ASSESSMENT OF THE NEED TO MAINTAIN THE SYSTEMIC RISK BUFFER REQUIREMENT (MAY 2018)

SUMMARY

The nature of the buffer requirement and the need for reassessment. The systemic risk buffer (SRB) is a macroprudential measure defined in the Capital Requirements Directive of the European Union that member states can apply to increase the resilience of credit institutions to long-term non-cyclical systemic risks. Once the buffer requirement has been introduced, the macroprudential authority has to reassess its relevance and sufficiency at least once during the next two years.

The Estonian systemic risk buffer requirement was last reassessed in 2016 when Eesti Pank decided in parallel with the introduction of the additional buffer requirement for systemically important institutions to cut the rate for the SRB from 2% to 1% and to apply it only to exposures located in Estonia[1] (see Table 1). In the spring 2018 assessment, Eesti Pank decided to keep the SRB requirement unchanged.

The reasons for applying the SRB requirement. The reasons for the SRB requirement lie in the small size and openness of the Estonian economy, which make the economy vulnerable to negative developments in the external environment. The openness of the Estonian economy is characterised by the large share and concentration of exports and the close economic and financial linkages with neighbouring countries. The risks to financial stability are increased by the concentration of the loan portfolios of the banks and the modest level of household financial buffers. If the economic climate were to deteriorate unexpectedly, the ability of companies and households to service their debts could worsen rapidly, meaning that banks would need to cover higher loan losses from own funds at short notice.

The rate for the SRB. The vulnerabilities in the Estonian economy that led to the SRB requirement being introduced have not changed substantially in past two years. This makes it reasonable to maintain the buffer rate at 1%. As the SRB requirement applies only to risk exposures in Estonia, it is added to the other systemically important institutions, O-SII, buffer requirement.

Expected impact. At the end of 2017 all the credit institutions authorised in Estonia met the minimum requirements for own funds and the buffer requirements with a sufficient margin. The buffer requirements help to ensure there is sufficient capital in the event of a shock to the economy or the banking sector. Stress testing has shown that the SRB requirement together with other regulatory buffers would help cover the possible scale of loan losses in the event of a sharp and steep drop in foreign demand.

Reciprocation by other countries. Although the share of branches of foreign banks in the Estonian banking market declined in the final quarter of 2017, they still accounted for more than 10% of the total assets of the banking sector. Furthermore, the non-financial sector in Estonia has also received loans directly from foreign banks. In order to ensure a level playing field for all the banks competing in the Estonian banking market and to underpin the effectiveness of the measures, it is important that the authorities of other member states apply equivalent additional buffer requirements to the banks that provide banking services in Estonia through branches or directly cross-border for their risk exposure in Estonia. Eesti Pank considers that the requirement should apply at least to those institutions that have exposures in Estonia of 250 million euros or more, which is the

Table 1. Setting and review of the systemic risk buffer requirement

	2014	2016	2018
Buffer rate	2%	1%	1%
Scope	all banks and banking groups on an individual and consolidated basis	all banks and banking groups on an individual and consolidated basis	all banks and banking groups on an individual and consolidated basis
Risk exposure	total risk exposure amount	risk exposures located in Estonia	risk exposures located in Estonia
Entry into force	01.08.2014	01.08.2016	01.07.2018
Reciprocity	voluntary reciprocity without the ESRB Recommendation	ESRB Recommendation (published in 10.08.2016)	request for continuation of reciprocity (institution-specific threshold of 250 millions of euros)

1 See Systemic risk buffer and other systemically important institutions buffer. Analysis of the setting of the buffer requirements in Estonia (April 2016)

amount that corresponds to 1% of the total assets of the banking sector in Estonia as at the end of 2017.

