Eesti Pank

EUROSÜSTEEM

Lending Review

December 2011

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SUMMARY

In the second half of 2011, the deepening of the debt crisis in the euro area started to have an impact on bank lending to the European private sector too. Growth in loans slowed down in the euro area in the second half-year, driven by both demand and supply. While the non-financial sector was not ready to make new loan commitments in the context of an unstable economic climate and heavy debt burdens, the banks have at the same time reduced their offers of loans due to their strained financing. Finland and Sweden – our closest neighbours – have so far succeeded in differentiating themselves in a positive manner from the general trends in the euro area, but even their loan markets showed signs of a slowdown. The financial results of the Estonian companies have significantly improved in 2011 following the swift recovery in economic activity and primarily due to strong external demand. The turnover of non-financial sector companies has increased and companies have stepped up their take-up of short-term loans, especially overdrafts, in order to finance their evolving stock. The significant growth in profits has made it possible to finance new investments from internal funding sources. Foreign-owned companies have been actively raising external financing, meaning the share of foreign debt liabilities in total liabilities has increased to the pre-boom level of 26%.

The increasing employment and the falling unemployment rate boosted household confidence until autumn. Nevertheless, households have been making reasoned and considered consumption decisions and depositing any funds remaining after consumption in bank accounts, thus increasing their financial buffers. Borrowing has been cautious, but it has somewhat increased for purchasing cars or homes, because the price levels continue to be favourable when compared to incomes. Even so, the growth in the number of new housing loans has been more modest, implying that more expensive and high-quality property has been bought.

The high level of capitalisation and the improved financing base of the Estonian banking sector provide a solid basis for financing companies and households. Domestic cash flows from loan repayments and increasing deposits from the non-financial sector are currently sufficient to support new lending volumes that are significantly higher than the present level. The income base of banks is declining as their loan book decreases, and this should act as an incentive for banks to issue new loans. Driven by competition, the decline in the interest margins on new loans granted to the non-financial sector has been somewhat faster than expected in spring, with housing loans reaching the average euro area level by autumn.

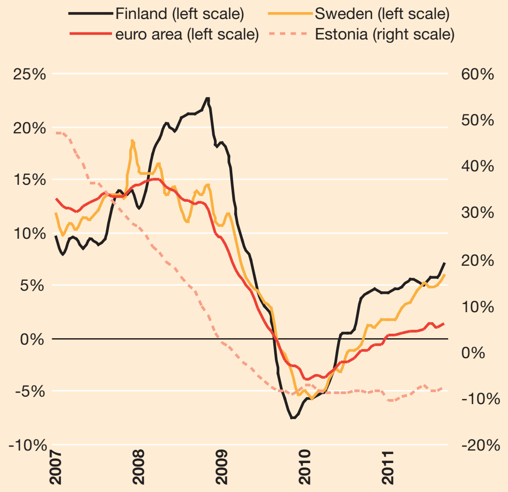
Parent banks from Nordic countries have so far remained outside the epicentre of the euro area debt crisis and there have been no major problems with funding. However, due to their continuously high share of wholesale funding, parent banks are still vulnerable to adverse developments in the financial markets. The unstable external environment may affect local banks especially through increasing funding costs, which may pressure them to raise interest margins on new borrowers.

Local companies may postpone their investments due to increasing uncertainty as the debt crisis deepens in Europe. Lower external demand would probably curb the need to finance business activities through short-term loans, and this then could hamper credit demand. Household borrowing may also decline to a considerable extent in the context of an insecure economic climate.

The credit stock of the Estonian non-financial sector has been decreasing constantly throughout 2011, although new borrowing has increased. The credit stock had fallen by almost 3 billion euros (17%) by the end of October 2011 from its peak in autumn 2008. While new lending is expected to grow in 2012, loan repayments will still exceed the volume of new loans and the credit portfolio will thus continue to shrink in 2012. However, 2013 may witness modest growth of around 2% in the credit portfolio.

LOAN GROWTH IN THE EURO AREA, FINLAND AND SWEDEN

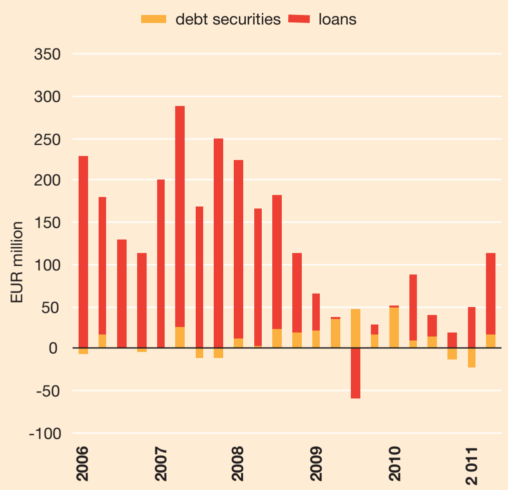
The economic downturn that began at the end of 2008 significantly hampered the growth in the stock of corporate loans. The annual growth rate dropped from 15% in 2008 to –3% in early 2010. This was partly driven by shifts between bank loans and financial market funding. The main cause, however, was the sudden drop in credit demand.[1] The annual growth rate of corporate bank loans has been positive again since the first quarter of 2011, but the growth has been quite modest due to the relatively high debt burden of companies. At the end of September, the annual growth in the stock of corporate bank loans was about 1% in the euro area. The annual growth rate of corporate loans in Sweden has been positive since the fourth quarter of 2010 and it has recovered more swiftly than in the euro area. In September 2011, the stock of corporate bank loans in Sweden increased by 6% compared to the previous year. Like in Sweden, the increase in the stock of corporate bank loans in Finland has also exceeded the growth in the euro area. In September, the annual growth rate in Finnish corporate loans was 7%.



Annual growth in corporate credit

Sources: European Central Bank, Eesti Pank

The annual growth in the stock of household loans remained largely unchanged in the third quarter of 2011. In September, the stock of housing loans, which are the main loan product for households, increased by 4.2% on an annual basis. However, the annual growth in consumer credit has been negative over recent months. The recovery in growth has been hindered by households' uncertainty about the economic environment, which means they are currently not ready for larger expenditures.[2] While the growth in the housing loan stock of euro area households halted due to the economic downturn in mid-2009, the effects of the crisis were smaller in Finland and Sweden, only causing growth to slow down. In Sweden, the growth pace also



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

Source: European Central Bank (euro area financial account statistics)

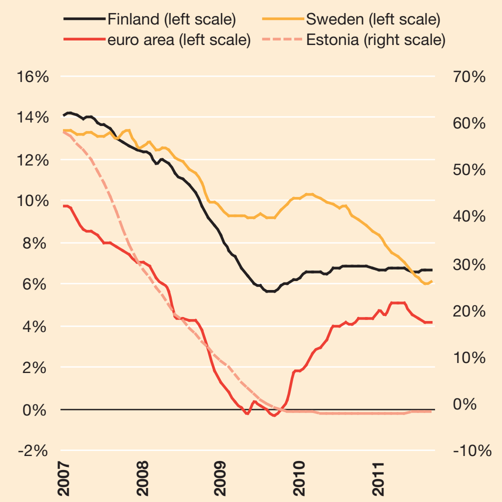
[1] ECB, Monthly Bulletin, November 2011.

[2] ECB, Monthly Bulletin, November 2011.

slowed in the first half of 2011 when loan margins were raised and growth in real estate prices slowed down.[3] While the annual loan growth in Sweden was over 9% in September 2010, the growth pace had slowed to almost 6% by September 2011. In Finland, the annual growth in the housing loan stock has been stable in recent months. The demand for new housing loans is supported by favourable interest margins and the relatively sound employment status in the current economic situation.[4] In September, the annual growth in the housing loan stock reached almost 7% in Finland.

