V. FINANCIAL STABILITY ENSURING AND BANKING POLICY

FINANCIAL POLICY IN 2002

Throughout the last ten years, Eesti Pank has been following the same guiding principles in developing banking policy. **The currency-board-based monetary system and highly experienced, reliable and decision-committed core owners** – these are the principles that have brought stability and transparency into the Estonian financial environment.

In 2002, the Financial Supervision Authority was launched. From the start, the operation of the unified supervision agency has been very successful – no problems typical of the early stage of a new institution have emerged, the distribution of tasks with the Ministry of Finance and Eesti Pank has been defined and cooperation has been smooth.

Compared to earlier years, less time was devoted to legislative drafting required for implementing the *acquis communautaire* of the European Union, as the majority of this work has already been completed. The improvement of legal acts carried out in 2002 and continued in 2003 can rather be seen as fine-tuning aimed at bringing the financial sector legislation closer to the respective EU legislation. In view of the peculiarities of Estonia's rapid economic development sometimes stricter norms and requirements have to be applied than those used in stable and well-developed economies.

In October, Eesti Pank and the Financial Supervision Authority draw credit institutions' attention to the need to maintain loan quality and increase domestic saving[1]. It was pointed out that favourable interest rates, the resulting high loan demand and strong competition between banks may lead to underestimation of the risks related to potential changes in the economic environment.

Besides the general principles, such as assessing the solvency of the lender and credit risk management including updating the strategy and principles of credit risk management by banks and consideration of economic and interest rate cycles, credit institutions were advised to observe the minimum down payment requirement for housing loans and carefully evaluate the debt servicing ability of clients. In view of commercial real estate it was emphasised that the project's connection with the company's main activity and possible decline of real estate prices must be taken into consideration while determining the risk level of loan projects.

[1] See also Measures Applied in Autumn by Eesti Pank and the Government, pp 59–60.

Division of Tasks between Eesti Pank and the Financial Supervision Authority

In 2002, the Financial Supervision Authority (FSA) was set up at Eesti Pank as an independent agency for supervising the entire financial sector. As a result, the central bank is no longer directly involved in the supervision of credit institutions, but focuses on ensuring systemic financial stability. At the same time this means that the central bank has to cooperate with the FSA in analysing the financial sector and making policy decisions.

Two-way information exchange channels were developed during FSA's first year, both on the executive and expert level. Besides the exchange of analytical and market information, coordination of financial sector policy is very important, particularly in the field of banking policy. One part of it covers the improvement of legal acts regulating banking. These acts of lower level, which mostly concern supervision, are enforced by the decree of the Governor of Eesti Pank[2]. The FSA and the central bank also cooperate in drafting legislation and working out amendments.

Another field of cooperation between the FSA and the central bank is collection of financial sector reports and statistics. As the data collected for statistical and supervision purposes are largely overlapping, cooperation is aimed at avoiding repetition of queries in order to minimise the reporting burden. However, cooperation also covers the division of data processing between the central bank and the FSA, which helps to lower the data processing costs of both institutions. Cooperation is based on the protocol of joint action.

First experience of cooperation with the FSA has shown that the organisational solution chosen for financial sector supervision in Estonia is right – similar values and synergy form the basis for reaching a qualitatively new level of action. Cooperation agreement was signed by representatives of the Ministry of Finance, Eesti Pank and the FSA to ensure better arrangement of the formal side of the cooperation. Joint working groups were formed in the framework of the cooperation agreement.

Safety Net and Deposit Insurance

The safety net of the financial market covers a number of different components and it can be treated in a broader and a narrower sense. While the safety net in the broader sense covers the regulation, supervision and solutions to problems, the safety net in the narrower sense means, first of all, the **possibility of providing emergency liquidity help to banks for solving their liquidity problems, guarantee schemes for small depositors and investors, means of preventing systemic crises and pre-agreed principles of action for the quick and competent solution of problems by joint efforts of the central bank and the government in the event of a systemic crisis.**

In developing the safety net the year 1998 was an important landmark – in addition to the Banking Supervision, the Deposit Guarantee Fund (DGF) was set up, which proved its ability to fulfil its role of ensuring the systemic financial stability.

