

IDENTIFYING THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA AND BUFFER RATES IN 2020

European Union member states assess the importance of credit institutions for the financial system each year, and update the list of systemically important credit institutions and the buffer rates that apply to them. In Estonia the credit institutions that are systemically important for the financial system here are defined by Eesti Pank as O-SIIs, or Other Systemically Important Institutions. Eesti Pank also decides on the rate for the additional capital buffer for O-SIIs, and can set it at up to 2% of total risk exposure. The additional buffer is intended to make the operation of systemically important market participants and the system as a whole more resilient, and to reduce costs that may accompany problems at systemically important credit institutions.

Following substantial changes in the structure of the banking sector, Eesti Pank is adjusting the framework for assessing systemically important credit institutions. The need to adjust the framework followed from structural changes at Luminor Bank AS at the start of 2019, when it brought its Latvian and Lithuanian branches under its head office in Estonia. If the automatic methodology of the European Banking Authority (EBA) is used to calculate the score for systemic importance, domestic indicators that are significant for financial intermediation in Estonia are underestimated in the calculation following the structural changes. To increase the role of domestic Estonian indicators in the calculation of systemic importance, the framework has been complemented by the addition of optional indicators to the mandatory ones that are included in the EBA guidelines. The adjusted methodology takes account of the importance of the O-SIIs for the operation of the banking sector and for the supply of financial services to the Estonian economy.

The results of the assessment in 2020 make four banks in Estonia systemically important, and these are Swedbank AS, AS SEB Pank, Luminor Bank AS and AS LHV Pank. The assessment was run on data from the end of 2019. The result of the assessment was that the list of banks defined as O-SIIs was the same as last year and so were the O-SII buffer rates set for them. This means that the buffer rate of 2% continues to apply for Swedbank AS, AS SEB Pank and Luminor Bank AS, and the rate of 1% applies for AS LHV Pank.

Table 1. Score of the banks operating in Estonia (basis points)

| Institution | Overall score | | Criteria | | | | |
|------------------------|---------------|------------|----------|---|----------------------------------|--------------------|---|
| | Base* | Adjusted** | Size | Importance (including substitutability / financial system infrastructure) | Complexity/cross-border activity | Interconnectedness | Importance in the Estonian financial system |
| Luminor Bank AS | 4599 | 2867 | 3650 | 2812 | 7457 | 4478 | 1134 |
| Swedbank AS | 2150 | 3429 | 2944 | 3498 | 860 | 1297 | 4708 |
| AS SEB Pank | 1548 | 2103 | 1823 | 2148 | 845 | 1374 | 2659 |
| AS LHV Pank | 733 | 823 | 806 | 904 | 204 | 1018 | 914 |
| Bigbank AS | 148 | 90 | 153 | 116 | 208 | 113 | 33 |
| AS Coop Pank | 133 | 179 | 162 | 157 | 35 | 179 | 225 |
| AS Inbank | 130 | 95 | 123 | 95 | 137 | 164 | 60 |
| AS TBB pank | 57 | 50 | 42 | 50 | 12 | 125 | 43 |
| Holm Bank AS | 11 | 15 | 15 | 10 | 1 | 18 | 19 |

* The automatic score is calculated using the EBA methodology.

** The adjusted score takes account of the structural changes of the Estonian financial system. A fifth category has been added with two optional indicators for private sector domestic deposits and private sector domestic loans.

DEFINING THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA

The starting point for identifying systemically important credit institutions in Estonia is the two-stage methodology in the guidelines of the European Banking Authority (EBA)¹. In the first

¹ Guidelines issued on 16 December 2014 by the EBA on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs).

stage, other systemically important institutions, or O-SIIs, are identified automatically using the criteria and the mandatory indicators in the EBA guidelines. The overall score for systemic importance is calculated from ten mandatory indicators, which are divided into four categories for size; importance, which includes substitutability / financial system infrastructure; complexity / cross-border activity; and interconnectedness. To calculate the indicator scores the indicator values for each credit institution are divided by the aggregate value for that indicator summed across all the credit institutions in the country². The overall score for each credit institution is the weighted average value of the indicator scores. All banks that exceed the threshold value of 350 basis points³ are automatically classed as O-SIIs. The second stage is a supervisory assessment in which any other credit institutions that scored below the O-SII threshold in the first stage but are still systemically important for the domestic financial system can be classed as O-SIIs.