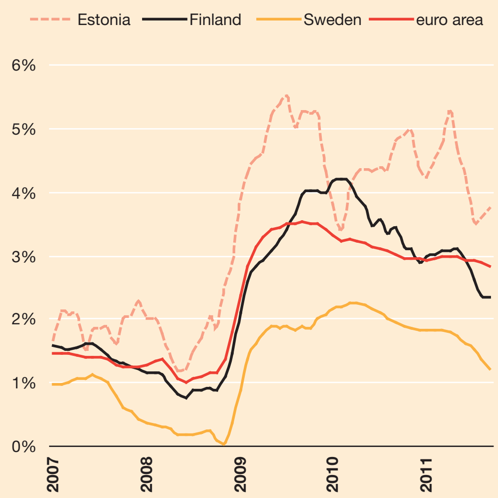
Although the interest margins on corporate bank loans have somewhat declined compared to end-2009, they are still higher than they were during the pre-crisis period. The bank loan margins of euro area companies have been relatively stable compared to early 2011. In Finland and Sweden, corporate loan margins have even fallen from where they were at the beginning of the year.

The interest margins on housing loans have remained stable in recent months in both the euro area and also Finland. In Sweden, the margins have risen. This can partly be explained by the larger funding costs faced by the housing credit institutions over the last year which is related to adjustments to new regulations.[5] A survey by the Swedish National Institute of Economic Research shows that Swedish households expect interest rates to rise. At the same time, the percentage of new loans at fluctuating interest rates has declined, meaning that borrowers increasingly prefer loans with fixed interest rates.[6]



Annual growth in credit for house purchase

Sources: European Central Bank, Eesti Pank, Statistics Sweden



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

Sources: European Central Bank, Eesti Pank

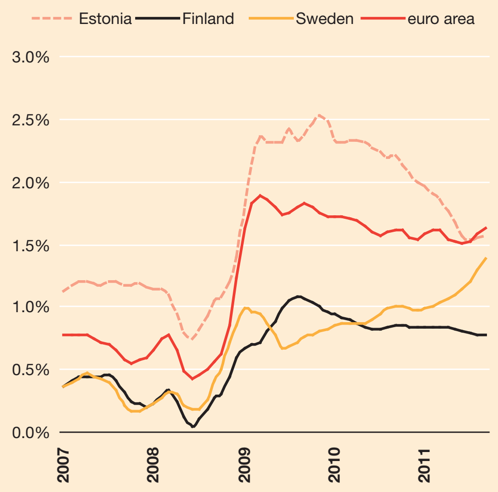
[3] Riksbank, Monetary Policy Report, October 2011.

[4] Suomen Pankki, Bulletin, 2/2011.

[5] Riksbank, Monetary Policy Report, October 2011.

[6] Riksbank, Monetary Policy Update, September 2011.

The euro area bank lending survey of September 2011[7] showed that banks tightened their credit standards in the third quarter of 2011 compared to the second quarter, whereas the tightening of the terms and conditions on corporate and housing loans exceeded expectations. According to banks, the loan demand from companies and households has also declined, especially as regards housing loans. However, lending conditions are currently significantly better than they were in the third quarter of 2008, when the global crisis that followed the bankruptcy of Lehman Brothers started to spread. Banks expect the credit standards for companies to be tightened even more in the euro area in the fourth quarter of 2011, but the deterioration in households' lending conditions will be more modest.



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

Source: European Central Bank

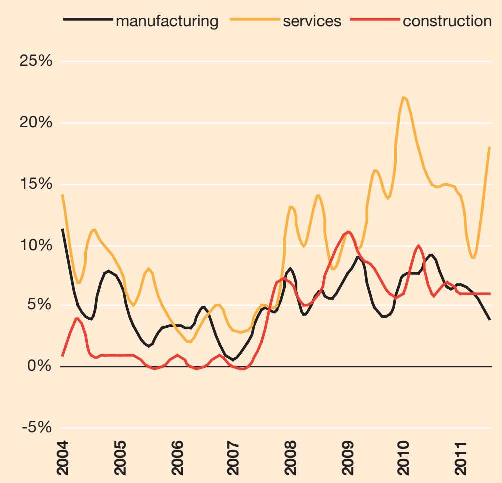
[7] ECB, Monthly Bulletin, October 2011.

The impact of the economic environment on financing

Significant improvement in sales volumes and economic results in 2011 and a positive future outlook increased the **confidence** of companies in the first half-year. At the end of summer, the external environment deteriorated, which had adverse effects on the overall Estonian economy. According to the Estonian Institute of Economic Research, the confidence of Estonian companies dropped in the third quarter of 2011, because expectations for future demand were more pessimistic. Insufficient demand is considered the major factor hindering business activity both in industry and in the service sector. However, the construction sector points out that demand has increased over the first 10 months of 2011, and in fact sees labour shortage as its major concern. According to manufacturing and construction companies, financial problems have been replaced by other factors hindering business activity. Financial problems are, however, still high on the agenda of the service sector and they became even more acute in mid-2011.

In October 2011, companies' estimates for demand in the following three months were mostly negative. The manufacturing sector expects the steepest drop in orders. The number of companies who expected demand to decline exceeded by 11% the amount of those who expected it to grow. According to the manufacturing sector, domestic demand was more secure and stable than the declining export demand from mid-2011. It is highly probable that the drop in export demand will sooner or later be translated into similar effects in the domestic market. The utilisation level of production capacity reached a four-year peak of 74% in autumn 2011, which is relatively close to its historical peak of 80%.

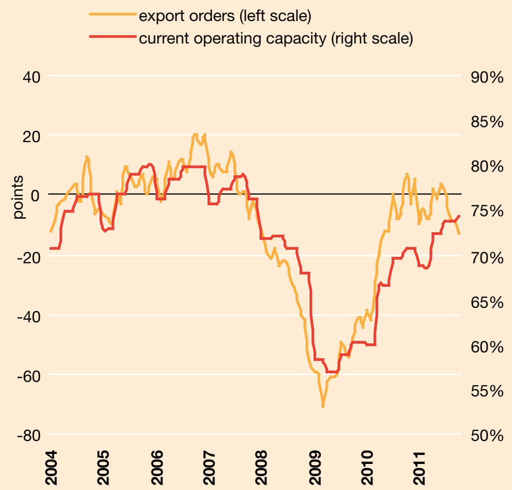
While sales revenue was rising, the first half of 2011 also witnessed annual growth of almost



Financial constraints as the main factor limiting production*

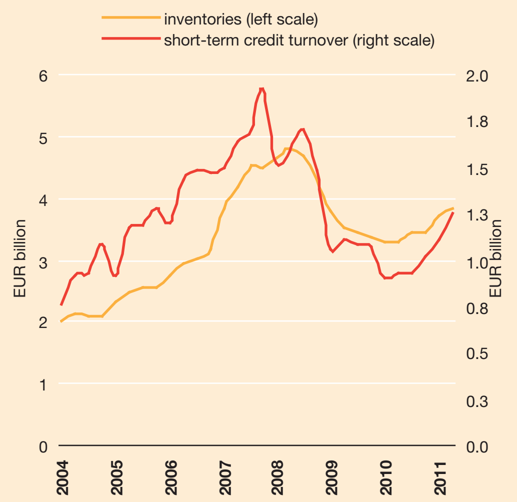
* percentage of respondents claiming this factor as most hindering production

