

Estonian Financial Market Overview 2016



Finantsinspektsioon

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This overview is based on the data presented by the market participants under the supervision of Finantsinspektsioon.

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Credit institutions

Number of market participants

16

Volume of assets

↑ € 24.5 bn

2015: € 23.1 bn

Increase in loan stock

↑ 9.0%

2015: 8.2%

Increase in the volume of deposits

↑ 5.0%

2015: 4.5%

Return on equity

↑ 11.9%

2015: 5.6%

Tier 1 Common Equity ratio

↓ 34.6%

2015: 36.0%

Main developments

- The growth in loans issued by credit institutions has remained high – at 9%. This also includes transactions made within banking groups – without them, the annual increase in loans would have been 6.3%. The stock of loans issued to non-financial corporations increased 7.4% over the year and those issued to households 5.1% – in both cases, the growth was higher than in the previous year. At the same time, the volume of deposits has also increased and the loan-to-deposit ratio has remained low.
- Loan quality has improved: the share of overdue loans is still decreasing. The share of loans in long-term overdue has also diminished, including in most economic sectors. The ratio of discounts to loans in long-term overdue has increased by 10 percentage points and almost all (98%) the long-term overdues are covered by discounts.
- Credit institutions have not eased the conditions for lending. The rapid loan growth has been primarily caused by an increase in demand, which is supported by wage growth and low unemployment. Credit institutions have not become more lenient in granting loans and still place emphasis on the quality of loans. Despite the relatively rapid loan growth, credit institutions remain conservative in granting new loans.
- The volume of non-residents' deposits has continued to decrease, 17.5% over the year. As non-residents' deposits are highly volatile, this development increases the stability of the resources of credit institutions and decreases liquidity risk and the risk of money laundering and terrorism financing. The outflow of non-residents' deposits has also been caused by the fact that credit institutions have started to take less risks and change their strategies.
- Low interest rates have not affected banking much. Credit institutions have managed to remain successful in such an interest environment and maintain their interest income.
- The liquidity and capitalisation of the sector has remained strong. Credit institutions' liquidity and capital buffers are nearly twice as large as required by regulations.

Assessment of risks

The risk with the highest potential impact and scope threatening Estonian banking originates from the economic environment of parent banks. There is still a risk that real estate prices may fall in the home market of parent banks. In addition, household debt in Sweden has increased faster than their incomes. Should the risks materialise, then its impact would carry over to the Estonian banking market. However, the good capitalisation and profitability of the Estonian credit institutions and their inclusion in the Single Resolution Mechanism should definitely reduce the probability of these risks being carried across borders.

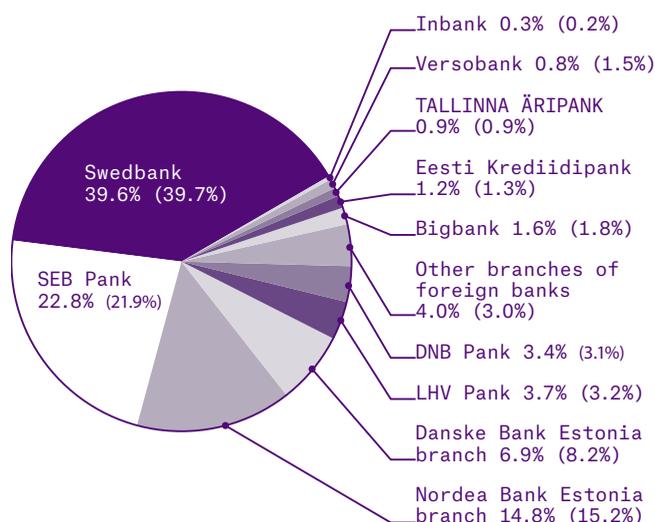
Thus far, the impact of low interest rates has been small and they have not posed a major risk to the profitability of credit institutions.

The planned amendments to legislation (International Financial Reporting Standards, Capital Requirements Directive and Regulation, etc.) could have an impact on the organisational structure of credit institutions and set stricter requirements for compliance checks. The volume and complexity of new legislation lead to elevated compliance risk.

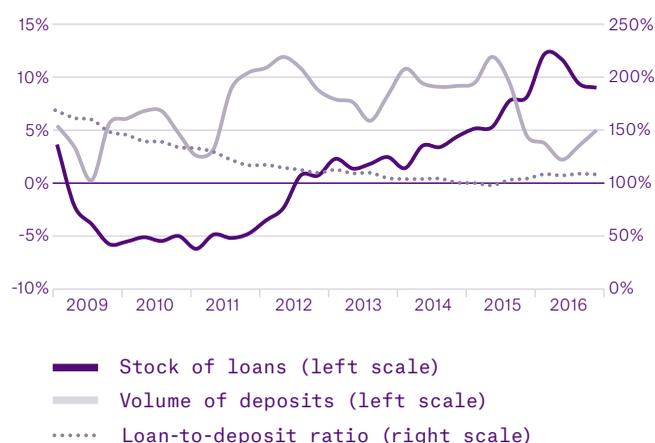
The management boards of credit institutions have changed considerably, which has an effect on corporate governance. In addition, several credit institutions are looking for opportunities to increase their profitability, enter new markets, and develop new lines of business and products.

The loan growth of credit institutions is relatively fast, which may cause economic imbalances. In terms of micro-supervision, however, the capital buffers of credit institutions are sufficiently large; if the loan portfolio quality should deteriorate, the credit institutions would probably stay sufficiently capitalised.

