Andres Sutt: Are ROEs peaking?

Luncheon speech by Mr Andres Sutt, Deputy Governor of the Bank of Estonia, at the 9th Annual Nordic Financial Services Conference, Stockholm, 31 August 2006.

Background slides (PPT) for the speech can be found on the Bank of Estonia's website.

*   *   *

Ladies and Gentlemen,

It is my honor to address you at this conference. You represent financial institutions that control the flow of money, the lifeblood of the economy. I as a central banker can contribute the experience of someone who stands in the middle. Central banks, as you know, have a double task: to safeguard the price stability on the one hand and the wellbeing of the financial system on the other. It is with this balance in mind that I would like to address three topics today.

- Firstly, what are the characteristics of a Nordic-Baltic region as a closely integrated economic and financial market;
- Secondly, the challenges posed by recent economic and credit growth;
- Thirdly, some financial sector policy and supervisory challenges in this highly integrated regional market.

Not surprisingly, the focus of my examples will mostly be on Estonia.

Some special characteristics of the Nordic-Baltic region

The economic situation in the Nordic-Baltic region is outstanding, especially in comparison with other regions of the EU. Output growth in the Nordic countries is up to two and in the Baltic countries even 4 to 5 times higher than the EU average. The employment level and wage growth are generally good; economic expectations are high.

A notable feature of the Nordic-Baltic markets is their high level of integration. Let's take the example of Estonia. Last year, Finland and Sweden accounted for about 40 percent of Estonian exports and 30 percent of imports. In the stock of FDI, the share of Sweden and Finland is about 75 percent.

Cross-border financial integration is all but complete, with the market share of Nordic financial institutions accounting for 99 percent of bank loans and leasing. A long list of Nordic companies regards Estonia and the other Baltic countries as their home market. Therefore, many important business functions, for example liquidity and risk management, are increasingly run on a group-wide basis. Viewing the Baltic countries as a part of the home market, Nordic companies take a long-term business view. This lowers the risk of sudden slowdown or reversal of capital flows, often named as the main risk in the Baltic environment of strong credit growth and high current account deficits.

A bit of history: entry of Nordic banks

Of course this high degree of integration has been achieved over time. In the Baltic countries, today's level of economic and financial development was a distant dream as recently as 10 years ago. The fall in GDP bottomed out in mid-1990s. The following years have brought rapid output growth. In Estonia, for example, the level of real GDP has more than doubled. (A side remark: output growth in the Nordic countries has also been robust in the past 10 to 15 years. Swedish GDP, for example, has doubled. Such pace of development is likely to have contributed to the growth in the Baltic countries.)

Coming back to the Baltics, 1997 and 1998 were the years of the Asian and Russian crises. In the Baltic states, these crises led to the collapse of the stock markets, bankruptcies of many companies, including banks, and a surge in interest rates and unemployment. Thus it was a good time to make cheap acquisitions in many industries, including Baltic banks. That said, strategic entry of Nordic banks was at the time of critical importance to restore market confidence. SEB and Swedbank acquired minority shares in two largest Estonian banks, and started to increase their control. In the year 2000, Sampo Bank followed.

Indeed, the presence of foreign banks in emerging markets has generally been found to increase stability, efficiency, and governance. Combined with improved regulation, strong Nordic banks have brought a qualitative change in the Baltic financial sector. As a result, we can proudly say that the Estonian financial system stands out in the EU for integration, e-banking, and credit conditions, to name a few.

Nordic investment in Estonian banking sector has proven profitable: ROE has been around 20 percent. Furthermore, local know-how helped the Nordic parent banks to enter the Latvian and Lithuanian as well as the Russian markets.

Effects of EU accession

The EU accession has led to even better market access for local producers and has given Estonia as well as the other new Member States a kind of "seal of quality" as an investment destination. Already the *prospect* of the EU accession enhanced these countries' credibility in the eyes of investors. But since the accession, the inflow of funds has been especially strong, as economic situation in the euro area was combined with higher global liquidity.

Furthermore, the geography of investors has broadened. The prospect of adopting the euro in a relatively near future has lowered interest margins in several of the new Member States including Estonia and has given an additional boost to investments. The above factors, including convergence, as a background, one may speculate about the length of the current economic cycle, and where exactly we stand in that cycle at the moment. In short, there are some suggestions that we might have entered unusually long economic cycle and may be coming closer to the peak of the cycle.

However, many of the current vulnerabilities of the Baltic economies are also tied in with these effects of the EU accession and rapid convergence. Understanding these risks requires careful analysis.

Let me now turn to my second topic - challenges the strong economic and credit growth are offering.