Source: Estonian Institute of Economic Research



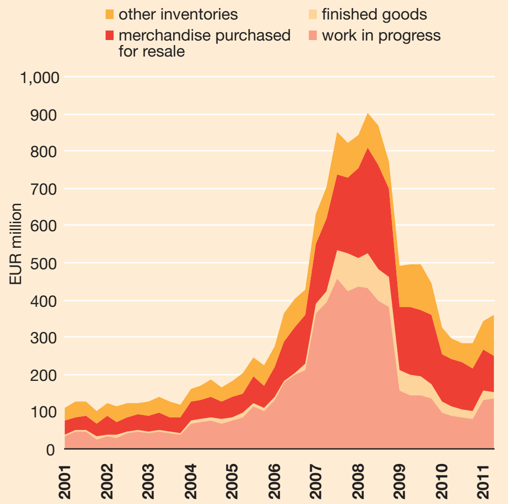
Export demand for manufacturing companies and current production capacity

Source: Estonian Institute of Economic Research



Inventories and short-term credit turnover

Sources: Statistics Estonia, Eesti Pank

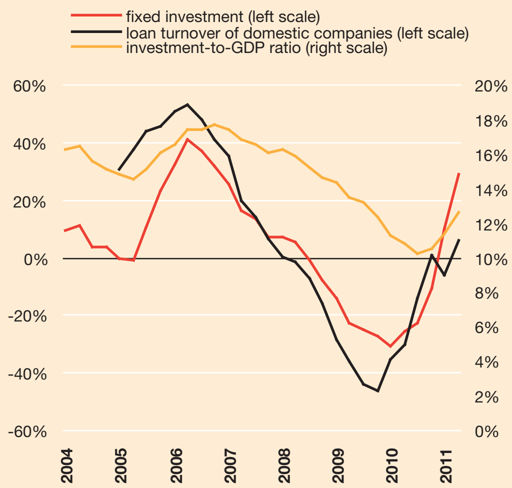


Construction and real estate sector inventories

Source: Statistics Estonia

17% in companies' inventories. Inventories increased by a third in manufacturing, construction and other sectors, and fell only slightly in the trade sector. Construction and real estate companies have somewhat increased their business activity according to Statistics Estonia. Inventories increased to where they had been in the second quarter of 2010 as supplies of work-in-progress grew, whereas the amount of finished goods decreased. However, the number of building permits fell by 8% during the same period. Diminished stocks of finished goods highlight the potential need for new investment in areas related to real estate.

Corporate **investment** has been growing since early 2011. In the first half of 2011, the total of investment by companies in fixed assets was over one billion euros, which is 61% more than in the first half of 2010. The main contributors to investment were manufacturing, where investments grew by 88%, and transport and storage, where investment grew by 124%. The most of investments were made in the construction and



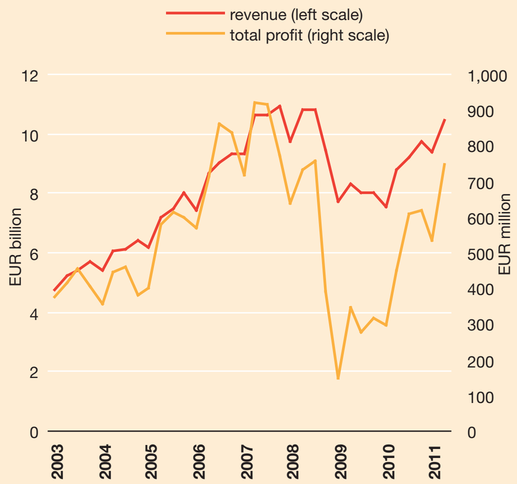
Corporate new borrowing from credit institutions and fixed gross investment (4-quarter annual growth)

Sources: Statistics Estonia, Eesti Pank

reconstruction of buildings and facilities and in machinery and equipment.

The pace of investment growth is faster than the growth in domestic long-term bank loans, implying that investment is increasingly funded from sources other than credit.

Investment as a share of GDP started to grow again at the beginning of 2011 after four years of decline. However, this is below the long-term level and therefore, we can expect larger investment in sustainable activities and in the growth of companies. The high utilisation level of production capacity will also support investment, but the willingness to invest and thus also the demand for credit may be curbed by uncertainty over the future, which has been increasing over recent quarters.

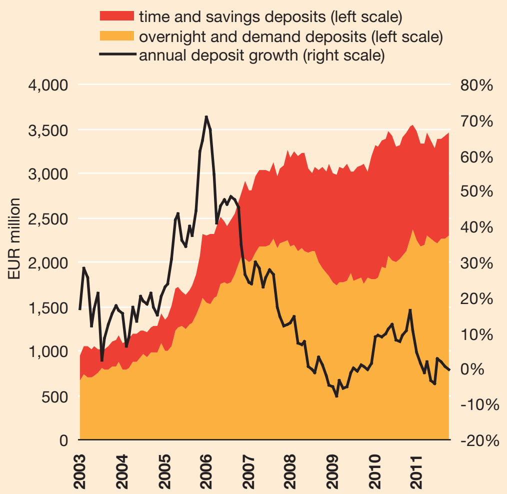


Corporate revenue and profit

Source: Statistics Estonia

Internal financing

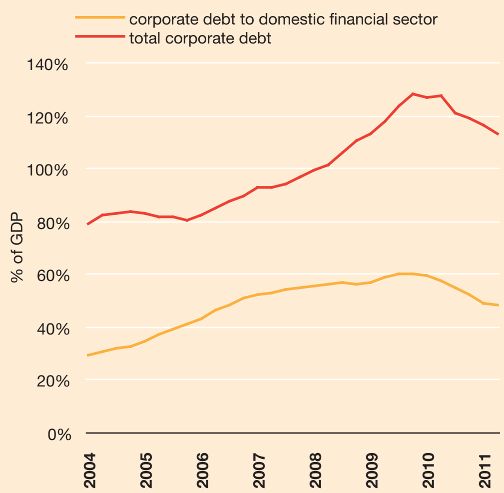
Corporate financial results improved significantly in 2011. According to the business statistics of Statistics Estonia, the annual growth rates of corporate sales revenue and total profits were 22% and 72%, respectively, in the first half of 2011. Sales revenue in absolute numbers increased in all sectors compared to the previous year. The main contributor was manufacturing, where turnover increased in June by 35% on an annual basis. Growth in the sales revenue of the business sector is expected to slow in the future due to the increasingly improving reference base. One third of the profits in the business sector is provided by manufacturing, which increased its profits by 76%. Like before the growth was again driven by exports, although the exceptionally high annual export growth of 71% in March slowed down to 30% in September. Exports to Sweden increased the most among the major trade partners.



Volume and growth of corporate deposits

In the first half of 2011, costs increased less than revenues, growing by 19%, with labour costs increasing by 9%. According to the business statistics of Statistics Estonia, the beginning of 2011 witnessed an even bigger increase in overall profitability, or the share of total profits in sales revenue. Overall profitability was generally within the 7–8% range before the global financial crisis, and it regained its pre-crisis level of 7% by the second quarter of 2011.

The financial account shows that the total value of companies' money and deposits was 3.9 billion euros at the end of the second quarter of 2011, which was 5.7 % less than at the end of 2010. The annual growth of deposits held in domestic banks was only 1% at the end of the third quarter of 2011. Despite the fact that companies are using current cash flows and accrued profits in order to meet the need for financing, their present liquidity buffer is bigger than it was before the economic slowdown.