There were as many loss events of credit institutions concerning business disruptions and system failures in this sector during 2016 as the year before. As a result of supervisory activities, the quality of reporting on incidents concerning disruptions and failures has improved for some credit institutions. However, the duration of incidents declined in 2016: there were fewer long-term incidents with a recovery time of up to several hours.



Market shares of credit institutions by volume of assets at the end of 2016 (end of 2015 in brackets)



Annual growth of loans and deposits, and loan-to-deposit ratio

Investment firms

Number of market participants

3

Volume of customer assets

↑ € 1.1 bn

2015: € 0.5 bn

Volume of assets

↑ € 47 m

2015: € 44 m

Profit

↑ € 2.6 m

2015: € 1.4 m

Net service charges

↓ € 20.2 m

2015: € 21.5 m

Ratio of fixed costs to net service charges

↑ 69%

2015: 55%

Return on equity

↑ 6.9%

2015: 2.8%

Tier 1 Common Equity ratio

↑ 36.7%

2015: 36.4%

Main developments

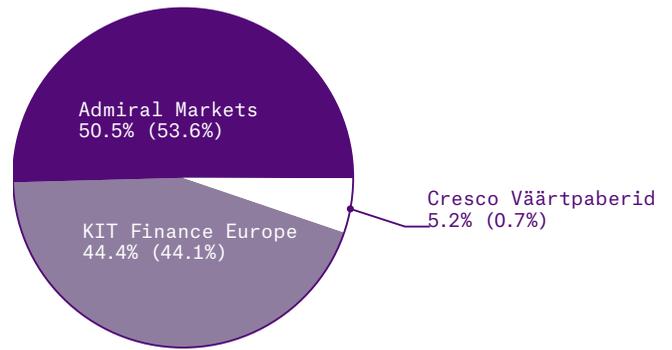
- The volume of customer assets, which are managed and held by investment firms, has increased by more than twice in the span of a year and reached 1.1 billion euros. The volume of non-residential customer assets increased the most.
- Investment firms mostly operate in Estonia on a cross-border basis: only 0.2% of customer assets belong to local residents.
- Income from net service charges has slightly decreased, whereas total net income (including financial and other revenues) has remained about the same as last year.
- In 2016, the profit of investment firms increased by 88%. In 2015, the profit was lower mainly because investment firms had to pay off many claims against customers that had surfaced during the brokering of securities. In the longer term, profitability has still decreased significantly. Investment firms' return on equity is satisfactory and amounts to nearly 7%.
- The Tier 1 Common Equity ratio is very high, nearly amounting to 37%. Pursuant to law, the ratio must be at least 8% (4.5% minimum requirement + 2.5% capital conservation buffer + 1% systemic risk buffer for exposures in Estonia). However, in addition to the requirements established by law, Finantsinspektsioon has set substantial additional capital requirements for investment firms. Considering all the capital requirements, the actual capital ratio was 2.06 higher than required.

Assessment of risks

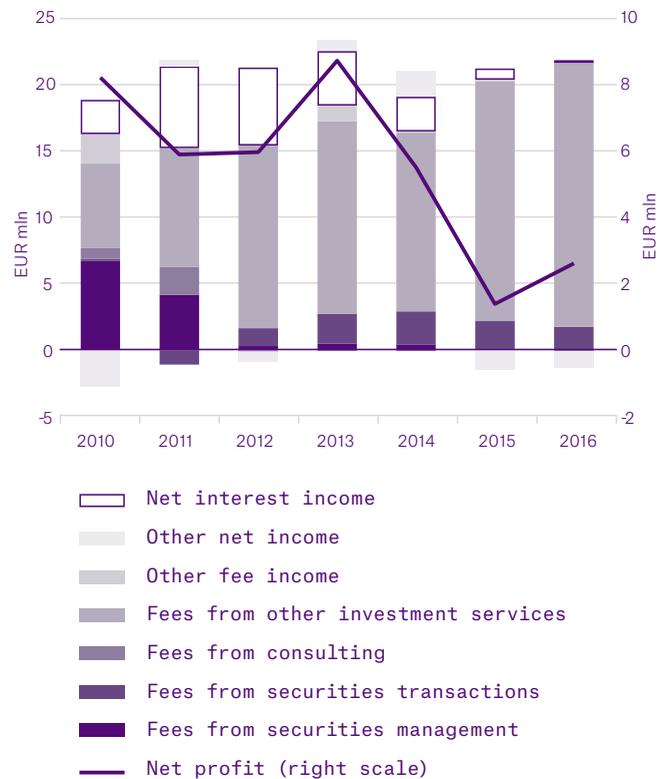
Investment firms are exposed to substantial currency risk in their business activity: the sum of the absolute value of open currency positions constitutes 143% of capital ratio. As investment firms are taking a market risk that is inherently volatile, their income base varied quite significantly during the year.

In terms of organisation, investment firms are much smaller than credit institutions, but have to comply with the same legislation. They also operate in many countries, including those outside the EU, which means that they have to comply with the legislation in each of these countries as well. This brings about a heightened level of compliance risk.

As investment firms earn their revenues mainly from cross-border activities, they are also more exposed to geopolitical risks compared to credit institutions (sanctions imposed to Russia, Brexit, etc.).



