Q4 2018 overview of banking sector

There were 16 banks operating in the Estonian market at the end of 2018, of which eight were branches of foreign credit institutions.

Key indicators	Q3 2018	Change	Q4 2018
Annual increase in loan balance	5%	?	5,7%
Annual increase in loan balance	3,6%	?	4%
Loan-to-deposit ratio	108%	?	109%
Long-term overdues as % of credit portfolio	0,6%	?	0,5%
Liquidity coverage ratio	162%	?	162%
Profit	73 mln €	?	128 mln €
Cost and income ratio	47%	?	43%
Return on equity	9,6%	?	11%
Return on assets	1,4%	?	1,5%
Tier 1 Common Equity ratio	30,7%	?	30,3%

Yearly growth in the loan portfolio of banks operating in Estonia increased in 2018 from 5% in the third quarter to 5.7% by the end of the fourth quarter. This was driven particularly by yearly growth of 6.2% in loans to private customers, 80% of which were housing loans, where growth over the year was 6.5%. Yearly growth in loans to companies slowed over the year from 4.3% in first quarter to 2.5% in the fourth. The main cause of the slower growth in corporate loans was the reduction in the presence of Danske bank in the Estonian market.

The yearly growth in deposits increased to 4% in the fourth quarter from 3.6% in the third quarter. Although growth in loans was faster than that in deposits, the loan-to-deposit ratio for the banking sector as a whole, including branches, rose over the year to 109%. Without branches, the loan-to-deposit ratio of the banks was 101%. The ratio was 470% for branches, which was much higher than 180% a year earlier. This was also because of the Danske bank branch, where deposits were replaced with funds from the parent bank.

The loan quality of the Estonian banking sector is very good. The share of bank loans overdue by more than 90 days continued to decline as there were fewer overdue loans and as the loan portfolio grew, and it stood at 0.52% at the end of the year. The share of loans overdue by other amounts also fell in the fourth quarter. The quality of loans improved at the consolidated level and the share of problem loans fell to 1.17% in the fourth quarter.

The liquidity position of the banks remains strong. All the banks met the Liquidity Coverage Ratio (LCR) with sufficient margin in the fourth quarter, and the average indicator for the sector was 162%. Alongside the funds dedicated for meeting the Liquidity Coverage Ratio, the banks also have other liquid assets, notably deposits in credit institutions, and including these, liquid assets were 20% of assets at the end of the fourth quarter.

The funds of the banks increased by 308 million euros, or 1.4%, in the fourth quarter. There was more growth in term deposits than in demand deposits and the share of demand deposits fell from 68.3% in the third quarter to 67.7% in the fourth.

Client deposits were up 1.2%. Resident deposits increased by 3.8%, while non-resident deposits declined by 21%. The decline in non-resident deposits came from a reduction in deposits from offshore regions and other areas. The fall in non-resident deposits over the quarter was 7.9%, having been 11.8% a year earlier.

Banks and branches operating in Estonia earned 128 million euros in profit in the fourth quarter at the individual level, which is 75% more than in the third quarter. Profit at the individual level increased by 55 million euros over the quarter, which was a result of dividends taken from subsidiaries at the end of the year. The consolidated profit of the banking sector was reduced by income tax payments by 13% in the fourth quarter to 75 million euros. In 2018 as a whole the banking sector had individual-level profit of 369 million euros, or around 8% more than a year earlier.

The return on equity over the year for the banks was 11% in the fourth quarter, and it rose because of dividends received. Without dividends the return on equity of the banks would have been 9.2%. The return on equity has been on a downward path in recent years because of faster growth in equity. The average return on equity in the banking sector of the European Union was 7.2% at the end of the year.

The revenues of the banks increased by 283 million euros, or 31%, in the fourth quarter, and this growth was driven by dividend income. Among the main sources of revenue, interest income was up by 3% over the quarter and 3% over the year, while service fee income was unchanged over the quarter and up 2% over the year. Gross income increased by 16% over the year to 969 million euros. The expenses-to-income ratio was 43% at the end of 2018, while the average for the European Union was 63%.

Capitalisation indicators for the banking sector remained essentially unchanged in the fourth quarter at both the individual and consolidated levels. The Common Equity Tier 1 ratio remained at 28% in the fourth quarter and at the consolidated level it was 30.3%.

Main development trends and risks

- The share of loans overdue more than 90 days continues to decline, and long-term overdue loans are covered by write-downs.
- The banks have liquidity. The average Liquidity Coverage Ratio (LCR) of the banking sector is met with a very large margin. On top of meeting the requirement, the banks hold additional liquidity in non-LCR instruments.
- Although the sale of problem loans has improved the quality of loans, the banks must

consider the risk that such loans cannot be sold in the event of an economic crisis or only under unfavourable conditions.

- The share of market risk is relatively low, and the securities portfolio accounts for 3% of assets. Most of the assets exposed to market risk are linked to bonds and have been invested in high quality securities.
- The profitability of the banks remains good despite low interest rates and volatility in financial markets. The return on equity was 11% in the fourth quarter.
- The share of non-resident deposits fell to 7.9% at the end of the year. As non-resident deposits are by their nature more volatile, the banks are holding higher liquidity buffers to cover the liquidity risk from these deposits.
- The banks are exposed to significant reputational risk from serving non-resident clients in earlier periods, and this could have an important impact on the share prices of the parent banks and could affect the behaviour of depositors and investors.
- Real estate prices fell in Sweden in the fourth quarter, but over the whole year they have remained relatively stable. The risks related to the Swedish real estate sector remain high and any realisation of these risks could impact the Estonian banking market. This makes it important for the banks to maintain sufficient capital buffers to guard against the realisation of these risks, and these buffers reduce the impact of cross-border risks.

Quarterly reviews of the banking sector

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