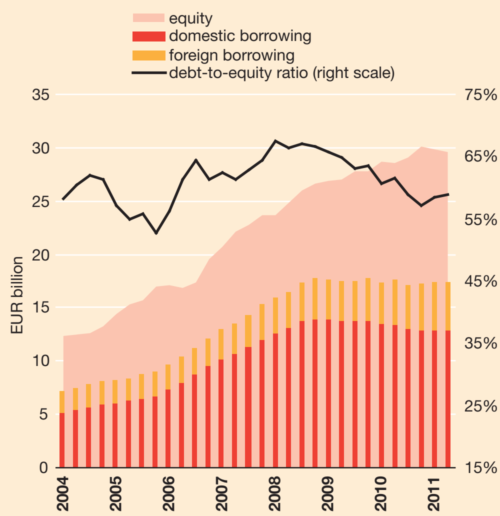
Debt-to-GDP ratio

Sources: Statistics Estonia, Eesti Pank

External financing

In the second quarter of 2011, the debt burden of Estonian companies as a share of GDP experienced an annual decrease of 15 percentage points to 115%,[8] primarily due to the rapid GDP growth. At the same time, the commitments of Estonian companies to domestic banks as a share of GDP declined by 9.3 percentage points, dropping to 48% in June. Corporate leverage expressed in the debt-to-equity ratio remained essentially stable in the first half of 2011.

The **financing structure** of the Estonian business sector is quite well established. Estonian companies meet the majority of the need for financing through domestic funding sources, such as bank loans and leases. The role of external borrowing, either intra-group or from other creditors, and bond emissions is smaller.



Corporate sector's equity, loans and debt-to-equity ratio

[8] Also includes debt commitments to non-financial institutions (source: quarterly financial account of Eesti Pank).

Structure of Estonia's corporate sector funding

	2004	2005	2006	2007	2008	2009	2010	I h/y 2011
Total debt liabilities (financial account)	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**
Domestic debt liabilities	**73.5%**	**75.1%**	**78.8%**	**78.5%**	**78.3%**	**78.1%**	**74.5%**	**74.1%**
Bank loans, leases and factoring	41.0%	54.2%	58.9%	58.6%	52.6%	48.2%	45.1%	43.5%
Lending from non-financial institutions	31.4%	19.8%	18.4%	16.4%	23.6%	28.1%	27.7%	29.0%
Debt securities	**1.0%**	**1.1%**	**1.6%**	**3.6%**	**2.2%**	**1.8%**	**1.6%**	**1.6%**
Foreign debt securities	26.5%	24.9%	21.2%	21.5%	21.7%	21.9%	25.5%	25.9%
Intercompany lending	11.9%	11.3%	9.8%	10.3%	10.8%	10.2%	10.6%	11.7%
Other foreign loans	12.1%	9.5%	8.3%	8.6%	8.1%	9.1%	12.2%	11.7%
Debt securities	2.6%	4.1%	3.0%	2.6%	2.8%	2.6%	2.8%	2.5%

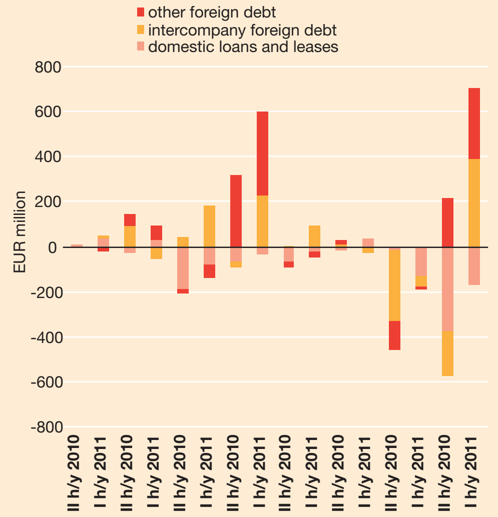
While the volume of domestic bank loans and leases at the end of the second quarter was 7% smaller than a year ago, the balance of foreign loans had increased by 6%. At the end of June, external debt amounted to 26% of the overall corporate debt, having increased by 2 percentage points within the year.

During the period 2003–2007, external intra-group financing grew significantly faster than did financing from other sources. Preferences in external financing started to change in 2008, and the share of financing from external sources has increased in companies' portfolios of external liabilities. Important sources of external financing include trade credit, and the stock of trade credit has doubled over the last two years due to increased export activities.

In the first half of 2011, the stock of debt increased in all sectors. The foreign debt of the trade sector has increased by half. Real estate, construction and logistics were at the top of the list in assuming additional intra-group external liabilities. Manufacturing increased its liabilities to creditors outside the group significantly, but repaid its intra-group loans at the same time and to almost the same extent.

Foreign equity investment in the Estonian companies grew in parallel to the increase in foreign borrowing, with an annual growth of 8% at the end of June 2011, year-on-year. Equity increased the most in manufacturing and in the service sector. In the first half of 2011, reinvested income accounted for the majority of direct investment at 80%, which is comparable to the pre-crisis level. A temporary change occurred in the structure of direct investment in 2008–2009, when equity contributions formed the majority of equity investments.

Over the past five years, equity has increased the most as compared to reinvested income in trade, industry, logistics and agriculture. In the first half of 2011, reinvested income was positive in all sectors, particularly so in agriculture and industry.



Change in total corporate sector debt

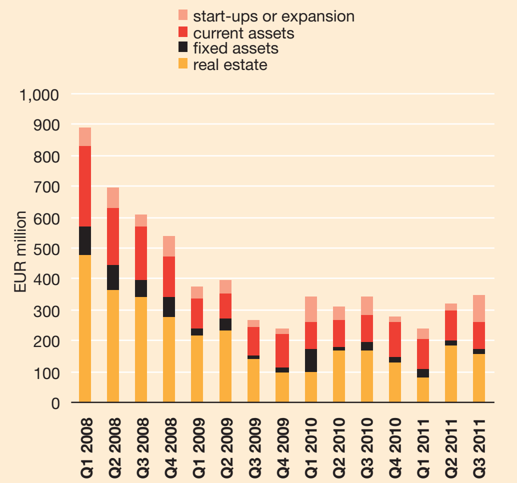
Domestic borrowing

The structure of domestic financial liabilities changed considerably over the year. The share of short-term loans in the total stock of loans had increased by 3.3 percentage points to 30% by mid-2011, a level which is comparable to that before the boom.

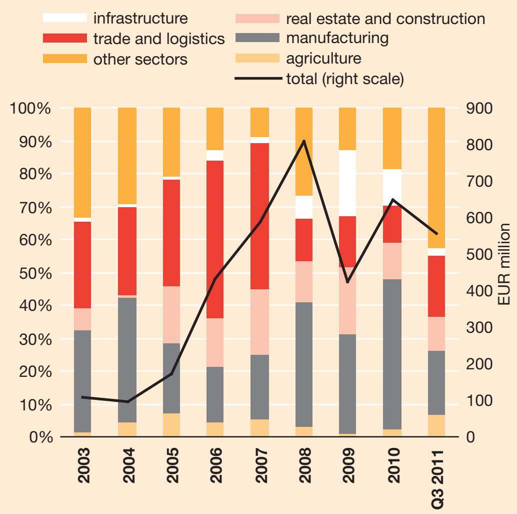
According to banking statistics, corporate goals in borrowing from banks have changed slightly. The turnover of loans taken to finance fixed assets has declined by half, while loans taken to finance current assets have grown by 10% at the same time, which is natural in the context of increased economic activity. The turnover of loans taken for the purchase of real estate remained stable over the first three quarters of 2011 compared to the same period last year.