Market shares of investment firms by volume of assets at the end of 2016 (end of 2015 in brackets)



Structure of income and net profit of investment firms

Fund management companies

Number of market participants

↓ 15

2015: 17

Volume of assets of fund management companies

↓ € 129.2 m

2015: € 159.4 m

Volume of managed assets

↑ € 5.5 bn

2015: € 4.6 bn

Ratio of fixed costs to net service charges

↓ 44%

2015: 46%

Return on equity

↑ 16.3%

2015: 10.4%

Own funds requirement coverage

↓ 237%

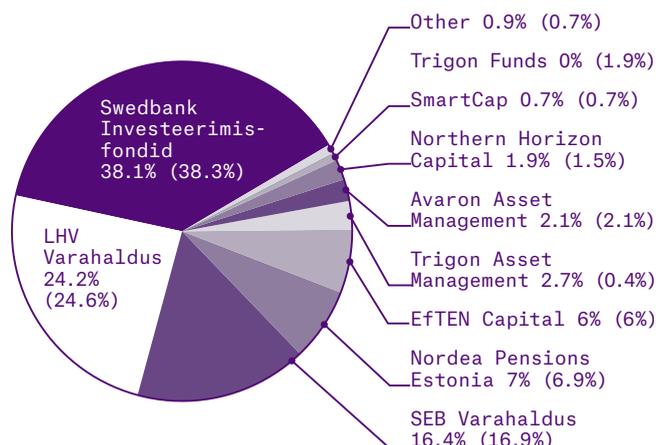
2015: 372%

Main developments

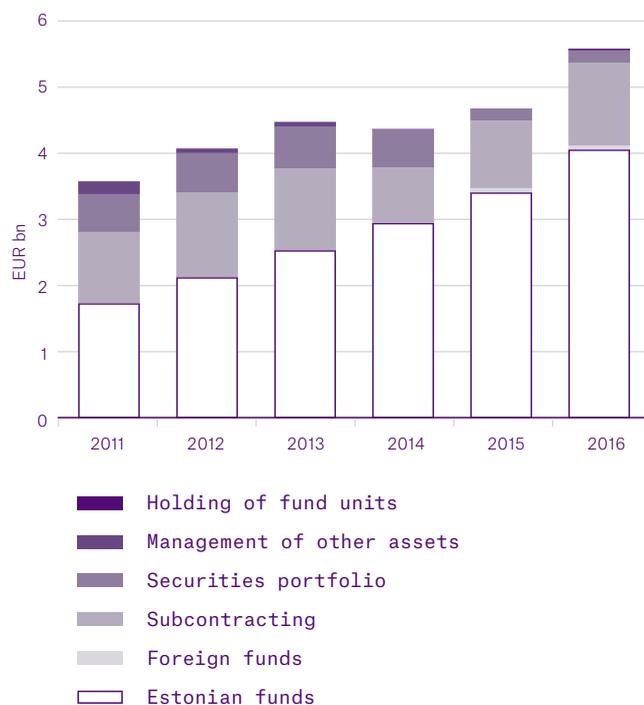
- The number of fund management companies has decreased. Danske Capital merged with LHV Varahaldus and Trigon Funds exited the market. Before exiting, Trigon Funds transferred all of its business to Trigon Asset Management.
- During the year, two fund management companies were granted the authorisation to act as an alternative fund manager, which makes it easier for them to conduct business in foreign markets. There are now three fund management companies with such an authorisation in the market. Among other things, they started managing alternative funds registered in foreign countries (on the basis of the relevant directive of the European Union).
- Alongside the management of one's own funds, the fund management companies also manage the investments of the funds of other management companies via subcontracting. Of all the assets managed by fund management companies, the total volume of managed funds accounted for 74% and the funds managed via subcontracting accounted for 22%.
- The consolidated balance sheet of fund management companies decreased significantly as a result of one of the market participants exiting the market. Dividend payments and reductions in share capital also contributed to the decrease in the total balance sheet.
- Annual profit before taxes was about as large as in the previous year: 18.3 million euros according to unaudited data. On one hand, investment profit decreased, but on the other, net service charges increased faster than fixed costs. According to unaudited data, the sector's net profit increased from 15.4 million euros in 2015 to 17.6 million euros.

Assessment of risks

At the beginning of January 2017, a new Investment Funds Act entered into force. One of the objectives of the new act is to make the Estonian fund market more attractive for investors and service providers. Among others, the capital requirements set for pension fund management companies were significantly lowered. An operational risk remains in the entire sector.



Market shares of fund management companies by volumes of managed Estonian funds at the end of 2016 (end of 2015 in brackets)



Volume of assets managed by fund management companies at the end of the year by business segments