1. THE AIM AND REASONS FOR THE SYSTEMIC RISK BUFFER IN ESTONIA

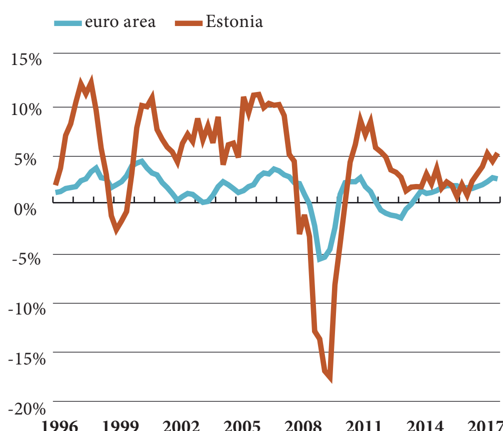
The systemic risk buffer is intended to increase the resilience of the financial sector to non-cyclical systemic risks that could have a serious negative impact on the national financial system or the real economy. A systemic risk buffer helps ensure the banks have sufficient capital so they can cope better with unexpected financial problems.

The main reason the systemic risk buffer requirement was introduced in Estonia was the small size and openness of the Estonian economy, which make the economy vulnerable to negative developments in the external environment. Estonia's gross domestic product in 2017 was around 23 billion euros, making the Estonian economy one of the smallest in the European Union. The volatility in the real growth in Estonian GDP has been much greater than that in the euro area as a whole (see Figure 1) and it has also been higher than in other rapidly growing transition countries.

The openness of the Estonian economy is characterised by the large share and concentration of exports. The total value of Estonia's exports and imports in the past five years averaged over 160% of GDP, which is around twice the European Union average (see Figure 2). Almost 40% of total Estonian exports in 2017 went to three countries, with Finland taking 16%, Sweden 14% and Latvia 9%, while the share of exports going to Russia increased to 7%. The economies of Estonia's neighbours are closely interrelated, so the impact of a deterioration in the external environment can spill over swiftly across the whole region, making it harder to recover from problems.

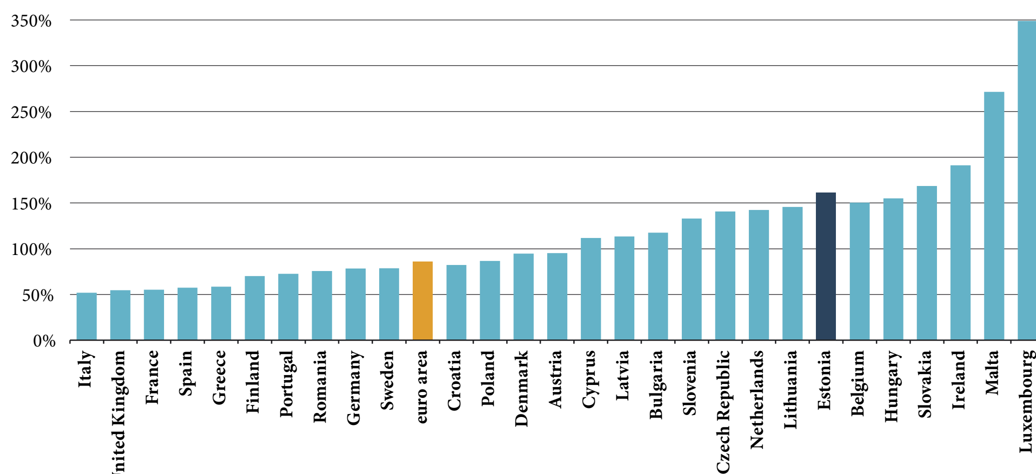
It should also be remembered that the lion's share of the Estonian banking sector is owned by large Nordic banking groups whose main operating

Figure 1. Real GDP growth year on year in Estonia and the euro area



Sources: Eurostat, Statistics Estonia

Figure 2. Trade openness measured as exports and imports in % of GDP



Note: 2012–2016 average
Source: Eurostat

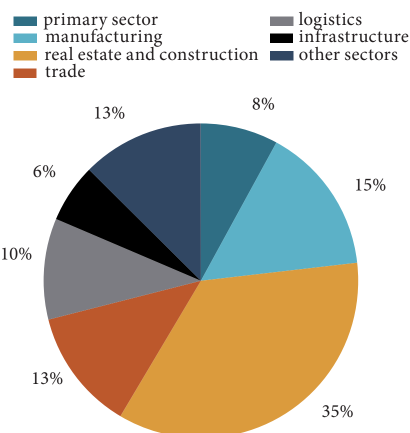
regions overlap with Estonia's main export markets. A negative development in one or more countries in the region could in consequence reduce the supply of funds, exacerbating the problem further.