A total of almost 557 million euros was borrowed during the first three quarters of 2011 for starting or expanding business. This is about the same as the amount borrowed during the same period in 2010 and more than half as much compared to the amount borrowed in 2009. Although the first half of 2010 witnessed considerably more active borrowing than 2011, the volume of such loans granted in the third quarter of 2011 exceeded the volume of loans granted a year ago by 63%. Agriculture and infrastructure were top of the list for borrowing to start business during the first three quarters of 2011, while industry, trade and logistics borrowed the most to expand business, accounting for 40% of the total volume.

An analysis of the turnover of long-term loans[9] shows that the number of such loans has increased. The number of long-term loans granted during the first nine months of 2011 exceeded by a quarter the number of such loans granted during the same period in 2010, though



New lending to corporates by loan purpose



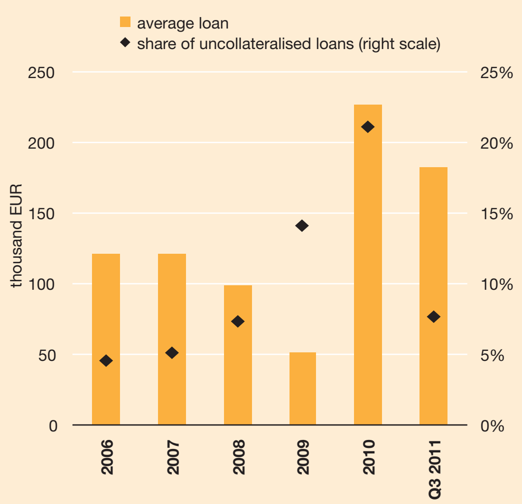
New lending for start-ups and expansion by sectors

[9] With maturity of more than one year, not including overdraft facilities.

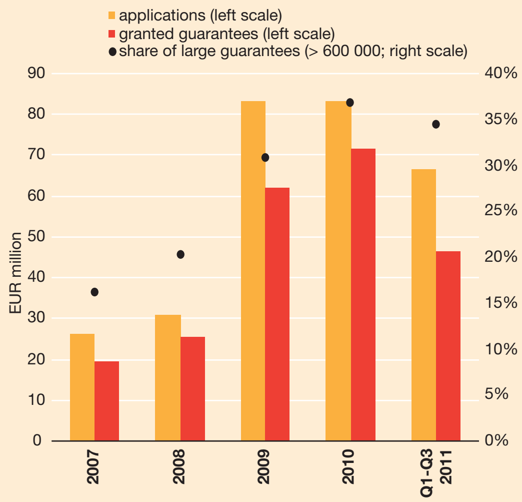
the average loan amount fell by 20% at the same time. The share of uncollateralised loans has also fallen in 2011, to only 7.7% of loans granted, from 21% in 2010. This trend indicates that the borrowing activity of smaller companies and projects has been stronger this year.

KredEx data show that the volume of applications submitted in 2011 for guarantees and loans was almost identical to that of 2010. The number of companies receiving support was 14% higher than in the same period of 2010. However, the value of successful applications has fallen, pointing to the increased activity of smaller companies.

When looking at the relation between interest rates and the size of loans, it can be concluded that the difference between the interest rates on smaller loans (of up to 250,000 euros) and on loans with a maturity of more than one year and other loans has narrowed significantly since the beginning of 2010. The difference between the interest rates on smaller loans and larger loans (of more than 1,000,000 euros) averaged 2.8% in 2010, but only 1% in 2011. The difference between the interest rates on medium-size loans (of 250,000-1,000,000 euros) and big loans has been smaller and more stable in the last two years. At times, the average difference in the interest rates on such loans has even been below 1% in 2011.



Average size of long-term corporate loans and share of uncollateralised loans (without overdrafts)



Applications for corporate loan guarantees by KredEx

Sources: KredEx, Eesti Pank

FINANCING OF HOUSEHOLDS

The economic situation of households

Consumer confidence fell in October 2011 for the third quarter in a row and dropped below its long-term average for the first time since the first quarter of 2010. The main driver for this was uncertainty about the economic outlook. Households' assessment of their economic situation for the next 12 months has also deteriorated somewhat. This year the drop in confidence indicators occurred earlier than customary seasonal patterns would have expected. This was probably due to risk factors stemming from the external environment, such as increasing problems in several euro area countries with public debt and solvency and their possible effects on the Estonian economy.

In general, labour market indicators have strengthened the potential of household financing. In the third quarter, the number of the employed was 8.6% higher than a year earlier and the employment rate was 61%, the highest level since the start of 2009. The number of the unemployed and the unemployment rate continued to decline in parallel with the growth in employment, dropping to 77,000 and 10.9%, respectively, in the third quarter. The average gross wages increased in the second quarter for the fifth quarter in a row, at an annual rate of 4.2%. Real wages that mirror the effects of changes in consumer prices continued shrinking, dropping a further 1% within the year. However, it is likely that declining real wages have also hindered consumption in earlier quarters, even though the consumer confidence level has remained quite high so far.

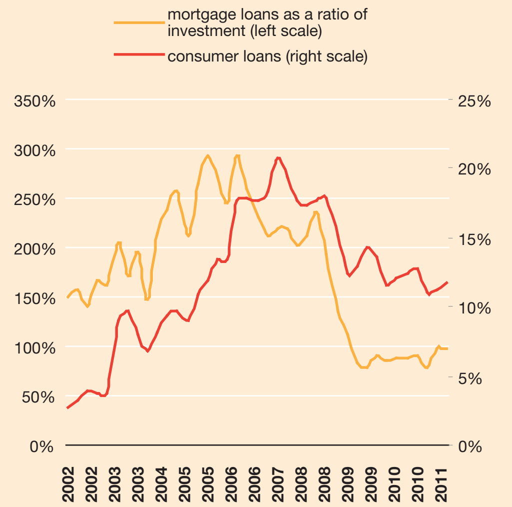
Household consumption decisions are more reasoned and continue to be cautious due to the crisis, and consumption is at about the 2007 level. Looking ahead, the drop in confidence may be mirrored to a certain extent in retail sale indicators, although the annual increase in retail sales in September was 4% in constant prices. The forecast on the purchase of durables, which had been rising steadily since the second quarter of 2009, has been declining since early 2011. However, the forecast on the sale of durables has become positive again. This could be owing to year-end sales expectations, increasing nominal incomes in recent months and formerly postponed consumption decisions.

The financial behaviour of households

While almost 20% of private consumption expenditures during the economic boom were financed through consumer credit, meaning that the latter boosted consumption, the drop in consumption expenditure during the recession was accompanied by a decline in the share of these loans in financing such expenditures. The share of consumer credit will remain stable in the future when private consumption recovers. An increase in the share of loans is also unlikely in financing household investments, since households are still borrowing prudently.

