



EUROSÜSTEEM

IDENTIFYING THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA

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SUMMARY

The European Union Capital Requirements Directive 2013/36/EU allows capital buffer requirements to be set for systemically important institutions. Systemically important institutions are global systemically important institutions (G-SIIs) and other systemically important institutions (O-SIIs). The international Financial Stability Board (FSB) found 30 global systemically important banks in November 2015 using the methodology of the Basel Committee on Banking Supervision, of which 13 banks were registered in the European Union¹. There are no credit institutions registered in Estonia that meet the criteria for global systemically important institutions, and among the parent groups only Nordea has been listed as such an institution.

Credit institutions that are systemically important to the domestic financial system must be identified annually in each member state and in Estonia this is done by Eesti Pank. Eesti Pank also decides on the need for a buffer for other systemically important institutions, and can set the rate for it at up to 2% of total risk exposure. This year Eesti Pank is only confirming and publishing the list of O-SIIs. Decisions on the buffer rates for those institutions will be taken together with the reassessment of the systemic risk buffer rate in the first half of 2016².

The guidelines of the European Banking Author-

ity (EBA) are taken as the common starting point in the European Union for identifying O-SIIs. In defining institutions as O-SIIs, Eesti Pank used only the indicators listed as mandatory in the EBA guidelines and did not consider it necessary to use any additional indicators to add to the list.

When the criteria and the mandatory indicators given in the EBA guidelines are applied to the banks operating in Estonia, three credit institutions – Swedbank AS, AS SEB Pank and AS LHV Pank – had a total score that was higher than the threshold of 350 basis points that defines an O-SII (see Table 1). Eesti Pank finds that the data for the end of 2014 allow only two banks, Swedbank AS and AS SEB Pank, to be considered as important to the domestic financial system. This finding is reached because of a specific feature of the Estonian financial system that the EBA methodology does not fully take account of.

The total score for AS LHV Pank was relatively high because it is one of the few banks that has obtained funds by issuing bonds, but the amount issued is relatively small in terms of the bank's own assets or of the assets of the banking sector as a whole. The role of bonds in funding is small because foreign banks are a large part of the Estonian banking sector and foreign-owned banks do not issue bonds themselves but instead access market-based funding through their parent banks.

Table 1. Scores of the banks operating in Estonia derived from EBA mandatory indicators

Institution	Overall score	Criterion			
		Size	Importance (including substitutability/financial system infrastructure)	Complexity/ cross-border activity	Interconnectedness
Swedbank AS	3194	4049	4072	2806	1850
AS SEB Pank	1930	2346	2274	2091	1011
AS LHV Pank	917	251	231	290	2894
Versobank AS	337	116	297	324	611
AS DNB Pank	205	292	205	135	188
BIGBANK AS	169	147	146	383	1
TALLINNA ÄRIPANGA AS	150	87	104	201	207
AS Eesti Krediidipank	99	116	120	103	55

¹ Financial Stability Board. 2015 update of list of global systemically important banks (G-SIBs), 3 November 2015.

² The Capital Requirements Directive calls for the systemic risk buffer rate to be assessed at least once every two years. The systemic risk buffer started to apply in Estonia from 1 August 2014.

1. SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS AND HOW THEY ARE COVERED IN EUROPEAN UNION LAW

The goal of defining systemically important banks and requiring them to hold additional own funds is to increase the resilience of systemically important market participants and through that of the whole system. The additional capital buffer requirement helps to reduce the risks to the financial system that would emerge were a systemically important institution to fail to operate. The requirement also reduces the potential impact on the taxpayer of any such bank going bankrupt.

1.1 The principles for identifying and declaring systemically important credit institutions

Section 24¹ of the Eesti Pank Act gives Eesti Pank the responsibility for identifying the parts of the financial system whose actions may exert a significant influence on the formation of systemic risks. Section 86⁴⁸ (7) states that it is Eesti Pank that defines the list of other systemically important credit institutions in Estonia. The list is set by a decree of the Governor of Eesti Pank.

Directive 2013/36/EU of the European Parliament and the Council and Section 86⁴⁸ of the Credit Institutions Act define the categories to be used in identifying O-SIIs as their:

- size;
- importance for the economy of the European Union or of the member state;
- importance in cross-border activities;
- interconnectedness with the financial system.

More detailed instructions on identifying O-SIIs are given in the EBA/GL/2014/10 guidelines of the European Banking Authority of 16 December 2014³ (see section 2.1 for the EBA methodology).

Member states of the European Union have to identify systemically important credit institutions for the first time by 1 January 2016, and after that the list of systemically important institutions has to be assessed and decided by 1 December each year.