As domestic indicators representing the supply of financial services to the Estonian economy were underestimated in the score for systemic importance following the changes in the Estonian banking sector at the start of 2019, the scores found automatically using the EBA methodology do not adequately reflect the systemic importance of all the banks operating in Estonia. In consequence Eesti Pank has adjusted the automatic methodology of the EBA. So that the scores would better describe the risks of the O-SIIs for the local Estonian financial system, Eesti Pank has added indicators for private sector domestic deposits and private sector domestic loans from the selection of indicators given in Annex 2 of the EBA guidelines. These domestic indicators are presented as a fifth category in the adjusted methodology of Eesti Pank and are given a 50% weighting in the calculation of the overall score. Having taken account of the particular structure of the Estonian financial system, the assessment of systemic importance follows the principles of the EBA methodology for the other indicators, as the other categories have an equal weighting of 12.5% each, and the indicators within the categories of importance, complexity and interconnectedness are also equally weighted at 4.17% each (see Table 2).

Table 2. The core set of indicators for scoring systemic importance in the EBA methodology and the adjusted methodology

| Criterion | Indicators | Weight - EBA methodology | Weight - adjusted methodology |
|--|---|--------------------------|-------------------------------|
| Size | Total assets | 25.00% | 12.50% |
| Importance (including substitutability/financial system infrastructure) | Value of domestic payment transactions | 8.33% | 4.17% |
| | Private sector deposits from depositors in the EU | 8.33% | 4.17% |
| | Private sector loans to recipients in the EU | 8.33% | 4.17% |
| Complexity/cross-border activity | Value of OTC derivatives (notional) | 8.33% | 4.17% |
| | Cross-jurisdictional liabilities | 8.33% | 4.17% |
| | Cross-jurisdictional claims | 8.33% | 4.17% |
| Interconnectedness | Intra-financial system liabilities | 8.33% | 4.17% |
| | Intra-financial system assets | 8.33% | 4.17% |
| | Debt securities outstanding | 8.33% | 4.17% |
| Importance in the Estonian financial system | Private sector domestic deposits | | 25.00% |
| | Private sector domestic loans | | 25.00% |

Four banks were defined as systemically important in 2020, and these were Swedbank AS, AS SEB Pank, Luminor Bank AS and AS LHV Pank (see Table 3).

² The O-SII assessment process at Eesti Pank covers the whole of the banking sector. Investment associations are not affected by the assessment.

³ The institution responsible for defining O-SIIs can raise this threshold to a maximum of 425 basis points or lower it to a minimum of 275 basis points to take account of the specific nature of the banking sector in the member state, and the consequent statistical distribution of the scores.

Table 3. Scores of the banks operating in Estonia (basis points)

| Criterion | Indicators | Luminor Bank AS | Swedbank AS | AS SEB Pank | AS LHV Pank | Bigbank AS | Coop Pank AS | Inbank AS | AS TBB pank | Holm Bank AS | Branches |
|--|---|-----------------|-------------|-------------|-------------|------------|--------------|-----------|-------------|--------------|----------|
| Size | Total assets | 3 650 | 2 944 | 1 823 | 806 | 153 | 162 | 123 | 42 | 15 | 283 |
| Importance (including substitutability/financial system infrastructure) | Value of domestic payment transactions | 1 224 | 4 105 | 2 809 | 1 306 | 6 | 116 | 0 | 90 | 0 | 344 |
| | Private sector deposits from depositors in the EU | 3 486 | 3 454 | 1 617 | 812 | 165 | 191 | 160 | 41 | 15 | 58 |
| | Private sector loans to recipients in the EU | 3 727 | 2 936 | 2 019 | 594 | 178 | 164 | 126 | 17 | 16 | 224 |
| Complexity/cross-border activity | Value of OTC derivatives (notional) | 6 601 | 2 100 | 1 299 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| | Cross-jurisdictional liabilities | 7 140 | 152 | 1 004 | 555 | 276 | 96 | 230 | 11 | 0 | 536 |
| | Cross-jurisdictional claims | 8 630 | 328 | 233 | 57 | 348 | 9 | 180 | 26 | 2 | 187 |
| Interconnectedness | Intra-financial system liabilities | 2 851 | 1 190 | 3 162 | 1 134 | 15 | 91 | 11 | 38 | 1 | 1 505 |
| | Intra-financial system assets | 2 179 | 2 693 | 961 | 947 | 260 | 174 | 204 | 338 | 52 | 2 192 |
| | Debt securities outstanding | 8 403 | 9 | 0 | 973 | 64 | 273 | 278 | 0 | 0 | 0 |
| Importance in the Estonian financial system | Private sector domestic deposits | 880 | 5 241 | 2 450 | 984 | 16 | 218 | 47 | 61 | 15 | 88 |
| | Private sector domestic loans | 1 389 | 4 175 | 2 868 | 844 | 51 | 233 | 73 | 25 | 22 | 321 |
| Overall score (EBA automatic methodology) | | 4 599 | 2 150 | 1 548 | 733 | 148 | 133 | 130 | 57 | 11 | 491 |
| Adjusted methodology* | | 2 867 | 3 429 | 2 103 | 823 | 90 | 179 | 95 | 50 | 15 | 348 |

* The automatic score is calculated using the EBA methodology.