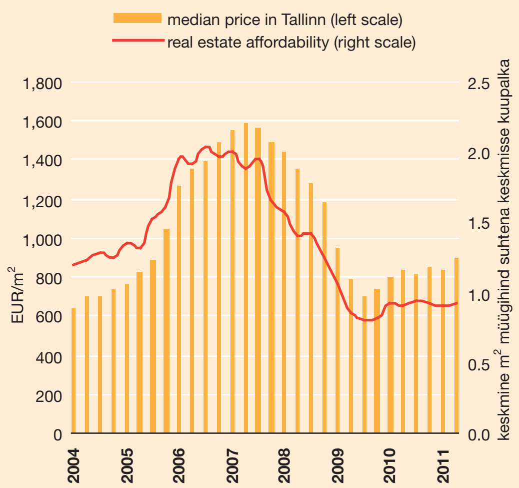
The purchasing power of households in the real estate market has been quite stable since early 2010. In the second quarter, the housing affordability index for a person living in Tallinn and earning average gross wages was 0.92, which means that average gross monthly wages of a person living in Tallinn were 8% higher than the average price per square metre of an apartment in Tallinn. This index has been below 1 since the second quarter of 2009. The median price of apartment transactions in Tallinn has been on the rise since the second half of 2009, but still remains at its 2005 level. However, the number of transactions has not significantly increased from its pre-recession level. It has remained approximately the same over the years, but the transaction price has increased by almost 15%

The borrowing activity of households is quite modest. Loans are taken primarily to purchase



Share of loans in household expenditures

Sources: Statistics Estonia, Eesti Pank

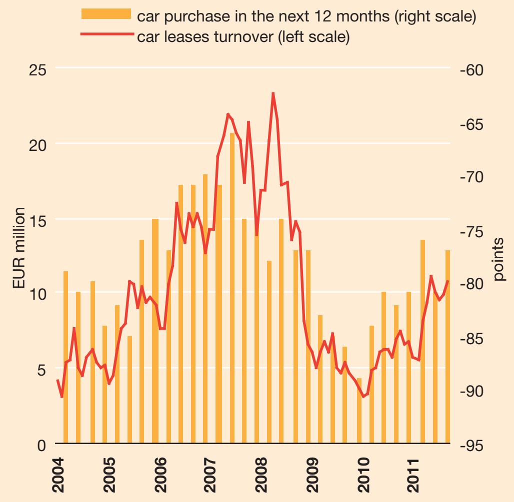


Real estate affordability and median price in Tallinn

Sources: Land Board, Eesti Pank

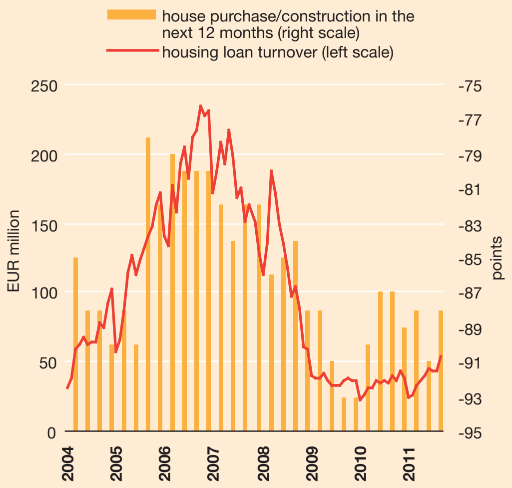
cars or dwellings. The turnover of housing loans increased by almost a fifth from early 2011 until September, but the number of loans granted has been quite stable. This may have been caused both by the purchase of more expensive property and by the decreasing share of down-payments. Consumer credit turnover experienced extremely modest growth of less than 5% in the second and third quarter, illustrating the cautiousness of households. The car-lease turnover increased by a remarkable 65% during the first ten months of 2011, but the growth has slightly slowed in recent months.

The growth in household deposits gained momentum in the third quarter of 2011. The total deposit volume reached 4.2 billion euros at the end of September, representing an annual growth of 13%, which was the highest since early 2008. Overnight and demand deposits accounted for almost 50% of household deposits but were 19% smaller than in 2010. The share of more liquid deposits increased primarily because of



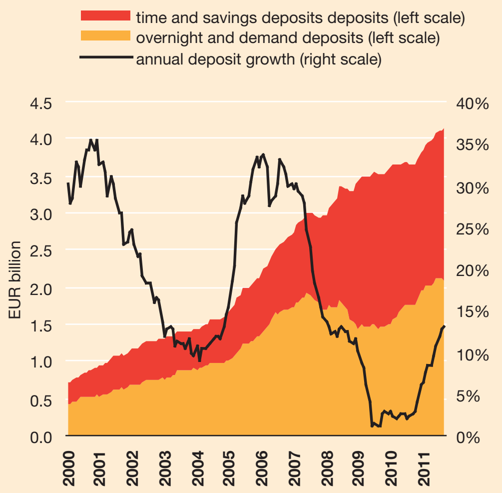
Household car leases turnover and car purchase

Source: Estonian Institute of Economic Research, Bank of Estonia



Household housing loan turnover and house purchase intention

Sources: Estonian Institute of Economic Research, Eesti Pank



Household deposits

the low interest rates of term deposits. Term and savings deposits accounted for 48% of deposits and their volume grew by 8% within the year

In general, saving increased and thus the financing potential of households has strengthened. This is reflected in the financial position of households, labour-market developments, and the increase in deposit volumes. Given the confidence indicators and the cautiousness caused by external risks, the credit demand of households will probably remain quite conservative in the future.

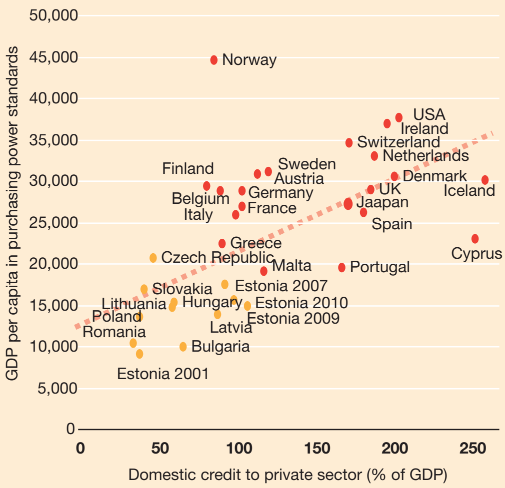
FACTORS AFFECTING THE LOAN VOLUMES OF COMPANIES AND HOUSEHOLDS DURING THE RECESSION

Growth in credit stock is usually coupled with economic growth.[10] The recession in the Estonian economy turned into growth in 2010. In contrast to traditional patterns, however, the growth was not accompanied by a recovery in credit volumes. The credit stock has been decreasing since the end of 2009 in all major customer groups, for both companies and households. This is not a very common situation in international terms, but neither is it unheard of. It is normal in developed countries that every fifth or sixth recovery from economic recession is creditless. This occurs even more frequently in developing countries, where every fifth recovery is creditless.[11] The following figure illustrates the developments in credit volume and economic growth in Estonia over the last decade and provides an international comparison.

[10] See e.g. Levine (1997).

[11] Abiad, et al. (2011); Bijsterbosch and Dalhaus (2011).

Analysis of micro data from households and companies[12] shows that these sectors have slightly different factors of credit recovery. While 28% of households in 2008 intended to take a loan, pay in instalments, sign a lease agreement or use a credit card in the next year, this share had dropped to 18% by 2009. Household demand for loans and leases declined the most, and the demand for instalments and credit cards fell less. Economic growth started to recover in 2010, but household credit demand was still modest. Only 20% of households wished to take a loan, pay in instalments, sign a lease agreement or use a credit card. About a third of the drop in credit demand can be explained by the smaller incomes of households and their lowered income expectations. The other two thirds of it can be explained by the change in household behaviour patterns. An example of this is that credit demand was supported by employment before the economic slowdown, but the willingness of employed people to borrow has been much lower since the crisis. The role of the loan supply in the weak credit demand is irrelevant. Altogether 33-35% of the households that applied for a housing or consumer loan from a bank in 2010 did not receive the loan or received it for less than expected or assumed that the bank would not grant the loan anyway. The majority of these credit constraints applied to households with a very high credit risk, high indebtedness and small incomes.



