Q1 2019 overview of banking sector

There were 16 banks operating in the Estonian market in the first quarter of 2019, of which eight were branches of foreign credit institutions. Finantsinspektsioon issued a precept to Danske Bank in February for breach of anti-money laundering rules, requiring the bank to terminate the activities in Estonia of its branch within eight months.

Key indicators	Q4 2018	Change	Q1 2019
Annual increase in loan balance	5,7%	?	6,5%
Annual increase in deposit balance	4%	?	5,8%
Loan-to-deposit ratio	109%	?	110%
Long-term overdues as % of credit portfolio	0,52%	?	0,93%
Liquidity coverage ratio	162%	?	135%
Profit	128 mln €	?	45 mln €
Cost and income ratio	43%	?	46%
Return on equity	11%	?	9,9%
Return on assets	1,53%	?	1,29%
Tier 1 Common Equity ratio	29,1%	?	26,3%

In the first quarter of 2019, Luminor Bank AS merged with banks in Latvia and Lithuania owned by the same owner. This large transaction had a major impact on the figures for the banking sector in Estonia. The addition of the assets and liabilities in Latvia and Lithuania to the balance sheet of the Estonian banking sector increased the assets of the sector by some 40% to 36 billion euros. The transaction increased the loan portfolio by 45% to 28 billion euros and the volume of deposits by 44% to 26 billion euros.

Without the Luminor transaction, the yearly growth in the loan portfolio would have been 6.5%. This means that the growth in lending in the first quarter of 2019 was a little faster than the 5.7% of the fourth quarter of 2018. The acceleration in growth in the portfolio came mainly from increased borrowing by state-owned and local government-owned companies.

Excluding the impact of the Luminor merger, the volume of loans to non-financial companies shrank by 2.6% over the year.

The volume of loans to private individuals in the first quarter of the year was at the same level as in the fourth quarter of last year, without the Luminor effect. Loans to private individuals were up by 6.1% over the year, with growth of 6.6% in housing loans.

Without the Luminor merger, the yearly growth in deposits was 5.8% at the end of the first quarter. As loans grew faster than deposits, the loans-to-deposits ratio of the sector as a whole rose to 110%. The high ratio at branches was caused by Danske bank, where deposits were replaced with funds from the parent bank.

The loan quality of the Estonian banking sector remains very good, though the share of loans overdue more than 90 days rose to 0.93% in the first quarter of 2019, still remaining below 1%. The share of non-performing loans at the end of the first quarter was 2.1%. Overall the loan quality of the sector improved, but structural changes at Luminor caused a one-off increase in the volume of problem loans in the sector.

The liquidity of the banks operating in Estonia remains good. All banks met the liquidity coverage ratio (LCR) with sufficient margin, and the average figure for the sector was 135%, exceeding the minimum required of 100%.

The resources of credit institutions increased by 2%, or 450 million euros, in the first quarter. The funds received from other credit institutions increased most, by 363 million euros, while those from households increased by 203 million euros and funds from businesses declined by 246 million euros.

Client deposits were up by 0.7%, or 129 million euros over the year in the quarter. Resident deposits grew by 0.3% and non-resident deposits by 6.2%.
The banking sector earned 45 million euros in profit at the individual level in the first quarter, which is 65% less than in the previous quarter. The decline was caused partly by the losses at Danske from the sale of the loan portfolio of private clients to LHV, and partly because the profit in the fourth quarter of 2018 was relatively large because of dividends.

The return on equity of the banks was 9.9% at the end of the first quarter of 2019, and the return on assets was 1.29%. The figures for the European Union at the end of 2018 were 6.5% for return on equity and 0.4% for return on assets.

The banks operating in Estonia earned total income of 302 million euros in the first quarter of 2019, which was an increase over the quarter of 7% or 19 million euros. The main cause of increased earnings was the growth of 50 million euros in interest income and of 16 million euros in service fee income. Dividends taken out at the end of the year caused dividend income to fall by 54 million euros in the first quarter. The current expenses-to-income ratio over the year was 45.8% in the first quarter of 2019. The ratio for the European Union was 64.6% at the end of 2018.

Prudential ratios fell in the first quarter of 2019 at both the individual and consolidated levels. CET1 at the individual level was 25.3% at the end of the first quarter, and at the consolidated level it was 26.3%.

Main development trends

- Banks operating in Estonia have liquidity. The average liquidity coverage ratio (LCR) for the banking sector exceeded the requirement with a margin. As well as meeting the requirement, the banks held additional liquidity in non-LCR instruments.

- The share of loans overdue more than 90 days was 0.9% in the first quarter of 2019. Long-term overdue loans are covered by write-downs. The quality of the loans in the Estonian portfolio continued to improve, with the improvement coming partly from the sale of non-performing loans. Although the sale of non-performing loans has an immediate positive effect on loan quality, the banks need to consider the risks to capital management, as such sales are not possible in an economic crisis, or the conditions for them would be unfavourable if they are possible.
- Finantsinspektsioon issued a precept to Danske Bank in February 2019 for breach of anti-money laundering rules, requiring the bank to terminate the activities in Estonia of its branch within eight months.
- The rapid growth in the loan portfolios of some small banks means they have to pay attention to their capital planning and the effectiveness of their internal control systems.
- The profitability of the banks remains good despite low interest rates and volatility in financial markets. The return on equity was 9.9% in the first quarter.
- The share of non-resident deposits rose to 8.3% by the end of the first quarter, excluding the impact of the Luminor merger. As non-resident deposits are by their nature volatile, the banks hold larger buffers to cover the associated liquidity risk.
- The risks associated with the Swedish real estate sector remain high. Real estate prices rose in the first quarter of 2019, but they still remain below their peak of 2017, and prices have been relatively stable over the past year. Any realisation of these risks could impact the Estonian banking market. This makes it important that the banks hold sufficient capital buffers to cover the realisation of any risks, as such buffers will reduce the cross-border transfer of these risks.

Quarterly reviews of the banking sector