** The adjusted score extends the EBA methodology with additional optional indicators for importance in the Estonian financial system. The optional indicators provide 50% of the score.

BUFFER RATES FOR THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA

When setting the buffer rate, Eesti Pank starts from the principle that the capital buffer rate should be higher the more systemically important a credit institution is. As it may be assumed that the costs to the economy arising from financial problems at a bank depend on how important it is in the financial system, the additional capital requirements set for systemically

important banks help to reduce the likelihood and the impact of them becoming insolvent. In developing its methodology for calibrating the buffer, Eesti Pank considered various points, including the score given in the assessment of the systemic importance of credit institutions, and the buffer rates applied to other banks in the Nordic and Baltic region. Eesti Pank generally applies a buffer rate of at least 0.5% to the credit institutions that pass the minimum threshold of 350 basis points in the assessment of systemic importance, which is adapted from the methodology of the European Banking Authority. The maximum rate of 2% is applied to those credit institutions that get a score of at least 1200 basis points. If the score for systemic importance is between 350 and 1200 basis points, the benchmark rate is found linearly, and the result rounded to the nearest 0.5 percentage point (see Table 4).

Following from the results of the assessment of the systemic importance of credit institutions, no changes have needed to be made in the buffer rates for systemically important institutions in 2020. An O-SII buffer rate of 2% continues to apply to Luminor Bank AS, Swedbank AS and AS SEB Pank, and a rate of 1% applies to AS LHV Pank. As the rates for the parent banks of Swedbank

Table 4. O-SII buffer rates

| Score for systemic importance | O-SII buffer rate |
|-------------------------------|-------------------|
| 350–633 | 0.5% |
| 634–917 | 1.0% |
| 918–1199 | 1.5% |
| 1200– ... | 2.0% |

AS and AS SEB Pank have been set at 2%, this does not prevent a 2% rate being set for them⁴. The buffer requirement applies to the total risk exposure of systemically important credit institutions, and must be met individually and at a consolidated level.

The calibrated buffer rates for Swedbank AS, AS SEB Pank, Luminor Bank AS and AS LHV Pank are higher than the minimum O-SII buffer requirements found using the methodology of the European Central Bank.

Single supervision of banking means that Eesti Pank shares responsibility with the European Central Bank in macroprudential supervision. The Capital Requirements Regulation and Directive (CRR / CRD IV) allow the European Central Bank to set even stricter requirements for macroprudential measures, including the buffer for systemic importance, than those that Eesti Pank has passed if necessary. The European Central Bank bases its decisions about O-SII buffer rates on the framework that is used to find the score for the systemic importance of each bank that is the basis for the minimum level of the O-SII buffer⁵ (see Table 5). The minimum level for the buffer rate for Luminor Bank AS found from the score at the end of 2019 was 1% or 0.75% depending on whether the EBA automatic methodology or the Eesti Pank adjusted methodology was used, for Swedbank AS it was 0.75% or 1%, and for AS SEB Pank it was 0.5% or 0.75%. The O-SII buffer rate for AS LHV Pank should be at least 0.25%. All these minimum rates are lower than the required buffer rate calculated using the Eesti Pank calibration framework for O-SII buffer rates.

Table 5. ECB: O-SII buffer floors

| Score for systemic importance | O-SII buffer floor |
|-------------------------------|--------------------|
| ... -1249 | 0.25% |
| 1250–1949 | 0.50% |
| 1950–2899 | 0.75% |
| 2900– ... | 1.00% |

⁴ The European Union's Capital Requirements Directive 2013/36/EU must be considered when decisions are taken on O-SII buffers, as the rate that can be applied to a credit institution that is part of a banking group where the parent bank is subject at the consolidated level to a buffer requirement as a globally systemically important institution (G-SII) or an O-SII may be up to 1%, or not more than the rate that applies at the consolidated level to the global or other systemically important institution. The O-SII buffer rate for Swedbank AB and Skandinaviska Enskilda Banken AB is 2%.

⁵ For more details see the ECB Macroprudential Bulletin, June 2017.