Under the 2002 Guarantee Fund Act, the Deposit Guarantee Fund was reorganised into the **Guarantee Fund** (GF) and the assets of the DGF became the **Deposit Guarantee Sectoral Fund** of the GF. In addition, the **Investor Protection Sectoral Fund** was set up to protect small investors and cover the risks deriving from the malicious activities of securities intermediators, and the **Pension Protection Sectoral Fund** to protect mandatory pension fund shareholders against possible risks (caused by fund managers).

[2] The list of decrees issued by the Governor of Eesti Pank in 2002 is given on pp 142–143.

The definition of guaranteed deposits was also specified. The Act also provides a schedule for increasing the minimum guarantee and compensation level of deposits and investments. Accordingly, the compensation level per depositor (and small investor) will rise from 40,000 kroons to 100,000 kroons at the end of 2003; by the end of 2005 the limit will be increased to 200,000 kroons and by the end of 2007 to 313,000 kroons (20,000 euros)[3]. Amendments were also made in the decrees of the Governor of Eesti Pank, concerning the bank liquidation manager's responsibilities in forwarding the data required for paying out compensations from the GF and data on the structure of deposits to be gathered from banks.

From the point of the central bank it is important that the sectoral funds of the GF have sufficient assets and the GF is always capable of paying compensations within the timeframe provided by the law. Therefore, at least once a year Eesti Pank evaluates the size of the Deposit Guarantee Sectoral Fund, the correspondence of banks' contributions to the deposits guaranteed and the ability of the GF to perform its legal duties. Taking part in the work of the GF Supervisory Board, Eesti Pank has the opportunity to participate in determining the deposit guarantee policy, including the size of contributions made by the banks. As the initial accumulation period accompanying the launch of the deposit guaranteeing is nearly over, the Board has lowered the quarterly contributions of banks twice – from 0.125% to 0.1% in 2001 and from 0.1% to 0.07% in 2002. For the central bank it is important that the contributions of banks were, on the one hand, sufficiently high in order to secure the functioning of the deposit guarantee scheme, and, on the other hand, sufficiently low in order to avoid unnecessary burden on banks.

Amendment of Legislation

A distribution of functions exists between the central bank and the FSA in the field of improving banking legislation. Experts of the FSA make preliminary suggestions for the necessary amendments on the basis of supervision experience. In cooperation with the central bank experts the need for these amendments is evaluated and the final changes will be endorsed by the decrees of the Governor of Eesti Pank.

At the beginning of 2002, the central bank and the FSA reviewed the new capital adequacy framework measuring the risk level of banks that had been tested for some time. One of the most important changes is the introduction of contractual nettings of positions open to credit risk. Also, the calculation of commodity risk was added in accordance with the relevant European Union directive. Other risk categories used for calculating capital adequacy were also amended.

The test period has shown that additional amendments are needed, concerning first of all currency risk and the market risk of the trading portfolio. The biggest change concerned the principles of calculating the currency risk of investments made into affiliated companies. **The amended decree on the rules of calculating capital adequacy and risk concentration was endorsed in July.**

Besides the above, there emerged the need to make changes in the calculation of currency and market risks on consolidated basis so that the banks would not be allowed to use mutual nettings for positions reflecting market and currency risks between affiliated companies. The FSA has worked out the new methodology and changes were implemented from the beginning of 2003.

Prevention of Money Laundering

For Eesti Pank, it is important that the state policy should guarantee internal readiness to combat money laundering and financing of terrorism and this activity is based on international requirements and standards.

[3] For mandatory pension fund shareholders 10,000 euros will be compensated fully and 90% of the rest.

The central bank is interested in sufficient attention to the prevention of money laundering and financing of terrorism as this contributes to ensuring financial stability. In this field Eesti Pank has set itself the following tasks:

- participation in inter-departmental cooperation with the aim of getting involved in the coordination of relevant state policy, drafting of legislation and developing Estonian views expressed on the international level;
- cooperation with international organisations, first of all the International Monetary Fund (IMF). This cooperation covers providing adequate information on Estonia and expressing views on developing international recommendations and good practices.