Perceived risks to financial stability: credit growth and real estate markets

The acceleration of credit growth is a prominent but natural part of the picture of robust economic growth and general optimism in the region. Improved access to credit in the Baltic countries has led to higher investments (much needed in rapidly developing economies) and helped to smooth consumption over time. For example, in Estonia the overall increase in bank credit and leasing accelerated to around 60 percent in mid-2006. This has by far exceeded the growth rates seen in the Nordic countries. On the other hand, the accompanying rise in indebtedness and current account deficits has given cause for concern to both domestic and international evaluators.

It is always worthwhile to put things in perspective. During the past five years, the growth in household indebtedness in terms of GDP has been fast in several "old" EU Member States, including Denmark - in fact, even faster than that in the Baltic countries.

At the same time it cannot be forgotten that the level of household savings (especially long-term savings) in Estonia and other Baltic countries is still low when compared to that in the Nordic countries. Therefore, households face a non-negligible risk to their balance sheets, as their financial assets are still rather low in international comparison. It is the lenders - banks and leasing companies - that need to take these risks into account.

Of all the factors of credit growth I would point out two. Firstly, there are longer maturities of real estate loans. Longer maturities have smoothed the growth of borrowers' debt burden in terms of monthly payments of a mortgage. Of course, looking at total loan servicing costs, the overall debt burden has increased.

When we compare Estonia and other Baltic countries with more developed economies, there is obviously room for further credit growth: total bank credit as a percentage of GDP in 2004 was over 100 percent in the euro area, around 60 percent in Estonia, and only 20 percent in Lithuania. And although it is rapidly increasing, the debt burden of Estonian households, at 32 percent of GDP by end-2005, was still about two times lower than in the Nordic countries.

Secondly, the increase in incomes enables people to upgrade their living conditions. For example, the number of square meters per capita in Estonia (at around 30) is relatively small compared to Sweden

(45) or Denmark (50). Moreover, older housing stock needs quality improvements. Both these factors may indicate that real estate markets may continue to perform reasonably well over the medium term, even if some slowdown might be ahead. Indeed, the relative contribution of Estonia's construction sector to GDP is hardly exceptional if compared to many other EU countries.

Are risk premia sufficient?

However, this rapid growth poses important questions of sustainability and stability, especially in countries with shorter borrowing experience.

While housing loans have historically been relatively "safe" in view of loan quality, real estate loans have come to dominate households' loan stock in Estonia and the other Baltic countries. And not all of the housing credit goes into investments.

The Bank of Estonia estimates that up to 10 percent of the growth of real estate loans in Estonia may have "leaked" into consumption in 2006 - a significant rise from past years. These developments suggest a need for vigilance from the lenders' side. In a highly competitive and profitable market, one may not appreciate how little borrowing experience households in these countries have.

At the same time, the interest margin over Euribor for housing loans is about 80 to 90 basis points in Estonia and Lithuania, but 50 basis points in Finland. Does this kind of fairly marginal difference in risk premia (30 to 40 basis points) adequately reflect respective country risk differences?

Can we say that the level of risk is indeed so similar? The differences in sovereign ratings show that risks are still higher in the Baltic countries than in the Nordic market. It seems that fierce competition for market shares in new markets may have led to excessive compression of risk premium in certain asset classes and suboptimal price discrimination between the borrowers based on their individual risk profile. These concerns keep the central banks and financial supervisors in the region alert.

In general, one may say that the level of risk depends on three factors: speed and sustainability of GDP growth, sectoral concentration of exposure (real estate), and currency mismatch in borrowers' assets and liabilities.

Faster GDP growth allows one to expect faster accumulation of assets and, therefore, faster improvement in the ability to service loans. However, estimating potential output growth is tricky. Such estimations are roughly based on the average of the past few years' performance. Today we think that potential output growth may be around 7 percent in Estonia. Let me remind you that a few years ago we thought it was 4 to 5 percent. Upward revisions are not the problem, of course, but there are also several examples of downward revisions: Portugal, Greece... even Poland. While credit growth has given a significant contribution to output growth, it is hardly sufficient in the long run. Too high indebtedness will limit output growth potential, as loan-servicing costs will eventually curb consumption and investment.

The effects of economic slowdown or recession on loan quality may be quite different over the business cycles, however. All things considered, Estonian borrowers weathered the effects of the Russian crisis of 1998 relatively easily. However, one has to keep in mind two things. Firstly, the household credit to GDP ratio was at around 10 percent. Now it is around 30 percent. Secondly, the households' loan servicing ability did not deteriorate dangerously, as low-income households who suffered the most in that recession had not had access to credit. In the current cycle there are more households with an access to credit, also from the lower income deciles, indicating the spread of the effects of the potential slowdown to a wider part of the economy.