The risks to financial stability are increased by the lack of diversity in the credit portfolios of the banks and the relatively small financial assets held by households.

- The credit risk of the banks is largely connected to the commercial real estate market. Loans and leases to real estate and construction companies made up more than one third of all the corporate loans issued by banks operating in Estonia at the end of 2017 (see Figure 3), and this share is quite similar to that in other euro area countries. At the same time, the loans to real estate and construction companies provide some 13% of the total assets of the banks, which is around double the euro area average[2]. Although problems may first appear more sharply in some other sector, the large share of loans to real estate companies increases the sensitivity of the banks to changes in the economic environment, including through second round effects.

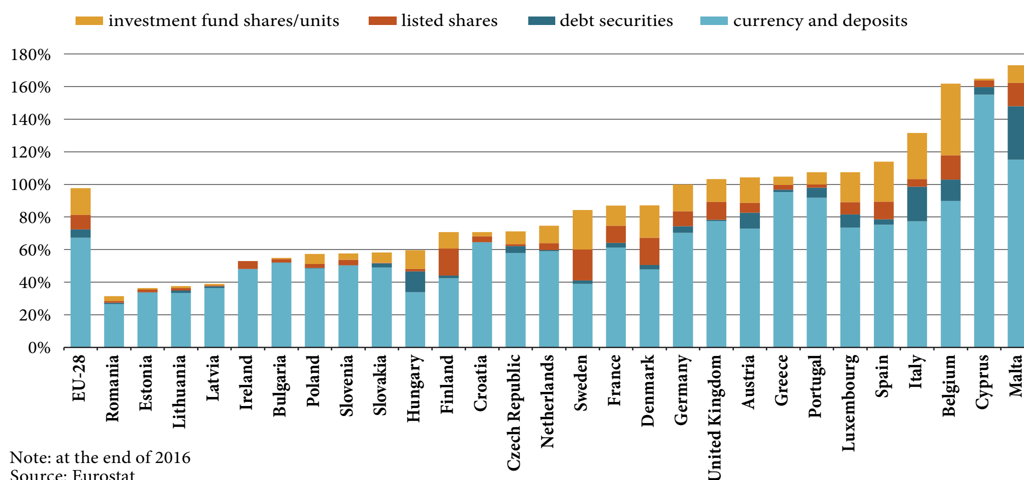
- Households in Estonia have substantially smaller financial assets than the average in the European Union (see Figure 4). Smaller buffers mean households are less able to absorb the impact of shocks from the external environment and to keep consumption at the same level if incomes fall. It should also be noted that the labour market in Estonia is more flexible than those in most other European Union countries. The more flexible labour market allows companies to reorient their activities faster if needed, but at the same time it makes changes in consumption and the ability of households to service loans harder to predict, especially when savings are small.

Figure 3. Structure of the corporate loan and lease portfolio of banks at the end of 2017



Source: Eesti Pank

Figure 4. Liquid assets of households to GDP



Note: at the end of 2016
Source: Eurostat

2 The big gap to the euro area average arises partly because the portfolio of loans to the private sector makes up a relatively large part of the assets of the Estonian banking sector, while the share of debt securities is very small.