Credit stocks and income levels in 2007

Sources: World Bank (credit), Eurostat (GDP per capita)

The corporate loan stock during and after the economic crisis was analysed using data from the Commercial Register. Both credit demand and supply have affected the credit stock presented in companies' balance sheets and it is thus difficult to distinguish between demand and supply factors using balance sheet data. Even so, the results of the analysis show that more indebted companies had a smaller growth rate during the recession. Service sector companies have suffered the most under high indebtedness. Companies operating in manufacturing, where credit constraints and loan costs have traditionally been bigger, also saw more moderate growth during the recession, especially small, domestic or young companies.[13] The lower growth rate of manufacturing companies during the recession demonstrates that the loan supply has had a major impact on corporate growth capacity. The effects of credit constraints are also quite

[12] Eesti Pank used the household data of the TNS Emor F-monitoring survey for the analysis.

[13] These results were found in the analysis despite the use of various reference indicators such as the growth in productivity, level of competition in the sector, or the increase in the sector's production volumes and exports.

significant in terms of the economy, as for example during the recession the growth rate of a manufacturing company which employed 10 workers was 20% lower than the growth rate of a similar manufacturing company with 250 workers and equivalent levels of productivity and exports. Furthermore, the growth rate of international companies that usually enjoy better access to credit was also 10% higher during the recession than was that of domestic companies with equivalent levels of productivity and exports.

In general, the loan volume of households is driven by demand rather than supply. Incomes have fallen and behaviour towards taking up loans is prudent. Different business sectors have different factors that explain the smaller corporate credit volume: the service sector is mostly affected by credit demand, but manufacturing is more affected by loan supply.

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Bijsterbosch, M. and T. Dahlhaus (2011). Determinants of creditless recoveries. ECB Working Paper Series, 1358.
Levine, R. (1997). Financial Development and Economic Growth: Views and Agenda. Journal of Economic Literature, 35(2), pp. 688–726.

The capitalisation and financing of banks

The loan supply capacity of banks depends on their financial position, and more specifically on the capital held to cover risks and the availability and price of the funds needed for lending.

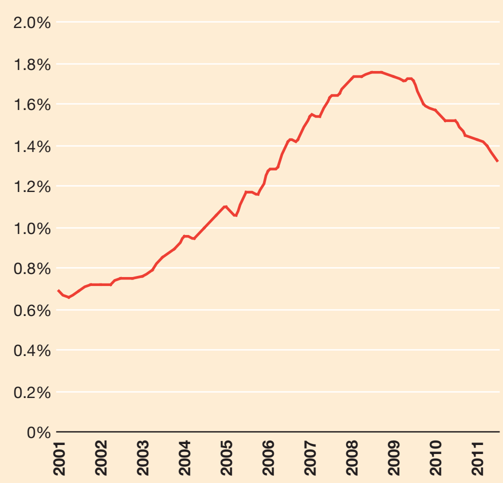
The main risk to the Estonian banking sector – **credit risk** – is diminishing. The amount of loans overdue by more than 60 days has dropped briskly since its peak of 7.6% of the loan portfolio in August 2010. However, any recovery of loans that are overdue for a very long time is rather unlikely and the decrease in non-performing loans is expected to slow in future. The banks still have extensive provisions that they accumulated earlier for credit losses, and almost 80% of long-term non-performing loans were covered by provisions at the end of September. This means banks have no need to pay additional attention to or provide additional capital for dealing with non-performing loans; instead, they can focus on increasing their income base in the context of persistently weak credit demand.

The **capitalisation** of banks has remained high throughout the current economic cycle, reaching 16.9% at the end of the third quarter and thus exceeding significantly the regulatory minimum of 10%. The banking sector's capital buffer is sufficient to cope with twice as many non-performing loans in the loan portfolio as there are at present.[14] The capitalisation of banks is thus adequate for managing potential risks even in a considerably worse economic environment, and the strong capital base supports their lending capacity.

The **funding** of banks operating in Estonia is increasingly based on domestic retail deposits. As households and companies have been increasing their deposits and new lending has been moderate, banks have been able to repay funds they mostly received from parent banks. The loan-deposit ratio dropped to 1.3 by the end of the third quarter, meaning the credit stock exceeded deposits by about 30%. This indicates that the need of local banks for external financing has lowered considerably from the situation a few years ago when only a little more than half of loans granted were financed with deposits.

The **domestic cash flows** of banks are currently sufficient for financing domestic lending. Banks have not needed additional funds to finance domestic lending since the fourth quarter of 2008. The flow of domestic funds, which consists of loan repayments and the increase in deposits, has exceeded new lending volumes during the last couple of years by about 300 million euros in each quarter. In other words, banks can use domestic funds to finance lending volumes that are about a quarter higher than at present.

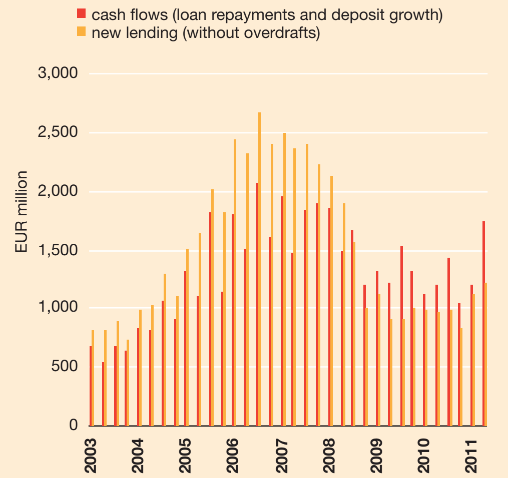
Although the need of local banks for funds from parent banks has significantly diminished, they



Loan-to-deposit ratio in Estonia*

* Based on the loan and deposit volume of non-MFIs

[14] For more details see Financial Stability Review 2/2011, subsection Banks.



Domestic quarterly cash flows and new lending of banks

are still affected by the **funding situation of parent banks**. The situation also varies across banks. The high uncertainty prevailing in financial markets has had a major impact on the funding of European banks, though banks from the Nordic countries are in a somewhat better position. The availability of funding for banks from the Nordic countries has been supported by the fact that their usual funding source, the covered bond market, has so far functioned slightly better than other capital markets. However, Nordic banks continue to be vulnerable to changes in financial markets, because short-term funding accounts for about 40% of their financing from financial markets.[15] This means that the funding conditions of the Nordic banks may also deteriorate sharply if the debt crisis in Europe, which represents the main risk, follows a worse-than-expected pattern. Adverse effects may quickly spread to their Estonian subsidiaries and branches, manifesting themselves primarily in funding costs but also in risk assessments.

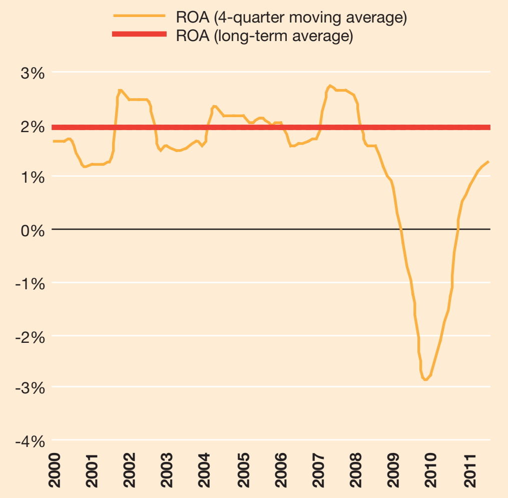
[15] Maturity of less than a year.