Investment and pension funds

Number of investment funds

↓ 64

2015: 65

Number of pension funds

↑ 34

2015: 30

Volume of assets of investment funds

↑ € 3.95 bn

2015: € 3.3 bn

Volume of assets of pension funds

↑ € 3.2 bn

2015: € 2.7 bn

Main developments

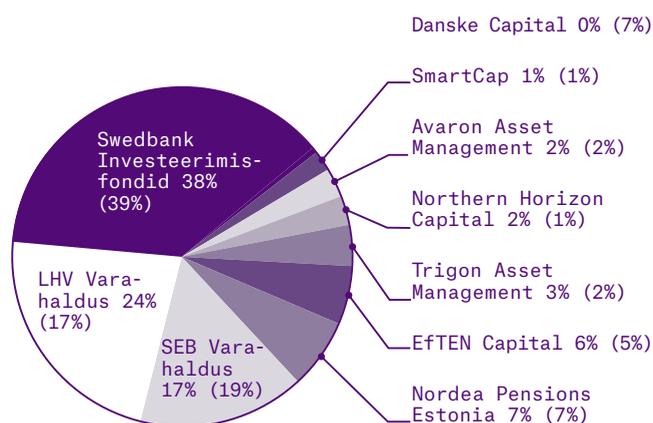
- The growth of the fund market has continued to rely on mandatory pension funds, the volume of assets of which increased by 483 million euros in a year. Pension funds with smaller fees, which passively invest in other index funds, have entered the market. The introduction of new pension funds has increased price competition between fund management companies.
- In a year, the volume of assets of real estate funds increased 61%, i.e. from 224 million euros to 359 million euros. The volume of assets of real estate funds is now larger than that of equity funds, meaning that real estate funds have become the second largest fund in terms of volume of assets.
- The number of equity funds registered in Estonia and the number of unit holders who invest in them continue to decrease. Management companies associated with credit institutions are liquidating undertakings for collective investment in transferable securities (UCITS) registered in Estonia, as it is economically (and due to legal provisions) more practical to offer UCITS with the same investment policies on a cross-border basis than it is to set them up in each country separately.
- Among the types of funds, mandatory pension funds still prevail with their 78% share of the entire fund market. They are followed by real estate funds with a market share of 9% and equity funds with a market share of 8.5%.
- In 2016, the fund market was impacted by the merger of LHV Varahaldus and Danske Capital. As a result, the market share of LHV Varahaldus increased from 17% to 24%. LHV Varahaldus has become the second largest fund management company after Swedbank in terms of the volume of assets. The market share of Swedbank Investeerimisfondid is 38%.
- In 2016, Finantsinspektsioon registered the terms and conditions of seven new contractual investment funds and coordinated the articles of association of a new investment fund set up as a public liability company. In addition, it registered the amendments to the terms and conditions of 24 funds and issued five authorisations for the merger of funds. Authorisations for liquidation was issued to ten investment funds.

Assessment of risks

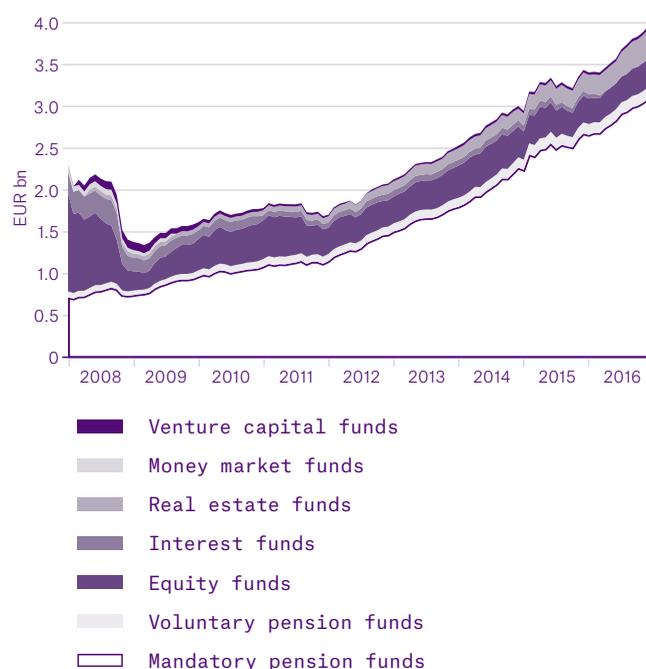
The Estonian fund market is still dominated by mandatory pension funds, as their share in the volume of assets and the number of funds in the fund sector grows every year. Mandatory pension fund investments are characterised by high levels of money and deposits (23% of all investments), which reflects the risk assessment of fund management companies regarding capital markets and the risks thereof.

If uncertainties continue to exist in the securities markets for an extended period of time, alternative investment positions may be potentially increased to achieve greater returns. Such investments may be less transparent and include valuation risk.

In the context of the new Investment Funds Act, it is important for smaller management companies in particular to adapt to the legislation applicable to new small fund management companies or, more precisely, to the less stringent regulatory environment and its risks.



Market shares of fund management companies by volumes of funds managed at the end of 2016 (end of 2015 in brackets)



Market value of funds by fund types

Life insurance undertakings

Number of market participants

5

2015¹: 5

Volume of assets

↑ € 1.14 bn

2015: 1.04 bn €

Volume of technical provisions

↓ € 840.7 m

2015: € 935.8 m

Volume of insurance premiums

↑ € 227.8 m

2015: € 218.1 m

Solvency Capital Requirement coverage

↓ 173%

2015: 191%

Main developments

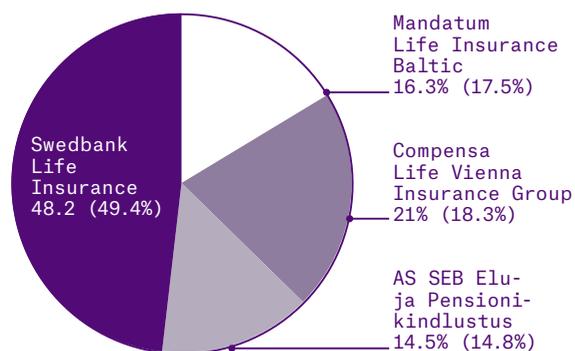
- Four insurance undertakings and a branch of a foreign life insurance undertaking have an authorisation to operate in the Estonian life insurance market.
- The most sold insurance products are unit-linked life insurance and products with an insured risk. The growth of the market is supported mainly by these products. In 2016, the market grew 4.5%.
- The volume of technical provisions of life insurance undertakings has decreased. This has been affected by the new insurance directive Solvency II, which was introduced at the beginning of 2016. Pursuant to Solvency II, obligations are calculated differently and technical provisions may also be negative.
- Three Estonian life insurance undertakings are operating on a cross-border basis both in Latvia and Lithuania.
- By the end of 2016, life insurance undertakings had exceeded the capital requirement by 173%. Under Solvency II, the capital requirement is calculated on the basis of risk: the main risks for life insurance undertakings are life insurance risk and market risk.