The second risk factor I would like to point out is the price level of real estate. Real estate prices have recently surged globally, and also in the Baltic countries. The possible factors behind this increase include rapid and relatively widespread income growth, favorable borrowing conditions, and international demand. However, despite these surges, absolute levels of real estate prices remain still about two times lower in Tallinn than in Helsinki, in line with the difference of overall price levels. There are signs that prices are now stabilized in nominal terms and may have slightly decreased in real terms.

Nevertheless, relative prices of real estate have increased dramatically. Whereas the ratio of price of a square meter to monthly wages is about one in Helsinki, it exceeds two in Tallinn. The expectations of real estate price convergence fuel credit demand in Baltic countries but imply ever-increasing risks to both borrowers and lenders. (It is fair to say, though, that the majority of real estate loans are used for buying homes, not for speculation.)

The third factor I wanted to mention - currency mismatch - has caught some attention from international observers. The issue is more nuanced than the classical approach. It is absolutely true that risks inherent in currency mismatch require vigilance from banks as well as from supervisors. But it becomes alarming when currency mismatch comes from skewed incentive structure as we have seen, for example, also in some EU member states where loans have been taken in foreign currencies because of lower nominal interest rates of foreign currency loans (e.g. Swiss francs). At the same time, most of the borrowing in the Baltic States is denominated in the anchor currency, the euro. It is quite natural in the context of the EU integration that new long-term contracts take into account the forthcoming euro adoption. Therefore, the issue at hand is not to "fight the liability dollarization". Such a fight would not only be a waste of scarce resources, but also completely futile in small open EU countries.

Implications for risk management and supervision

That brings me to the third topic I wanted to touch upon today, of risk management and financial supervision. I believe that the concerns I just mentioned should neither be overstated nor played down. These risks are a natural part of the immensely positive impact that financial integration has had on the development of the Baltic economies. In a rapid catch-up process, it is difficult to assess the level of optimal credit growth. Instead, it is important to analyze the loan growth in broader economic policy context where due consideration should be paid to the credibility of macroeconomic policies and the impact other policies may have on the incentive structure in the financial markets.

As I stated earlier, the presence of Nordic banks in the Baltic market is, of course, a hugely important positive factor. Parent banks are sometimes considered to have an implicit responsibility for the stability of the banking systems in the Baltic countries. It is said that the Baltic banks are *too small to fail*.

International experience lends support to this view, although the evidence is not always in one way. Hence, there are also potential risks. If parent banks are active in many countries of the region, a shock affecting exposure in one country may lead to a reduction in their exposure across the region. Build-up of exposures to common risk factors in a region may also increase the potential for contagion - a reduction in lending to countries not affected by a crisis. The potential for contagion is naturally higher in highly integrated economies.

Another potential risk factor is the smallness of the banks in the Baltics combined with their high profitability. While the Nordic banks have high profitability in all of their markets, profitability in the Baltic market is especially high. As a result, the share of banking groups' assets in the Baltics is significantly lower than the share of profits banks make in this region. This divergence may tempt the Nordic owners to be more aggressive in the high-growth market.

It is therefore and with these risks in mind - though with a very low probability at the time - that Bank of Estonia as a regulator has set higher capital charges for banks operating in Estonia.

From the point of view of a central bank or a financial regulator it is positive that Nordic banks seem to treat the Baltic market as a part of their home market. Parent banks extend their advanced risk evaluation models to their Baltic subsidiaries and branches. However, risk measurement and management systems used in the Nordic countries need to be appropriately calibrated when applied in the Baltic countries. The principles of risk evaluation that work well at the level of the whole group may not be optimal in countries where borrowers have a limited credit history, in most cases less than one full cycle. For example, there is no experience of loan servicing in the environment of increasing interest rates.

The integration and the presence of foreign banks have brought new challenges for surveillance and policy, especially regarding appropriate risk assessment. The host country's options for mitigating macroeconomic instability are often limited. Therefore, cooperation between supervisors and exchange of information is becoming increasingly important and a part of a business as usual practice. Bilateral cooperation can ensure the effectiveness of regulation, but it has its limits. Thus, it is vital to keep the EU legislation up with market developments. The forthcoming implementation of Basel II framework also underlines the need to address practical policy issues of supervisory cooperation.

Are ROEs peaking?

Finally, I would like to make my personal bet to the question of the day, "Are ROEs peaking?" I cannot quote the classics as a saying that "sky is the limit" proved wrong some 15 years ago just here in Sweden. At the same time, when one wants to believe the story of an unusually long economic cycle in the region I would say that the return-on-equity has not peaked but stabilised. But of course, as we all know, there is always a factor of uncertainty in every forecast - beauty as a prudence is in the eyes of a beholder.

Ladies and Gentlemen: Thank you for your attention.