2. EXPECTED IMPACT OF THE SYSTEMIC RISK BUFFER

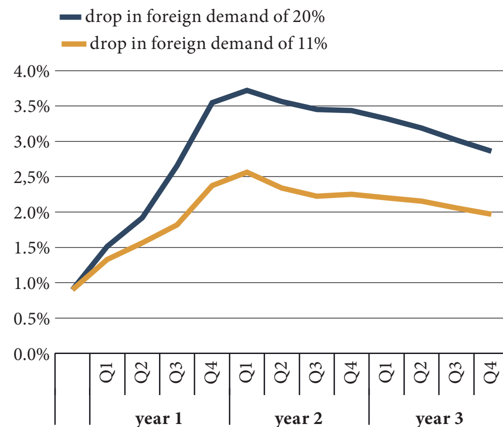
The sensitivity of the banking sector to a deterioration in the external economy

The main reason the systemic risk buffer requirement was introduced in Estonia was the vulnerability of the Estonian economy to possible negative developments in the external environment. Eesti Pank uses a macro model and a credit risk model for the banking sector to assess how this vulnerability affects the banking sector.

Sensitivity analysis of the banking sector shows that a drop in foreign demand very quickly affects economic growth and the loan quality of the banks. If foreign demand drops, the export revenues and profits of companies decrease first. Then economic activity declines because of falling investment and rising unemployment. The ability of companies and households to service their loans deteriorates and the volumes of non-performing loans and loan losses increase.

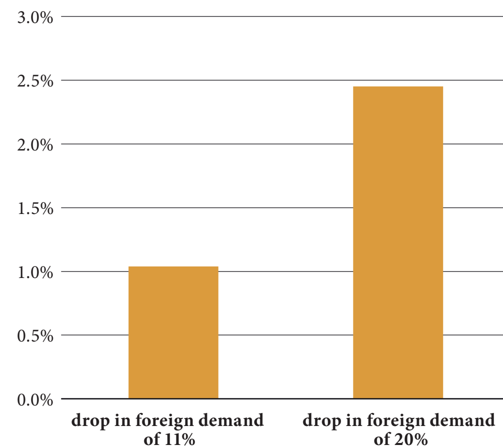
The Eesti Pank macro model suggests that a fall of 20% in foreign demand, which is similar to what happened after the global economic crisis of 2009, would lead the economy to contract by around 11% under current circumstances. The credit risk model of the banks shows that this would increase non-performing loans to 3.7% of the loan portfolio (see Figure 5) and loan losses would increase by around 200 million euros or around 2.5% of the credit risk exposures of the banks. This would bring the share of non-performing loans and loan losses to close to their peak levels by the end of the first year after the contraction in foreign demand. The systemic risk buffer at the rate of 1% would help cover additional loan losses that would arise if foreign demand fell by 11%, leading the economy to shrink by 6% (see Figure 6).

Figure 5. Share of overdue loans in the loan portfolio of banks in risk scenarios



Source: Eesti Pank

Figure 6. Ratio of additional loan losses to credit risk exposure



Source: Eesti Pank

Capital and buffer requirements and the capitalisation of banks

At the end of 2017, all the banks licensed in Estonia had to hold total own funds of at least 11.5% of risk exposures, of which common equity tier one (CET1) capital had to cover 8% of exposures. The two largest banks in the market, Swedbank AS and AS SEB Pank, were subject to an additional 2% O-SII buffer requirement and from 1 January 2018 AS LHV Pank had an O-SII buffer requirement of 0.5%. This meant the banks were required to hold total own funds to cover between 11.5% and 13.5% of risk exposures, with CET1 to cover 8–10% of the exposures (see Table 2).

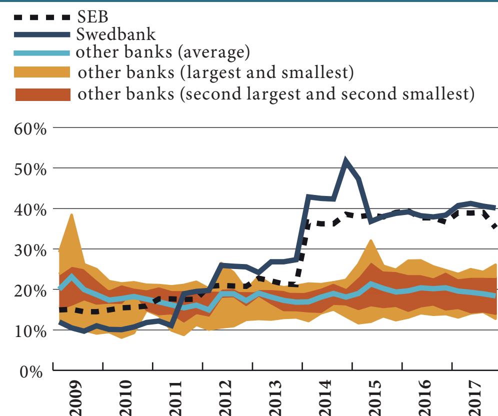
All the banks exceeded the minimum regulatory requirements for capital with a margin at the end of 2017. The total own funds of the banks as a ratio to risk-weighted assets averaged 30.5%.

