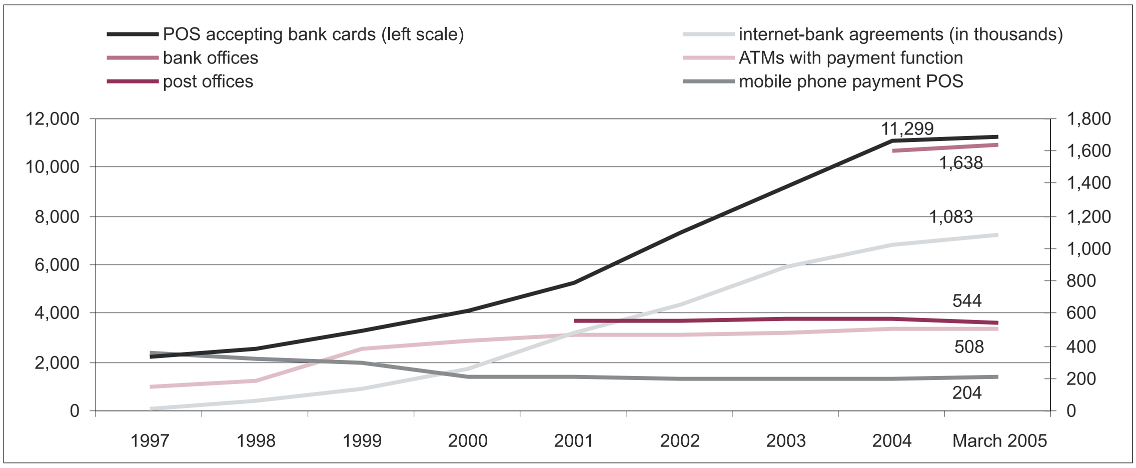

Figure 6.3. Channels for retail payments in Estonia (end-of-period figures)

At the end of March the annual growth in the number of subscribers for the Internet banking service was 21%, exceeding over one million contracts. The growth rate has accelerated by 6 percentage points compared to the growth rates of 2003 and 2004 (15%). One of the underlying reasons for the growing popularity of Internet banking is replacement of regular paper-based credit orders by electronic ones. Other electronic services also gained more and more popularity, e.g. e-invoices. The e-invoice service has been on the Estonian market for over four years now but its use increased remarkably just last year, mainly thanks to respective advertising campaigns[1].

The number of points of sale (POS) accepting mobile payments has grown most, i.e. by 24%, compared to other POS accepting payments. There were 1,638 POS accepting mobile payments for goods and services at the end of March, which is 318 more than a year ago (at the end of March 2004).

Table 6.1 compares the use of cash and payment cards in Estonia and in other new EU Member States. In Malta, which has the biggest volume of cash in circulation, card payments are rather popular as Malta is an attractive tourist destination. The more payment cards are issued, the larger the network required for their servicing is, and vice versa. Among the new EU Member States, payment cards are most frequently used in Slovenia where they have an extensive network of ATMs and POS. Similar to Slovenia, the use of cash is

[1] The number of subscribers for the e-invoice service provided by the information logistics company Itella AS is up to 800 contracts per day at peak times (BNS, 9 March 2005).

modest in Estonia, too. In Estonia, 35 card payments are made per capita per year at POS accepting card payments, i.e. about three payments a month. Card payments are preferred over cash payments as they are more convenient.

Table 6.1. Use of cash and payment cards in the European Union in 2003

	Cash in circulation / GDP	Number of card payments per capita	Number of payment cards per capita	Number of ATMs and POS terminals per 1 million inhabitants
Slovenia	2.7	49.00	1.70	16,674
Romania	3.2	0.22	0.22	658
Estonia	6.1	35.20	0.88	7,260
Poland	6.2	4.07	0.39	2,389
Cyprus	7.1	21.00	1.04	17,398
Hungary	7.3	7.00	0.66	2,702
Slovakia	8.0	5.60	0.56	2,852
Lithuania	8.3	7.30	0.62	3,475
Czech Republic	9.2	5.50	0.62	3,268
Latvia	10.2	10.20	0.77	4,789
Bulgaria	11.1	0.35	0.31	634
Malta	24.2	10.00	0.98	16,639

Source: European Central Bank, Blue Book, February 2005

Payments via Credit Institutions

Banks as providers of payment intermediation services have shifted their focus to services that create added value, offer more innovative solutions and personal approach to customers.

The number of credit orders initiated over a mobile phone tripled in a year (from 6,874 to 20,436). The use of direct debits and Internet bank credit orders remained at previous level (see Figure 6.4). As expected, the growth rate of credit orders initiated via Internet banking stabilised since the market is saturating.

