ENSURING FINANCIAL STABILITY

One of the main tasks of Eesti Pank is to ensure financial stability in Estonia by creating policies for the financial sector and operating well-functioning payment and settlement systems. The tasks of the central bank form a part of the wider **framework for ensuring financial stability** that includes the relevant legal environment and financial sector policy, efficient supervision and reliable information about the financial sector.

Financial stability means that the operation of the financial system is not interrupted or disturbed to the extent or duration that would considerably hinder financial intermediation and thus also the central bank's primary objective – price stability. In other words, the efficiency of monetary policy largely depends on the functioning of important financial institutions and infrastructure. For ensuring financial stability Eesti Pank mainly focuses on securing a smooth and integral functioning of the financial system and minimising the threat of a systemic crisis.

Forming its financial policy, Eesti Pank relies on continuous monitoring and analysis. The main output of financial sector analysis and stability assessments is the Financial Stability Review, which also includes recommendations on financial sector policy. As regards the performance of the essential components of the financial infrastructure – payment and settlement systems – Eesti Pank prepares special oversight assessments.

Pursuant to the law and the division of tasks within Estonia, Eesti Pank is also the banking sector regulator. In recent years, more attention has been paid to the development and improvement of financial crisis management framework. Being the national central bank of a European Union Member State, Eesti Pank participates in the elaboration of the single financial sector policy and legislation for the common market.

Financial sector analysis and financial stability assessment

Similarly to earlier years, also in 2006 the central topic of the financial stability analysis was the **rapid loan growth and related risks**. Part of the loan growth of Estonian companies and households can be attributed to the relatively low level of financial deepening compared to other countries. However, the brisk growth of indebtedness compared to incomes has also brought along higher risks.

The growing indebtedness inevitably increases borrowers' vulnerability. It may be negatively affected in the coming years by the deceleration of economic growth and an increase in loan-servicing costs resulting from rising interest rates.

Signals that could have changed borrowers' attitudes (e.g. the rise of interest rates, signs of stabilisation at the Tallinn apartment market, the postponement of adopting the euro, signs pointing to possible economic overheating) did not diminish optimistic future expectations. This may be caused by the strong inertia in the behaviour of borrowers, which shows especially clearly in the case of companies initiating new real estate development projects as well as households planning to take a housing loan.

Considering the risks associated with the robust loan growth, Eesti Pank decided to curb over-optimistic expectations with preventive **supervisory and monetary policy measures** (see background information "Measures adopted by Eesti Pank in 2006, p. 34).

As the development of the Estonian banking market largely depends on the activities and objectives of Nordic banking groups, it is essential to have an updated adequate overview of the primary trends and risks in the region. Since 2003, Eesti Pank has been participating in the **cooperation network of Nordic and Baltic central banks** where regular exchange of information and assessments concerning the region's financial stability takes place.

Together with other European Union central banks and supervisory institutions, Eesti Pank participates in the compilation of analyses and assess-

MEASURES ADOPTED BY EESTI PANK IN 2006

As of 1 March 2006, the new procedure for capital adequacy calculation entered into force. Pursuant to that banks had to increase the **risk weight on housing loans** used for calculating capital adequacy to **100% instead of the earlier 50%**.

As a result, the capital buffers of banks increased and risks related to the financial sector decreased. However, this did not entail a change in the behaviour of borrowers and lenders. In order to limit the strong domestic demand driven by loan growth, Eesti Pank decided to **raise the reserve requirement from 13% to 15%** as of 1 September 2006.

As risks remain the same during the two-year forecast period, Eesti Pank decided to **preserve the 100% risk weight on housing loans and the 10% capital requirement for the three-year transition period** within the framework of the new capital adequacy accord (Basel II) that entered into force as of 2007.

ments on financial stability and the financial sector's structure in a wider region. In 2006, the main joint outputs of cooperation were **regular reviews of the European financial stability and banking sector structure**. Special issues, more significant for Estonia, included reasons for the rapid loan growth in Central and Eastern Europe. Moreover, the strength analyses of the EU banking sector were launched.

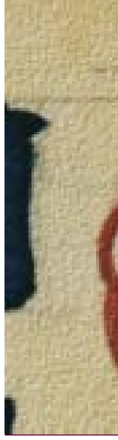
Cross-border cooperation and other EU financial policy issues

Compared to other Member States, Estonia's financial sector is more integrated and thus Eesti Pank pays special attention to those EU financial policy issues that deal with the **cross-border integration of the financial sector** and the resulting requirements on ensuring financial stability.

