

THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA AND BUFFER RATES FOR 2016

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. 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 buffer for O-SIIs, and can set it at up to 2% of total risk exposure. The additional buffer is intended to increase the resilience of systemically important market participants and through that of the system as a whole, and to reduce the moral hazard that arises for large credit institutions that are seen as being too big to fail. Eesti Pank assesses how appropriate the buffer rates are, given the developments in the Estonian banking system, and adjusts them if necessary, at least once a year.

Like it did in 2015, Eesti Pank designated two banks as systemically important credit institutions in 2016, these being Swedbank AS and AS SEB Pank. Using data from the end of 2015 and the mandatory indicators given in the guidelines of the European Banking Authority (EBA) shows that four credit institutions – Swedbank AS, AS SEB Pank, AS LHV Pank and Versobank AS – have a points score for systemic importance that is above the threshold of 350 basis points¹ (see Table 1). Eesti Pank finds that the data for the end of 2015 allow only two of these banks, Swedbank and SEB Pank, to be really considered systemically important. This finding is based on a specific feature of the Estonian banking sector that the EBA methodology does not fully take account of.

Eesti Pank decided to leave the buffer rate for Swedbank AS and AS SEB Pank that started to apply from August 2016 unchanged at 2%. The overall score for systemic importance for each of the two credit institutions calculated from data from the end of 2015 was at a level where Eesti Pank finds it necessary to apply the maximum rate of 2%.

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

Institution	Overall score	Criteria			
		Size	Importance (including substitutability / financial system infrastructure)	Complexity / cross-border activity	Interconnectedness
Swedbank AS	3040	3966	4209	2946	1039
AS SEB Pank	1906	2242	2312	1955	1116
AS LHV Pank	917	324	352	248	2743
Versobank AS	407	152	313	479	685
AS DNB Pank	204	312	211	146	149
BIGBANK AS	187	151	145	442	11
AS Eesti Krediidipank	119	131	139	132	74
Tallinna Äripanga AS	102	88	79	143	97
AS Inbank	77	19	8	10	273

¹ To simplify, 350 basis points is on average equivalent to market share of 3.5% of the assets and various activities of the banking sector.

1. IDENTIFYING THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA

The starting point for identifying systemically important credit institutions in Estonia is the methodology in the guidelines of the European Banking Authority (EBA)². There are two stages to the methodology. In the first, other systemically important institutions, or O-SIIs, are identified automatically using the criteria and 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. The values for each credit institution are related to the total score for the indicators for all the credit institutions in the country, meaning that different types of market share can be reflected. The final point score for each credit institution is the weighted average value of the indicators. All banks that exceed the threshold value of 350 basis points 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. This can be done on the basis of the score in any category or the qualitative and quantitative indicators listed in the EBA guidelines.

In identifying the O-SIIs, Eesti Pank takes account of the specific features of the Estonian financial system as well as the EBA methodology, and for that reason, two credit institutions were defined as systemically important in 2016, Swedbank AS and AS SEB Pank. If the first stage of the EBA methodology is followed strictly, the data from the end of 2015 would require AS LHV Pank and Versobank AS to be classed as systemically important banks as well (see Table 2). The scores of AS LHV Pank and Versobank AS exceeded the threshold because of a specific feature of the Estonian financial system that the EBA methodology does not fully take account of.

Table 2. Scores for indicators (basis points)

Category	Indicators	Swedbank AS	AS SEB Pank	AS LHV Pank	Versobank AS	AS DNB Pank	Bigbank AS	AS Eesti Krediidipank	Tallinna Äripanga AS	Inbank AS	Branches
Size	Total assets	3 966	2 242	324	152	312	151	131	88	19	2 616
Importance (including substitutability / financial system infrastructure)	Value of domestic payment transactions	3 622	2 257	411	771	171	3	138	143	0	2 484
	Private sector deposits from depositors in the EU	5 000	2 152	413	155	120	211	183	74	24	1 667
	Private sector loans to recipients in the EU	4 004	2 525	233	13	342	221	98	19	0	2 544
Complexity / cross-border activity	Value of OTC derivatives (notional)	6 413	2 784	28	80	0	0	0	0	0	695
	Cross-jurisdictional liabilities	1 590	1 845	138	427	354	321	193	171	0	4 960
	Cross-jurisdictional claims	836	1 237	577	931	85	1 004	204	258	29	4 839
Interconnectedness	Intra-financial system liabilities	1 548	2 037	107	16	425	7	21	7	1	5 830
	Intra-financial system assets	1 232	1 311	460	807	21	24	201	284	51	5 610
	Debt securities outstanding	338	0	7 663	1 232	0	0	0	0	767	0
Overall score		3 040	1 906	917	407	204	187	119	102	77	3 040

² 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).

As the volume of bonds issued by the Estonian banking sector is very small, the indicator for it in the EBA methodology does not reflect the systemic importance of banks operating in Estonia. A large proportion of the banking groups operating in Estonia are foreign-owned, so the banks in Estonia base their financing largely on funds from their parent banks and local deposits. The local units themselves generally do not issue bonds, meaning that the total value of bonds issued by banks operating in Estonia is very small. Even so, the EBA methodology needs 10,000 basis points to be divided among the banks in proportion to their outstanding debt instruments, with this making up 8.33% of the final score. Even though the outstanding bonds of AS LHV Pank and Versobank AS had a total value that was relatively small on 31 December 2015 at only 4% and 1% respectively of each bank's own assets, they accounted for 77% and 12% of the total outstanding debt instruments of the banking sector. This added 638 basis points to the final score for AS LHV Pank and 103 points to the Versobank AS score. Without this indicator AS LHV Pank would have scored 278 basis points and Versobank AS 305 basis points, both below the threshold of 350 basis points.

As the banks in the Estonian banking market mainly concentrate on servicing the local private sector, the systemic importance that comes from the EBA methodology could be volatile and overestimated for small banks with a different business model. Small or temporary changes in indicators that do not describe the core activities of the banks operating here could significantly affect the score for systemic importance.

2. 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. Eesti Pank calibrates the level of the additional buffer for systemically important institutions in Estonia by considering various points, including the score given in the assessment of the systemic importance of credit institutions, the buffer rates applied to other banks in the Nordic and Baltic region, and analysis of data for the Estonian banking sector³. 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 points 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.

Following the results of the assessment of systemic importance of credit institutions in 2016, Eesti Pank decided to leave the O-SII buffer rate for Swedbank AS and AS SEB Pank unchanged at 2%. The buffer requirement applies to the total risk exposure of those credit institutions, and must be met individually and at an unconsolidated level. As Swedbank AS scored 3040 basis points under the EBA methodology for assessing systemic importance, and AS SEB Pank scored 1904 basis points, the O-SII buffer is applied to them at the rate of 2%. Table 3 shows the total capital requirements for the banks defined as systemically important for the Estonian financial system, in comparison with the requirements for other banks.

	O-SIIs	Other banks
Macprudential buffers	Countercyclical capital buffer	0%
	Systemic risk buffer	1%
	Other systemically important institutions buffer	2%
Capital conservation buffer	2.5%	
Minimum own funds requirement	8%	
Total capital requirements	13.5%	11.5%

³ For more details, see "Systemic risk buffer and other systemically important institutions buffer. Analysis of the setting of the buffer requirements in Estonia", April 2016