Eesti Pank must inform systemically important credit institutions, the European Commission, the

European Systemic Risk Board and the European Banking Authority of the names of the O-SIIs, and it publishes the list of names on its website.

1.2. Setting the capital buffer requirement for other systemically important credit institutions

Section 86⁴⁸ (3) of the Credit Institutions Act permits Eesti Pank to require other systemically important credit institutions to maintain a buffer of up to 2% of the total risk exposure calculated in accordance with Article 92 (3) of Regulation (EU) No 575/2013. The requirement may apply to a credit institution on an individual, sub-consolidated or consolidated basis and must be met from core equity tier 1. Eesti Pank assesses how appropriate the buffer rates are, and adjusts them if necessary, at least once a year. The Executive Board of Eesti Pank decides on the buffer rates and they are set by a decree of the Governor of Eesti Pank.

Setting the buffer requirement for an O-SII or changing a buffer rate that has already been set needs Eesti Pank to advise the European Commission, the European Systemic Risk Board, the European Banking Authority, and the competent or designated authorities of all countries affected one month before announcing the new rate.

When setting the buffer requirement for O-SIIs, Eesti Pank must also consider the principles for setting a systemic risk buffer requirement. If the credit institution is subject to an O-SII buffer and to a systemic risk buffer requirement that apply only to its exposures in Estonia, then the two requirements are cumulative. If the credit institution is subject to an O-SII buffer and to a systemic risk buffer requirement that apply to its exposures in Estonia and abroad, then it has to meet whichever of the two requirements is set higher.

If a credit institution that has been identified as an O-SII is part of a banking group where the parent bank is subject at the consolidated level to a buffer requirement as a G-SII or an O-SII, then an O-SII buffer requirement can be applied to that credit institution in Estonia at the individual or sub-consolidated level. This rate may be up to 1%, or not more than the rate that applies at the consolidated level to the G-SII or O-SII. The higher of these two values will set the limit for the rate.

³ Guidelines 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).

Setting the buffer rate under single banking supervision

Although the primary responsibility for the implementation of macroprudential measures lies with the national authorities, single banking supervision means the European Central Bank is involved in setting the buffer rate for O-SIIs.

Under the procedures in Article 5 of Council Regulation (EU) No 1024/2013, a national designated authority such as Eesti Pank has to notify the European Central Bank of the preliminary decision on the buffer rate for the O-SII ten working days before the final decision on the buffer rate is taken. The European Central Bank can object to the notified rate within five working days, and Eesti Pank must consider the arguments used by the European Central Bank prior to proceeding with the decision-making.

Single supervision allows the European Central Bank to set higher capital buffer requirements than those requested by the national authorities, and this also applies to the buffer rate for O-SIIs. It must inform Eesti Pank in advance of its intention to do this, and Eesti Pank may submit reasoned arguments against the proposed rate, which the European Central Bank then has to consider in its own decision-making processes.

2. IDENTIFYING OTHER SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS

2.1. The EBA methodology in brief

On 16 December 2014 the EBA issued its guidelines 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)⁴. In these guidelines, the EBA introduced a scoring process for systemically important credit institutions that has been taken as the basis for identifying the systemic importance of credit institutions in Estonia.

The EBA guidelines call for annual assessment in two steps. The first step is the calculation by the designated authority of the score for each credit institution within its jurisdiction at the highest possible consolidation level of the group, taking in subsidiaries in other member states and third countries as well. Discretion is granted in leaving out credit institutions whose relative size is up to 0.02% of total assets. The second step is supervisory judgement.

The systemic importance score is given in the first step from ten mandatory indicators in four categories. Each category has equal weighting, and each indicator within each category also has equal weighting relative to the other indicators within the category (see Table 2). The score is arrived at by:

1. dividing the indicator value of each individual institution by the aggregate sum for all the institutions in the member state;

2. multiplying the result by 10,000 to express the indicator scores in terms of basis points;
3. calculating the category score for each institution by taking a simple average of the indicator scores in that category;
4. calculating the overall score for each institution by taking a simple average of its four category scores.

Credit institutions that get a score of 350 basis points or more are classed as O-SIIs. The designated authorities can raise this threshold to 425 basis points or lower it to 275.

The indicators are defined in accordance with the European Union's common supervisory reporting FINREP. Alternative values are used for credit institutions that are not covered by the FINREP requirements and that have assets of 20% or more of total banking sector assets.