¹ The data for 2015 is based on the Solvency I Directive, which expired at the end of 2015. The data for 2016 is based on the new Solvency II Directive, which entered into force at the beginning of the year. Due to the different valuation principles, the majority of the indicators (excluding the volume of insurance premiums) are not entirely comparable.

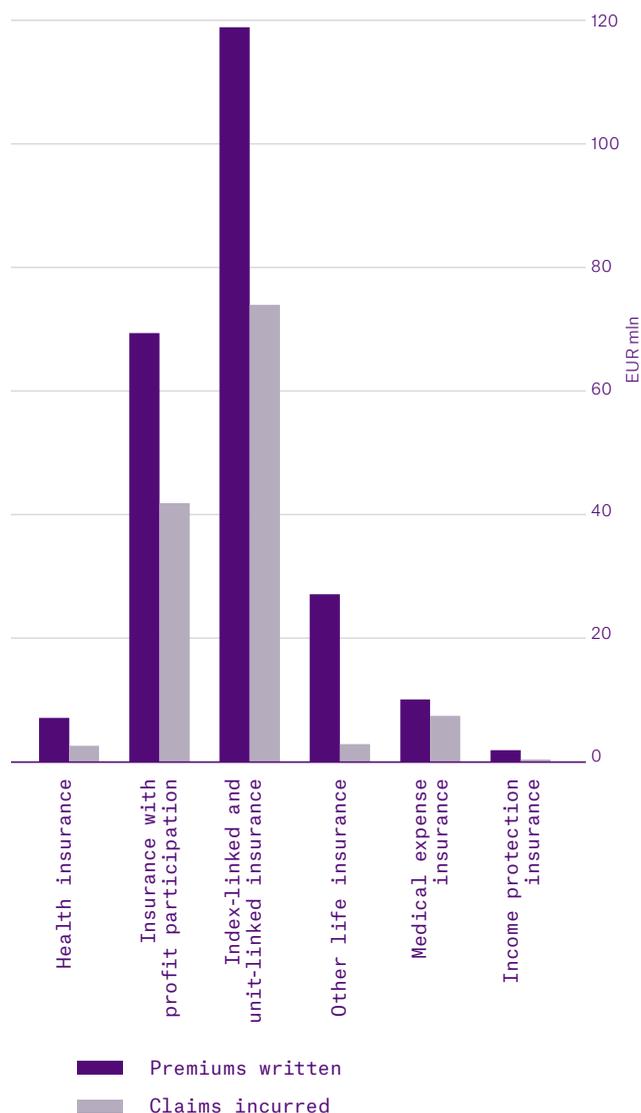
Assessment of risks

The environment of low interest rates does not favour the sale or development of products with an interest guarantee. As a result, insurance undertakings are focusing on the sale of risk and unit-linked products. Such an interest environment is particularly affecting life insurance undertakings with long-term financial guarantee obligations to policyholders.

The new supervisory framework for insurance, Solvency II, which was adopted in early 2016, has increased the costs of insurance undertakings in implementing new legislation and complying with the requirements set out in the framework.



Market shares of life insurance undertakings by volume of assets at the end of 2016 (start of 2016 in brackets)



Volume of insurance premiums written and claims incurred in 2016

Non-life insurance undertakings

Number of market participants

↑ 12

2015²: 11

Volume of assets

↑ € 675 m

2015: € 637.8 m

Volume of technical provisions

↓ € 271.6 m

2015: € 294.6 m

Volume of insurance premiums

↑ € 426.6 m

2015: € 395.5 m

Solvency Capital Requirement coverage

↓ 211%

2015: 353%

Main developments

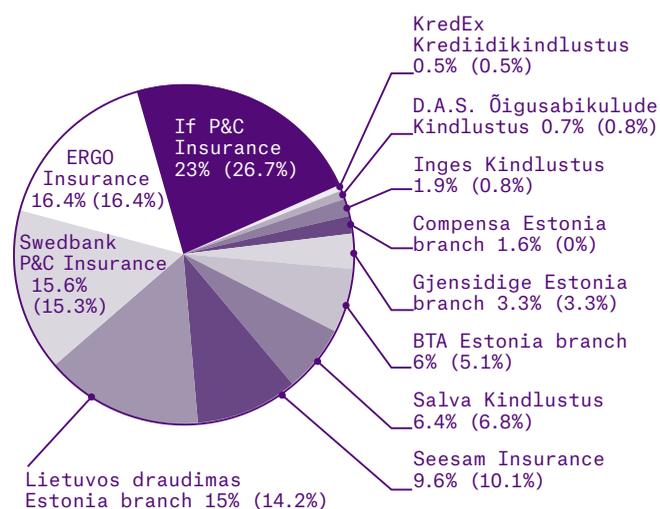
- Eight non-life insurance undertakings and four branches of foreign insurance undertakings have an authorisation to operate in Estonia. The largest classes of insurance are casco, motor third party liability, and property insurance, which account for about 80% of the entire insurance portfolio.
- The volume of insurance premiums of non-life insurance undertakings increased 7.9% in 2016. The total volume of the Estonian non-life insurance market was 304.4 million euros, which is 8.8% more than in the previous year.
- The non-life insurance sector profits from insurance activities: net combined ratio was 92.7%. Cost ratio remained about the same as the previous year, whereas loss ratio increased by 3 percentage points.
- Motor third party liability insurance continues to produce a negative return. According to the Estonian Traffic Insurance Fund, losses amounted to 9.7 million euros in 2016.
- Estonian non-life insurance undertakings collected 53% of their premiums in Estonia, 18% in Latvia, and 29% in Lithuania. The four largest non-life insurance undertakings also have branches in Latvia and Lithuania.
- The share of foreign branches in the Estonian non-life insurance market is increasing: in 2015, they had a market share of 22.5%, but by the end of the third quarter of 2016, it had amounted to 24.8%. In 2016, the volume of insurance premiums increased the most in branches of foreign insurance undertakings operating in Estonia.
- The non-life insurance sector is strongly capitalised. All insurance undertakings meet the Solvency Capital Requirement.