Estonia's activity in the prevention of money laundering is regulated by the **Money Laundering Prevention Act,** which fully corresponds to the current EU requirements in this area. Due to the supplementary legislation adopted by EU institutions in 2001, preparations were started in 2002 to make amendments in the respective Estonian legislation. As a result, the circle of businesses regulated by the Money Laundering Prevention Act will be expanded, the meaning of money laundering will be more precisely defined and the Penal Code will be applied to financing of terrorism.

In November 2002, the second mission of the Council of Europe Select Committee on the evaluation of anti-money laundering measures visited Estonia. The committee assessed the situation in the field of preventing money laundering and financing of terrorism, as well as the observance of recommendations proposed during the visit of the first mission in 2000. According to the preliminary estimation of the experts of the mission, Estonian activities in preventing money laundering and financing of terrorism in general correspond to international principles.

REGULAR ANALYSIS OF THE FINANCIAL SYSTEM

Aims, Object and Output of Analysis

Regular monitoring and analysis of the financial sector form an important part of the wider framework of ensuring financial stability. Constant monitoring of market behaviour and development helps to assess the potential risks of the financial system. The evaluation of the efficiency of the financial sector is equally important, since stable development is possible only for an efficiently functioning financial system.

Monitoring and analysis also have an important role in developing financial sector policy. The most important conclusions, which the central bank publishes in its regular surveys, indirectly guide the behaviour of the public and the private sector. The publication of data and analysis' results helps to strengthen market discipline and reduces moral hazard. The choice of additional measures for strengthening the reliability of the financial system also relies on the results of monitoring and analysis.

Besides financial stability related activities, regular analysis of the financial system also provides additional information needed in the evaluation of the sustainability of macroeconomic development.

Financial stability analysis has also been called macroprudential analysis. In this respect it differs from microprudential analysis, which falls under financial supervision and focuses on individual financial institutions. **Macroprudential analysis, which is the responsibility of the central bank, covers the entire financial intermediation of the economy, not just the financial sector (including banking, securities market, insurance).** Such a broader look at financial stability emphasises the role of the real (and public) sector financial behaviour and financial strength as well as the role of general infrastructure in developing the risk valuations of the financial sector.

Eesti Pank has analysed the development of the financial sector since the beginning of independent monetary policy. The analysis became regular and more risk-based in 1997 when the financial markets were particularly vulnerable and systemic risks were relatively high. The launch of the FSA in early 2002 gave an additional boost to developing analysis of the entire system. The separation of institution-based risk analysis from macroprudential analysis created better opportunities for analysing financial stability on the macrolevel at the central bank.

The central bank publishes the summary of the financial sector monitoring in its quarterly Monetary Developments & Policy Survey. Due to the change of emphases in the financial stability analysis, Eesti Pank began compiling the Financial Sector Survey in 2002, dedicated to macrorisks. Initially aimed at supporting the financial policy decisions of the central bank, the survey will be published twice a year starting from 2003. The main spheres of analysis include the systemic risks of the banking sector (including credit, liquidity and market risks), risk factors (including debt burden of households and businesses and their debt servicing ability), efficiency, profitability and financial strength of the banks and the wider international and macroeconomic environment, as well as the development and risks of other financial intermediators (including the securities market, investment funds, insurance) and payment and settlement systems.

Improving the Quality of Analysis[4]

In order to improve financial sector monitoring and analysis, Eesti Pank pays ever more attention to financial sector studies and improvement of analysing methods. Special emphasis has been put on elaborating financial sector forecasts and methods of stress testing. **The long-term goal is to integrate the financial sector forecast into the macroeconomic forecast of Eesti Pank, which would help to improve the quality of both.**

Regular exchange of analytic information with the Financial Supervision Authority also helps to improve the general quality of analysis. The central bank supports the FSA activities with macrolevel surveys and analysis, sharing macroeconomic information on Estonia and its major trade partners as well as financial markets. The central bank, in turn, can use in its evaluations on the stability of the system the microlevel information gathered and analysed by the FSA.