Table 2. Capital and buffer requirements in Estonia (as of 01.01.2018)					
		Systemically important credit institutions		Other banks
		Swedbank AS, AS SEB Pank	AS LHV Pank	
Macroprudential buffers	countercyclical capital buffer (Estonian exposures)	0%	0%	0%
	systemic risk buffer (Estonian exposures)	1%	1%	1%
	other systemically important institutions buffer	2%	0.5%	-
Capital conservation buffer		2.5%	2.5%	2.5%
Minimum own funds requirement		8%	8%	8%
Total capital and buffer requirements		**13.5%**	**12.0%**	**11.5%**
of which Common Equity Tier 1 (CET 1) requirement		**10.0%**	**8.5%**	**8.0%**

At 98%, the great majority of the own funds of banks in Estonia is high-quality CET1 capital. The two largest banks use internal rating systems for assessing credit risk, and Swedbank had a CET1 ratio of 40% at the end of the year, while SEB Pank had a ratio of 35%. The other banks also had a margin on the own funds they held against risk exposures, and their weighted average CET1 ratio was 18%, though capitalisation varied quite widely from bank to bank (see Figure 7).

The buffer requirements help to ensure that the banks have sufficient capital to cover systemic risks. The own funds buffers held voluntarily by the banks are currently relatively large, but they could shrink rapidly in response to developments in the economic or financial environment, changes in the business plans of the banks, or a decision by the owner of a bank to reduce own funds. For this reason regulatory buffers like the systemic risk buffer are necessary to ensure that the banks hold sufficient capital margins to cover any negative developments.

Figure 7. CET 1 as a ratio to risk weighted assets



Other banks: Luminor, LHV Pank, Bigbank, COOP Bank, Tallinn Business Bank, Versobank, Inbank
Sources: Eesti Pank, public financial reports of banks

Potential cross-border impact

There is little cross-border activity by the credit institutions operating in Estonia, and their foreign exposures are small. The banks in Estonia mainly focus their activities on the domestic market and some 93% of their credit exposures are in Estonia. The cross-border exposures of credit institutions licensed in Estonia in any country are marginal, and in most of the member states of the European Union they were below 0.1% of the total assets of the banking sector of each country at the end of June 2017. The exposures were a little larger only in Latvia and Lithuania, where they were 1−1.2%. The cross-border exposures of Estonian credit institutions were 0.004% of the assets of the whole European Union banking sector.

The buffer requirements applied to subsidiaries located in Estonia do not affect the other countries where the banking groups operate. Subsidiaries account for only a small part of the total assets of the banking groups, and their profitability and capitalisation levels are high. This means the buffer requirements introduced in Estonia do not increase the capital needs of the banking groups nor do they have any indirect impact on the financing of the economy of any other country.

Assuming that other member states reciprocate the measures, the same systemic risk buffer

requirement will apply to subsidiaries, branches of foreign banks and direct cross-border lending. This means there is no reason to expect the buffer requirement would move lending activity from subsidiaries to branches or head offices of foreign banks. Moreover, the large banking groups are currently subject to stricter capital buffer requirements at the consolidated level in their home countries.