The growth rate of telebank and paper-based credit orders slowed down. The number of paper-based credit orders continued to decline although at a slower pace (from 6% to 1%). The number of paper-based credit orders continued a decrease similar to that of previous periods as electronic payment methods are much more convenient and efficient. The use of telebank credit orders fell by 2%.

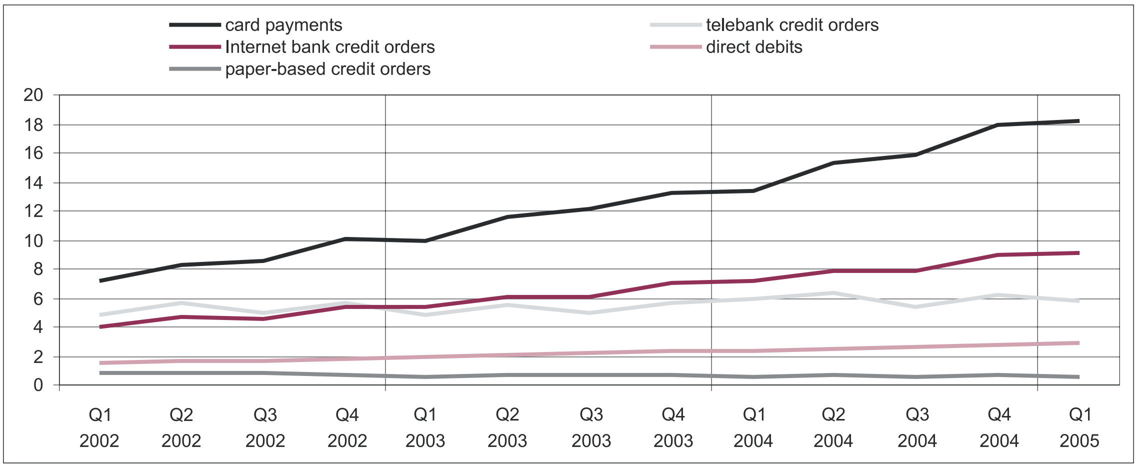

Figure 6.4. Widely used payment instruments in Estonia by number of payments (millions)

Use of Payment Cards

At the beginning of 2005 merchants intended to launch a campaign “Pay in cash” seeking to draw attention to the fact that servicing card payments was considerably more expensive for them than handling cash. The problem is that card transaction fees (interchange fees) are not transparent. While making a card payment is much more convenient for the card holder than paying in cash, the number of card payments in ATMs and at POS continued to rise (37%), reaching 18 million transactions in the first quarter of 2005. The value of card payments made at merchants' POS is an average of 3.6 million kroons per quarter. The number of POS accepting card payments grew by 15% in a year, reaching over 11,000 at the end of the first quarter of 2005.

The share of passive payment cards has remained the same and amounted to 23% of the cards issued (21% in March 2004).

Credit institutions issued over 7,500 credit cards and over 1,500 debit cards in the first quarter of 2005. As expected, the proportion of debit and credit cards issued changed because approximately 80% of the Estonian residents have a debit card, which means that the market is saturating. Therefore banks have shifted their focus to the credit card market as only every fifth resident has got a credit card. The number of actively used bank cards per 1,000 Estonian residents was 770; 664 of these were debit and 106 credit cards (see Figure 6.5). Two thirds of debit card holders and a half of credit card holders make active use of their cards.

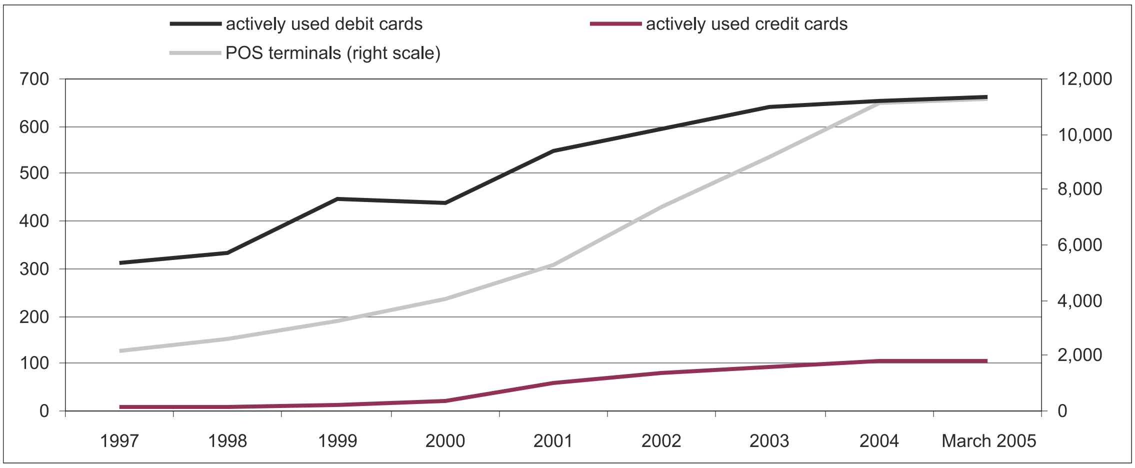

Figure 6.5. Number of payment cards in Estonia (left scale) per thousand inhabitants and number of POS accepting payment cards (right scale) at the end of a year