² The data of 2015 is based on the Solvency I Directive, which expired at the end of 2015. The data of 2016 is based on the new Solvency II Directive, which entered into force at the beginning of the year. Due to the different valuation principles, the majority of the indicators (excluding the volume of insurance premiums) are not entirely comparable.

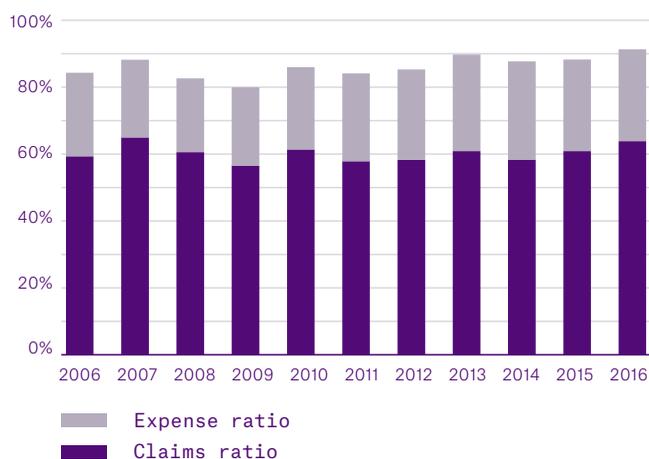
Assessment of risks

The greatest threat to non-life insurance undertakings is still non-life insurance risk. Motor third party liability insurance has been producing losses in the entire Baltic region for years now and the profitability of casco insurance is relatively low as well. Profit is made in property insurance and, to some extent, in health and liability insurance. Although the business volumes of non-life insurance undertakings have increased, their resources are limited and what becomes important instead is the efficiency of the cost base.

Although non-life insurance undertakings usually manage to comply with the new capital requirements, they do have problems with compliance with the qualitative requirements of Solvency II. There are shortcomings in the documentation concerning management systems, as well as technical aspects.



Market shares of non-life insurance undertakings by premiums written in 2016 (2015 in brackets)



Net combined ratio (claims ratio + expense ratio) of non-life insurance undertakings

Payment institutions

Number of market participants

↑ 13

2015: 12

Volume of payments

↓ € 518 m

2015: € 875 m

Number of payments

↑ 3.4 m

2015: 2.6 m

Profit

↑ € 1.6 m

2015: € 0.5 m

Return on equity

↑ 11.9%

2015: 4.9%

Own funds requirement coverage

↑ 565%

2015: 499%

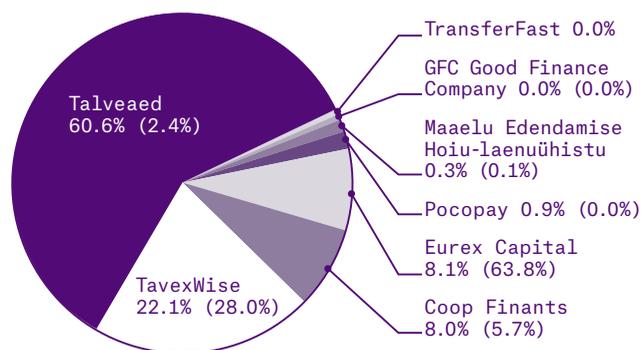
Main developments

- At the end of 2016, there were 13 payment institutions in the market and five of them operated under an exemption authorisation. Exemption authorisation means that requirements are more lenient for payment institutions and the volume of payments to be mediated by them is limited. A branch of a foreign payment institution is also registered in Estonia.
- The number of payments by fully authorised payment institutions is still increasing, but the volume of payments has decreased. The average amount of payments has thus fallen from 342 euros to 154 euros.
- As for payment types, the volume of the cash transfer service has decreased significantly and the volume of payment services requiring a payment accounts has increased. The share of cross-border payments doubled in 2016.
- About a quarter of the total sales revenue of the sector comes from the provision of payment services.
- The overall capitalisation of payment institutions is good.

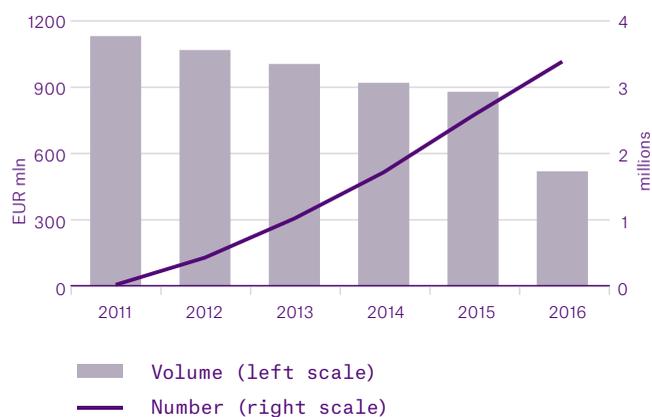
Assessment of risks

Some of the payment institutions that are not sufficiently profitable are reviewing their business models and looking for new or additional services to offer to their clients.