So that the scores can adequately reflect the banking sector of the member state, the indicator values of branches of institutions licensed in other member states or third countries are included in the denominators for the purpose of the scoring process. Alternatively, a virtual credit institution can be included in the sample with an indicator value equal to the total of the values of all the branches of foreign institutions. If branches from third countries are important in the local banking system and their data can be accessed and compared, the designated authority should consider calculating the score for them and identifying them as important institutions.

Table 2. The core set of indicators for the scoring of systemic importance from the EBA methodology

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

⁴ Credit institution, as the company concerned, is taken to mean credit institutions and investment firms operating as parent companies in the European Union, financial holding companies operating as parent companies in the European Union, mixed financial holding companies operating as parent companies in the European Union, or credit institutions and investment firms with a licence to operate in the jurisdiction of the designated authority.

The second step is supervisory assessment, where the designated authority assesses whether any other credit institutions that scored below the O-SII threshold in the first step but are still important for the domestic financial system should be classed as O-SIIs. This can be done on the basis of the score in any category or the qualitative and quantitative indicators listed in Annexes 1 and 2 of the EBA guidelines. Credit institutions that scored less than 4.5 basis points in the first step may not be named as systemically important institutions.

2.2. Identifying the other systemically important credit institutions in Estonia

Definitions of the indicators used for finding the scores with the EBA mandatory indicator methodology for the six banks that submit FINREP reports⁵ are given in Table 2 of Annex 1 of the guidelines. The closest possible alternative indicators have been found for those banks that are not covered by the FINREP requirements, and are taken from reports submitted to Eesti Pank. The scores arrived at for the indicators using the EBA methodology are given in basis points in Table 3.

If the first step of the EBA methodology is followed strictly, the banks defined as systemically important are Swedbank AS, AS SEB Pank and AS LHV Pank. This is still the case if the threshold is raised from 350 basis points to the highest permitted level of 425 basis points. The importance of Swedbank AS and AS SEB Pank for the Estonian banking system is already apparent from the size of their total

assets, but AS LHV Pank becomes systemically important largely because of a specific feature of the Estonian financial system that the EBA methodology does not fully take account of.

As the banking groups operating in Estonia are mainly foreign-owned, they finance their operations here from local deposits and funds taken from parent banks, so the local units themselves generally do not issue bonds, meaning that the total value of bonds issued by credit institutions operating in Estonia is very small. Even though this indicator is of low significance for the Estonian financial system, the EBA methodology needs 10,000 basis points to be divided among the banks in proportion to their outstanding debt securities, with this making up 8.33% of the final score. The outstanding bonds of AS LHV Pank have a total value that is relatively small at only 3% of the bank's own assets, but they account for 83% of the total outstanding debt securities of the banking sector. This added 688 basis points to the final score for AS LHV Pank. Without this, AS LHV Pank would have scored 229 basis points, which is well below the threshold of 350.

It is possible in the second step of the EBA methodology to nominate additional systemically important credit institutions because of their score in any category or because of other quantitative or qualitative indicators. As the first step identified all the important credit institutions, there is no need to designate any additional systemically important credit institutions in the second step.

Table 3. Scores for indicators (basis points)

Criterion	Indicators	AS SEB Pank	AS LHV Pank	BIGBANK AS	AS Eesti Krediidipank	Swedbank AS	TALLINNA ÄRIPANGA AS	AS DNB Pank	Versobank AS	Branches
Size	Total assets	2,346	251	147	116	4,049	87	292	116	2,596
Importance (including substitutability/ financial system infrastructure)	Value of domestic payment transactions	2,111	151	3	103	3,308	221	157	789	3,156
	Private sector deposits from depositors in the EU	2,157	344	219	156	4,897	71	116	91	1,949
	Private sector loans to recipients in the EU	2,555	198	218	102	4,009	18	342	13	2,545
Complexity/ cross-border activity	Value of OTC derivatives (notional)	3,338	98	17	0	4,271	0	0	63	2,212
	Cross-jurisdictional liabilities	2,394	96	321	149	1,445	183	282	323	4,808
	Cross-jurisdictional claims	542	676	812	159	2,701	420	124	585	3,980
Interconnect- edness	Intra-financial system liabilities	2,658	64	0	35	1,929	13	384	18	4,899
	Intra-financial system assets	375	360	2	130	2,868	608	180	826	4,651
	Debt securities outstanding	0	8,259	0	0	751	0	0	990	0
Overall score		1,930	917	169	99	3,194	150	205	337	2,999

⁵ FINREP reports were submitted on 31 December 2014 by Swedbank AS, AS SEB Pank, AS LHV Pank, BIGBANK AS, AS Eesti Krediidipank and Tallinna Äripanga AS.