BACKGROUND INFORMATION

CARD PAYMENTS

Five credit institutions were issuing payment cards in Estonia as at April 2005: Sampo Pank, Ühispank, Krediidipank, Hansapank, and Nordea Pank. Hansapank and the Card Centre of Banks manage the POS infrastructure (see Figure 6.6).

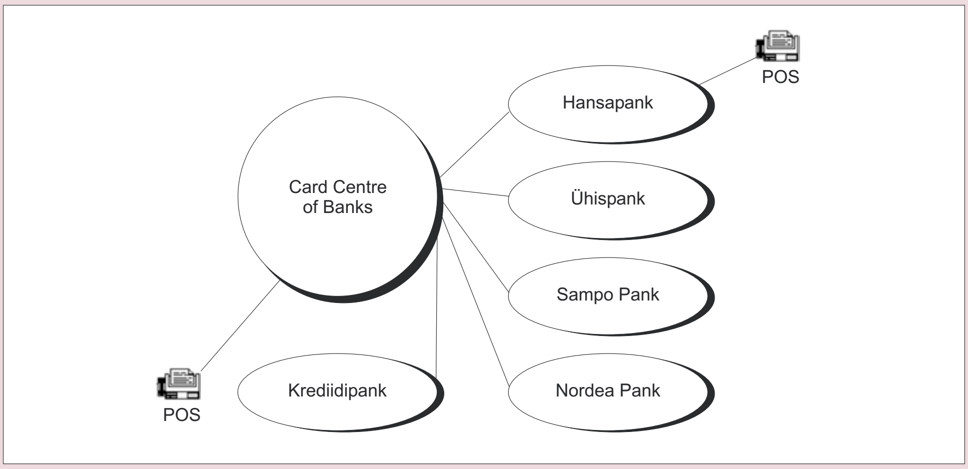

Figure 6.6. Credit institutions issuing payment cards and POS infrastructure managers in Estonia

There are two types of payment cards: debit cards and credit cards. The debit card allows the card holder to use the funds on the holder's current account. The credit institution does not provide credit for transactions carried out with the debit card. When using the credit card, the customer is granted a line of credit within the amount of prearranged credit limit.

According to the method how the customer returns the credit used, credit cards further subdivide as follows:

- Charge card: the card holder should repay his/her credit used over a fixed period on a fixed date as a one-off payment (17% of credit cards, 45% of the number of credit card payments, 58% of the value of credit card payments).
- Revolving credit card: the card holder can decide when or in which amount to repay the outstanding credit balance (20% of credit cards, 14% of the number of credit card payments, 12% of the value of credit card payments).
- Hire-purchase card: the card holder should repay the outstanding credit balance as instalments on fixed dates (44% of credit cards, 22% of the number of credit card payments, 17% of the turnover of credit card payments).
- Other credit cards: the card holder should repay the outstanding credit balance as a combination of the above repayment methods (19% of credit cards, 19% of the number of credit card payments, 13% of the value of credit card payments).

Card payments are by far the most widely used payment method intermediated by banks to pay for goods and services. The main reasons for the popularity of card payments are convenience and absence of transactions fees for the card holder. The reason why no transaction fee is charged from the card holder is that according to common practice the originator of the transaction pays such fees to the credit institution. As the originator of the transaction is the merchant with a POS that accepts card payments, the merchant is obliged to pay the transaction fee. In April 2005 fees for servicing card payments charged from the merchant by the credit institutions ranged, depending on the card type and other factors, between 0.5–3.0%[2] of the payment value. Service fees charged by credit institutions from the merchant can by no means be regarded as a profit. Actually, credit institutions should, in their turn, cover fees charged by international card associations[3] (more than a half of fees) and fees charged by the Card Centre of Banks (almost 20% of the fees charged) from the collected interchange fees. Credit institutions should also cover indirect expenses related to card payments at the expense of service fees collected.

In conclusion, the amount of the service fees charged by the credit institutions from the merchant might **significantly decrease** in the future only at the expense of lower interchange fees charged by international card associations.

[2] In Finland between 0.2–1.5% and in Latvia between 2–4%.
[3] Eurocard/Mastercard, Visa.