BANKING POLICY IN ESTONIA IN THE PAST DECADE

Amendment of Banking Legislation

The first commercial banks of the former Soviet Union received their operating licences in Estonia in 1988–1989 from the then USSR State Bank (Gosbank). Eesti Pank has been authorised to issue banking licences since 1990. Therefore, the early 1990s can be regarded as a period of double regulation as far as banking supervision is concerned.

Formally, Eesti Pank's supervision activity began in 1992 when the Statute of the Banking Supervision was approved. By 1993, a solid framework of prudential ratios had been worked out[5]. The central bank has based its ratios on the recommendations of the Basel Committee on Banking Supervision at the Bank for International Settlements and more recently also on the requirements set down in EU directives. An extensive reporting has been introduced for monitoring adherence to the ratios and this has been supplemented with the improvement of legislation.

Thus, for example, capital adequacy calculation has been supplemented with sections on different risks (market risks) and the risk measurement has been specified. Changes in most important

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[4] For the role of financial statistics in improving the quality of analysis see p 71.
[5] Prudential ratios included the solvency ratio (later capital adequacy), liquidity ratio, risk concentration limit, maximum exposure to single borrower in relation to bank's own funds (later risk concentration ratio per single or related parties) and open forex net position limit.

lower-level regulations have been preceded by amendments in the Credit Institutions Act, with the aim of supporting banking supervision activities and specifying the requirements set on banks.

Proceeding from potential uncertainties in the economy and the financial sector, banking regulation has been made stricter than the minimum international standards. In reaction to the growth of the banks' loan portfolios and prices at the Tallinn Stock Exchange in 1997, capital adequacy ratio was increased from the internationally recommended 8% to 10%[6]*, in addition to other monetary policy measures applied.*

Due to the expansion of the activities of banks into other countries and in order to better assess the potential risks involved in the more active use of subsidiaries, consolidated supervision has been applied since 1995, which means that the risks of subsidiaries are evaluated together with the parent bank. In order to improve market discipline, the requirement of public disclosure reporting was imposed on banks.

Institutional Development

The institutional development of Estonian banks can be characterised by the following key words: mergers, winding up of weaker banks and involvement of strong owners. This development has been influenced by the entire environment: economic policy, development of the world economy and internal competition of the banking sector combined with higher efficiency and new products. An important landmark in ensuring financial stability was the launch of the deposit guarantee scheme in Estonia in 1998, when the Deposit Guarantee Fund was established and later reorganised into the Guarantee Fund. With the emergence of financial sector conglomerates and tightening of supervision on banking and the entire financial sector, a new unified supervision agency was created – the Financial Supervision Authority, which started operation on 1 January 2002.

The fact that the number of banks has dropped from 42 to 7 over the past ten years characterises the changes that have taken place the best. The main reason for the closure of banks in the early 1990s was changes in the economic environment related to the introduction of the kroon.

Another important reason for the shrinking number of banks was tightening of legislation in mid-1990s, which forced several small banks to merge. This period also saw privatisation of former state banks, which were mostly bought by commercial banks owned by local private capital.

The latest important wave of changes followed the rapid growth of 1997 and the financial crises of Asia and Russia. Excessive risks were taken during the period of rapid growth, which were amplified by the toughening of the external environment. As a result, several small banks went bankrupt. Being part of the financial sector safety net, the Deposit Guarantee Fund that had been set up by that time helped to ensure general financial stability and compensated 90% of the deposits of all small depositors. In larger banks, the change of environment was reflected through mergers and followed by entrance of new core investors from foreign banks. As a result of these changes, the soundness of Estonian banks has increased and the quality of management and efficiency has improved.

Eesti Pank's policy in everyday supervision, amendment of legislation as well as indirect measures has supported the involvement of strategic owners and consolidation of banks. This has laid the foundation for the strengthening of banking and the entire financial sector.

[6] See also Ten Years of Estonia's Monetary Policy, pp 61–62.