Other factors affecting loan supply

Apart from the ability to lend, the willingness of banks to grant loans is also important. Banks may enjoy a strong financial position, but the overall economic environment may be unfavourable for lending. Therefore, it is necessary to analyse the indicators that show whether banks have an incentive to grant loans.

Banks have resumed their profits after surviving a negative credit cycle. In spite of the extremely low funding costs, the low interest rates and modest lending volumes have kept the **profitability** of the banking sector below its long-term average. The poor rate of return forces banks to seek ways to increase incomes. Since the loan turnover is still modest and banks have enough funds for lending, they should be interested in expanding their income base by granting new loans to creditworthy borrowers.

The Bank Lending Survey shows that the **risk assessment** of banks varied in 2011 for different



Banking sector's profitability

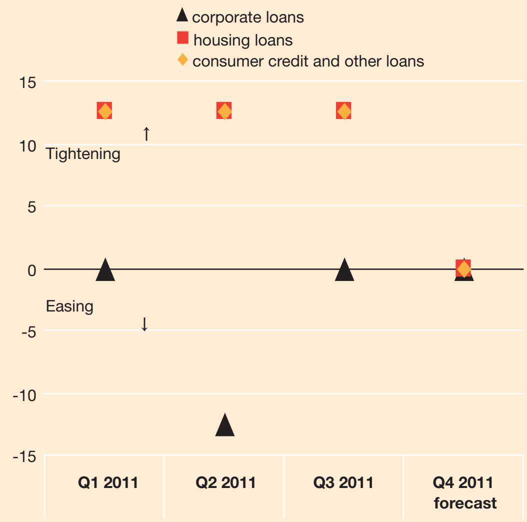
* Excluding one-off profits in Q3 2011.

segments of the loan market. Attitudes towards companies have been favourable and credit standards have been alleviated, whereas household lending conditions have been slightly tightened. Given that local banks do not finance themselves directly in financial markets, they expect the debt crisis to have negative effects on credit demand rather than on the need to tighten lending conditions.

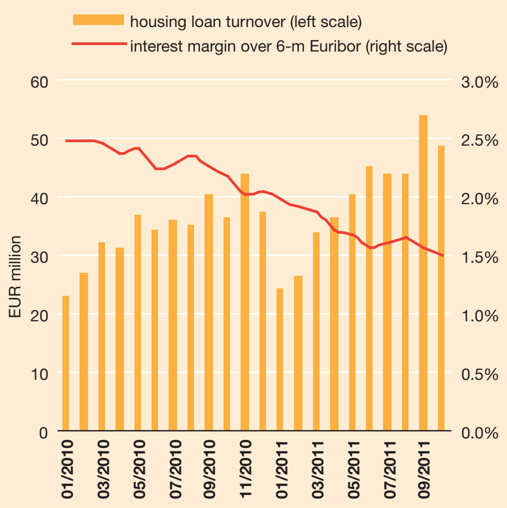
Although lending conditions to households have not been alleviated, the trends in this loan market sector imply severe **competition** between banks. The market for housing loans, which is a relatively homogeneous loan product, is especially suitable for analysing the competition situation. In our earlier review[16] we forecasted growing competition pressures and this forecast has materialised. Banks began to hunt for creditworthy clients and were forced to lower their margins even more as the macroeconomic outlook improved and the real estate market stabilised. Consequently, the average interest margin on housing loans had dropped by 50 basis points to 1.6% between early 2011 and September. Competition pressures have also forced the pricing of loans to become more similar to what it was during the boom period when different loan customers were charged similar interest margins. Of the housing loans granted since the second quarter of 2011, 30% had virtually the same margin. This implies that banks are basing their loan pricing on the overall macroeconomic outlook and that they are taking the specific features of different customers into account less than they did in 2009. However, the lowering of margins was not accompanied by a strong growth in loan turnover, which shows the continuing cautiousness of people in making loan commitments.

This year also witnessed the convergence of interest margins on long-term corporate loans

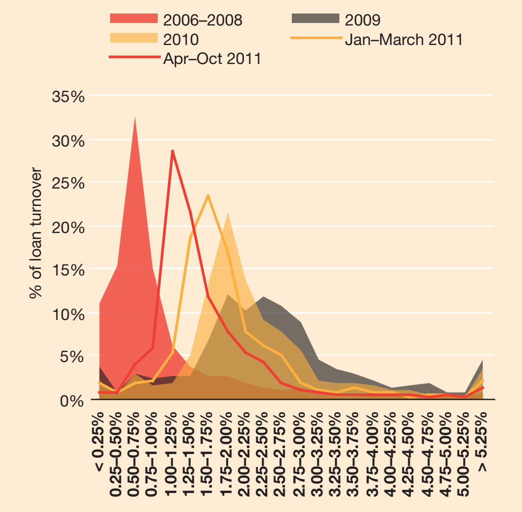
16 Lending Review, June 2011.



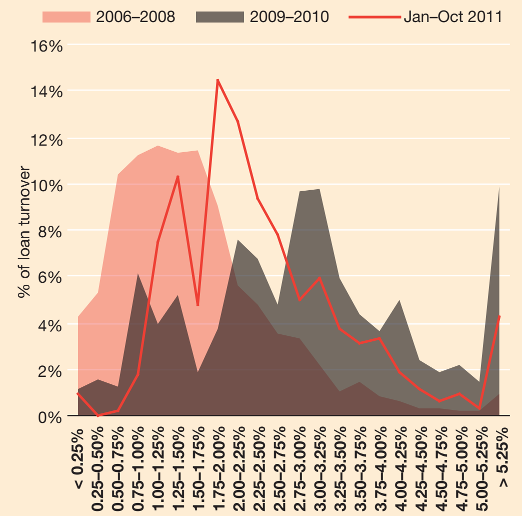
Diffusion index of changes in credit standards



Housing loan turnover and average interest rate margin



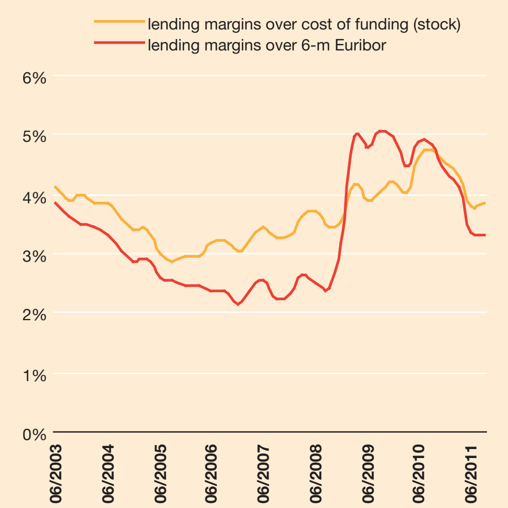
Housing loan interest margins as a ratio of 6-month Euribor



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

as the risk premiums charged from various loan customers are more similar than a year ago. On top of this, the average margin has also dropped significantly in 2011. On the one hand, this could imply improved risk assessment and more intense competition for creditworthy customers in the sense that banks are willing to make concessions over the margins for the sake of new customers. On the other hand, this may equally imply that banks are being more prudent in choosing loan customers and margins are thus lower and more homogeneous.

Interest margins vis-à-vis the common base rate of loan agreements, the 6-month Euribor, have decreased after a hike following the recession and to a larger extent than the cost-based margin of banks, which is the difference between the funding costs and the interest rates on new loans. However, the cost-based margin has been quite high compared to earlier years due to the drop in funding costs. On the one hand, this could demonstrate the banks' desire to increase their incomes, as their loan book is shrinking, but on the other hand, this could show their slightly increased risk aversion.



Lending margins for the non-financial sector