The biggest potential risk in the payment services sector is money laundering. According to the Money Laundering and Terrorist Financing Prevention Act, payment institutions must identify who their clients are and what the main business activity of these clients is – this sets a risk profile for the clients.



Market shares of payment institutions at the end of 2016 (end of 2015 in brackets)



Volume and number of payments made through payment institutions

Creditors and credit intermediaries

Number of market participants

62

Balance of issued loans

€ 741 m

Net interest income

€ 92.4 m

Main developments

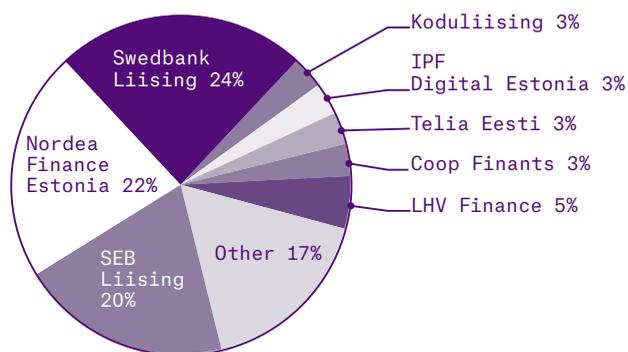
- Creditors and credit intermediaries are now under the supervision of Finantsinspeksioon. In 2016, Finantsinspeksioon issued authorisations to 44 creditors and four credit intermediaries. 12 creditors are operating under an exemption authorisation. One creditor was also granted authorisation to establish a branch.
- The majority of the loan portfolio of creditors belongs to creditors associated with credit institutions. As at the end of 2016, creditors had given loans in the amount of 741 million euros, 78% of which was made up by loans given by companies associated with credit institutions.
- The loan portfolio of creditors associated with credit institutions consists mainly of vehicle leases (79% of the entire portfolio). Among such creditors, the largest market share (24%) belongs to Swedbank Liising.
- The loan portfolio of other creditors most commonly includes small loans without a security and installment purchases of assets, which account for 80% of the loan portfolio. Among such creditors, the largest market share belongs to Koduliising and IPF Digital Estonia, both of whom have a 3% share of the entire market.
- Annual percentage rate differs significantly between creditors associated with credit institutions and other creditors: at the end of 2016, the average rate for creditors associated with credit institutions was 10% and for other creditors 43%.

Assessment of risks

The greatest risk for creditors' activity is the ability of companies to meet the requirements of responsible lending, especially in assessing the solvency of their customers, and the suitability of their owners and managers in such a task.

The analysis of creditors' loans shows that the quality of the loan portfolio varies significantly depending on which types of consumer loans it comprises. Small loans without a security (or the so-called instant loans) have a much worse quality than other consumer loans (such as mortgages, vehicle leases, installment purchases of assets, etc.). The average balance of the consumer loans of credit institutions is much higher than that of creditors. This (risk), in turn, also impacts the quality of their portfolio and annual percentage rate.

Creditors are not allowed to receipt deposits from the public. In order to receipt such means, they must apply for an authorisation to operate as a credit institution. Thus, in financing their own activities, creditors bear the risk that it may not correspond to the right type of authorisation.



Market shares of creditors by stock of loan portfolio at the end of 2016



Stock of loans issued by creditors at the end of 2016

Insurance brokers

Number of market participants

↑ 48

2015: 45

Volume of mediated premiums

↑ € 149 m

2015: € 145 m

Ratio of brokerage fees to premiums

↓ 13.0%

2015: 13.2%

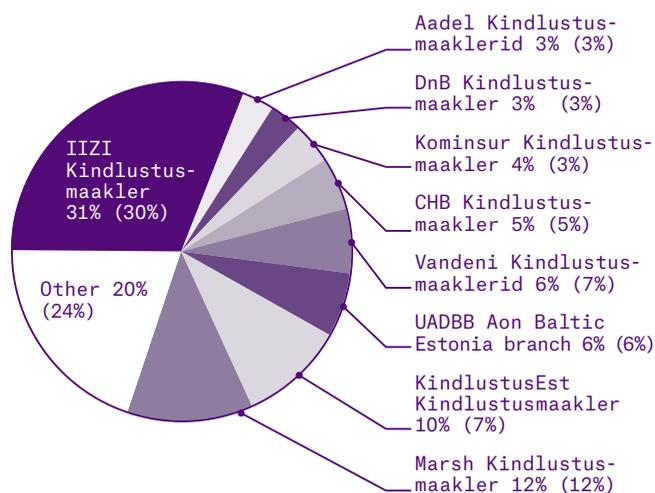
Main developments

- The number of insurance brokers has increased. In 2016, Finantsinspektsioon added three new insurance brokers in the list of insurance intermediaries. The list now includes 48 insurance brokers.
- In the area of non-life insurance, insurance brokers registered in Estonia mediated insurance premiums in 2016 in the total amount of 149 million euros³, which accounts for 49% of all premiums collected by insurance undertakings. The main types of insurance were land vehicle insurance with 46 million euros, motor third party liability insurance with 42 million euros, and property insurance with 27 million euros. In the case of motor third party liability insurance, insurance brokers accounted for 54% of all premiums collected by insurance undertakings in this category of insurance; this indicator was 54% in the case of land vehicle insurance and 34% in the case of property insurance.
- In the field of life insurance, insurance brokers registered in Estonia mediated insurance premiums in 2016 in the amount of 459 thousand euros, which accounts for 0.5% of all insurance premiums collected by insurance undertakings. Mainly, they mediated other life insurance contracts (including whole life insurance), the volume these insurance premiums amounted to 251 thousand euros. They also mediated accident and sickness insurance contracts in the amount of 207 thousand euros.