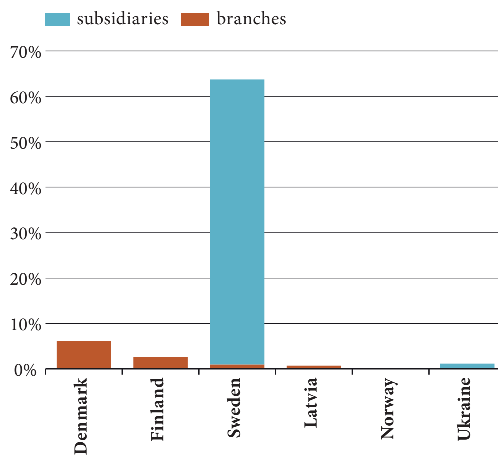
3. RECIPROCATION OF THE SYSTEMIC RISK BUFFER REQUIREMENT BY OTHER COUNTRIES

The impact of macroprudential measures depends on mutual reciprocation of them between countries. A large part of macroprudential measures, including capital buffer requirements, can be applied only to domestic banks and the subsidiaries of foreign banking groups. To ensure a level playing field for the whole market, to maximise the effectiveness of the measures, and to reduce the risk of regulatory arbitrage, equivalent measures have to be applied to foreign banks that are providing banking services through branches or directly across borders. The European Systemic Risk Board (ESRB) has issued recommendations on assessing the cross-border impact of macroprudential measures and mutual reciprocation of them[3].

The need for reciprocity of the Estonian systemic risk buffer requirement arises because a relatively large share of loans are taken from branches of foreign banks or directly across borders. There were 17 banks operating in Estonia at the end of 2017, of which six were domestic banks, three were subsidiaries of foreign banks, and eight were branches of foreign banks. Foreign banks had market share of 74% of the total assets of the banking sector, and some two thirds of this was held by the two largest subsidiaries. The market share of branches fell from 28% of the total assets of the banking sector a year earlier to 10% at the end of 2017 after Luminor was created on 1 October 2017 from the merger of DNB Pank and the branch of Nordea. The branches with the largest market share were from Denmark with 6% of the total assets of the banking sector, and from Finland with 3%, but banking services were also provided in Estonia by branches of credit institutions from Sweden, Latvia and Norway (see Figure 8).

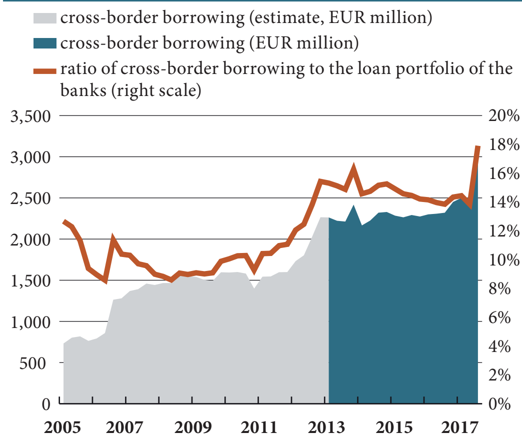
At the end of the third quarter of 2017, direct cross-border loans taken by households and companies accounted for 18% of the value of all the loans taken from the Estonian banking sector (see Figure 9)[4]. This share increased last year when one bank transferred a part of its loans to the portfolio of its foreign parent bank.

Figure 8. Market share of foreign banks by home countries at the end of 2017



Source: Eesti Pank

Figure 9. Cross-border borrowing by non-financial enterprises and households



Source: Eesti Pank

3 Recommendation of the European Systemic Risk Board of 15 December 2015 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2015/2).

4 The calculation uses data on the international investment position that cover not only loans from foreign banks but also loans from other companies (excluding intra-group loans), international institutions and development banks.

Eesti Pank has requested that other member states continue to reciprocate the systemic risk buffer requirement. In 2016 Eesti Pank assessed the relevance of the buffer requirements introduced two years previously and decided to set the systemic risk buffer requirement at 1% of domestic exposures, and it again requested other member states to reciprocate this. The ESRB issued a pan-European recommendation on this[5], following which more than half of the member states had reciprocated the Estonian systemic risk buffer by the end of March 2018.

Under the principles agreed at the ESRB, the member states can exempt individual banks from applying a reciprocating measure, if these banks have insignificant exposures to the risks being mitigated. Eesti Pank set the materiality threshold for reciprocity at 250 million euros, which corresponds to 1% of the total assets of the banks operating in Estonia at the end of 2017. This institution-specific threshold is 50 million euros higher than in the assessment of two years ago as the assets of the banking sector have grown.

5 Recommendation of the European Systemic Risk Board of 24 June 2016 amending Recommendation ESRB/2015/2 on the assessment of cross-border effects of and voluntary reciprocity for macroprudential policy measures (ESRB/2016/4).