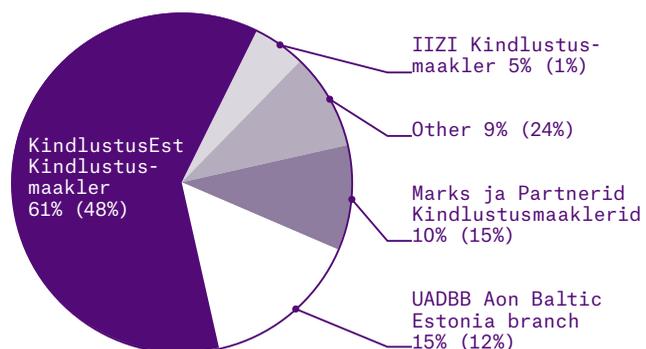
³ In addition to the contracts of insurance undertakings, the contracts of foreign reinsurance undertakings, which have not been added to this overview, were also mediated in Estonia. In 2016, the volume of these insurance premiums was 6.7 million euros.

Assessment of risks

The activity of an insurance broker is primarily related to the risk concerning the nature of their representative relationship: an insurance broker has a duty of loyalty to the policyholder, not the insurance undertaking. In the event of a conflict of interests, the insurance broker must be guided by the interests of the policyholder. This distinguishes the insurance broker from an insurance agent acting in the interests of the insurance undertaking. In order to manage such risks, the insurance broker must show due diligence in explaining the existence of such a representative relationship, provide the required and appropriate pre-contractual information and be guided by this when making (mediating) a sufficient amount of offers and the best offer to the policymaker, by collecting the necessary information about the policyholder's insurance interest.



Market shares of insurance brokers by non-life insurance premiums in 2016 (2015 in brackets)



Market shares of insurance brokers by life insurance premiums in 2016 (2015 in brackets)

Securities market

Shares listed on the Tallinn Stock Exchange

14 companies on the main list

2 companies on the secondary list

Turnover of the Tallinn Stock Exchange

↑ € 159 m

2015: € 148 m

Market capitalisation of the Tallinn Stock Exchange

↑ € 2.3 bn

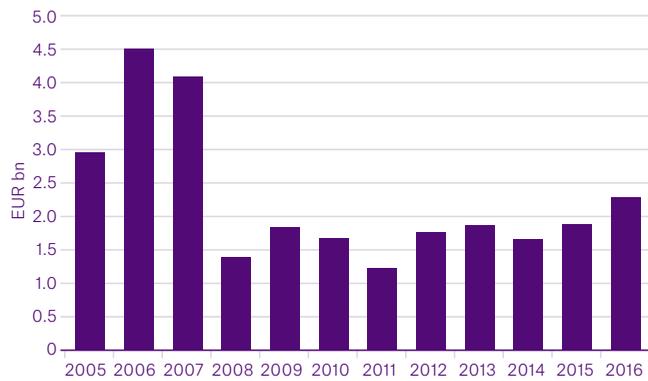
2015: € 1.9 bn

Main developments

- The Nasdaq OMX Tallinn index rose 20% in 2016, i.e. to 1075.5 points. Although the year was politically unstable, the events that took place did not negatively affect the stock markets. After the UK referendum in June, the prices of shares fell rapidly all over Europe, but recovered almost just as quickly.
- Trading activity on the Tallinn Stock Exchange has increased. In 2016, a total of 51,170 transactions with shares were made, which is 4.2% more than in the previous year. The total turnover of Tallinn Stock Exchange increased by 7.6% and amounted to 159 million euros.
- In 2016, the shares of 14 undertakings were listed on the main list of Tallinn Stock Exchange and the shares of two undertakings were listed on the secondary list. Three corporate bonds are listed in the bond market. The shares of one undertaking and the bonds of one undertaking are listed in the alternative market First North.
- The most actively traded shares were the shares of Tallink Grupp, followed by the shares of the Olympic Entertainment Group and Tallinna Vesi.
- On the main list, the share prices of Silvano Fashion Group (+131%) and Nordecon (+27%) rose the most. However, the share prices of Skano Group (-37%) and Baltika (-17%) fell the most.
- An opportunity to trade with a fund has been added for investors: a real estate fund named Baltic Horizon has been listed.
- As at the end of 2016, the market capitalisation of the Tallinn Stock Exchange stood at 2.3 billion euros, which is 401 million euros more than in the previous year. The increase in market capitalisation was supported by the increase in share prices and the listing of the shares of LHV Group.
- As at the end of 2016, Tallinn Stock Exchange had 19 members. In terms of turnover, the most active members of the Tallinn Stock Exchange are SEB Pank, who is responsible for 40% of the total turnover, and Swedbank, who is responsible for 26%. In terms of the number of transactions, the most active member of the Tallinn Stock Exchange is LHV Pank, who is responsible for 35% of all transactions.
- In terms of countries of origin, the share of Estonian investors on the Tallinn Stock Exchange increased in 2016 from 61% to 64%.



OMX Tallinn Stock Exchange index in 2016



Market capitalisation of Tallinn Stock Exchange