One example of cross-border cooperation is the **harmonisation of supervision**, which includes establishing common procedures and requirements as well as common supervisory principles and views. An important benchmark in the harmonisation of financial supervision was the adoption of the Lamfalussy framework. However, in this context we can speak of harmonising a regulatory framework rather than practices. As most credit institutions operating in Estonia are subsidiaries of banks registered in other Member States, the perspective of the host country in the division of tasks concerning cross-border financial stability is especially important for Estonia. In other words, as a result of harmonising practices and the improved efficiency of supervision, it is only natural that some of the competence is transferred to the supervisory authorities of the host country, but in that case also responsibility should shift together with the rights.

Another important issue in ensuring cross-border financial stability is the **organisation of crisis management** and the related principles for banking groups operating across borders.

From the central bank's viewpoint, the third important field of financial sector cross-border activities is **securities settlements**, i.e. the post-trading infrastructure of the securities market. One of the major obstacles in creating a single European Union capital market is the lack of interoperable securities settlement systems. After completing an analysis mapping the shortcomings, it was possible either to support the integration of settlement systems by non-regulatory measures or apply an approach based on common legislation. It was decided to opt for the first possibility, which is better from the perspective of free economy but has some drawbacks as to guaranteeing fair competition and



effective application. In addition, the European Central Bank proposed to start providing a central securities settlement service in the Eurosystem. The project was called **TARGET2-Securities**. A consultation round involving various interest groups began at end-2006, as a result of which a final decision concerning the creation of an appropriate central infrastructure will be made.

As regards amending EU directives, the proceedings of two draft legislation were of special importance for Eesti Pank. The first dealt with the **amendment of sections regulating mergers and acquisitions in the directive laying down provisions for the take-up and pursuit of the business of credit institutions**. The aim of the amendment is to accelerate the process of cross-border acquisitions and mergers of market participants in the European Union via a more harmonised legal framework applicable throughout the European Union. The second proceeding concerned the **directive on payment services**, which should stimulate the creation of a single market for payment services, uniform access for market participants and their equal treatment. In this area, the topics important for Eesti Pank include the supervision of payment service providers, the scope of harmonising the terms and conditions for the transparency of payment services and the scope of rights and obligations in the provision and usage of payment services.

Financial safety net

As regards the financial safety net, Eesti Pank's main priority in 2006 was developing domestic and cross-border cooperation on crisis management. Eesti Pank concluded cooperation agreements on the management of financial crises with major domestic and foreign cooperation partners and participated in crisis management exercises.

On 5 December 2006, Eesti Pank, the Financial Supervision Authority and the Ministry of Finance concluded a Memorandum of Understanding (MoU) on the management of financial crises. The goal of this agreement is to improve the readiness of institutions responsible for Estonia's financial stability to act in a crisis endangering the financial system. The MoU lays down the tasks for the parties and grounds for taking coordinated action in case of crises that threaten the financial system stability. The MoU emphasises the primary responsibility of bank owners and management boards in securing the financial soundness of the bank and bearing the costs arising from crises. The state provides liquidity or capital support for solving a crisis affecting the financial system only if private sector solutions are ineffective or insufficient.

On 18 December 2006 in Stockholm, Eesti Pank and the central banks of Latvia, Lithuania and Sweden concluded a Memorandum of Understanding (MoU) on the management of financial crises. The goal of the MoU is to enhance cooperation in the event of a financial crisis concerning cross-border banking groups. According to the MoU, the central bank that is first to identify a potential financial crisis is obliged to inform also the other parties to the agreement. In addition to information exchange in case of potential financial crises, the MoU discusses regular cooperation on sharing information and assessments under normal circumstances.

The organisation of **crisis simulation exercises** supports the elaboration of an appropriate crisis management framework. In spring 2006, a joint financial crisis exercise of Eesti Pank, the Financial Supervision Authority and the Ministry of Finance took place. The main aim of this exercise was to harmonise participants' understanding of their and other parties' roles and test mutual information exchange and communication with the public in a crisis situation. The training provided valuable experience and improved the institutions' understanding of the needs and possibilities for effective crisis coordination.

In addition to the domestic crisis exercise, in April 2006 Eesti Pank, the Financial Supervision

Authority and the Ministry of Finance also participated in a cross-border financial crisis exercise arranged by the Economic and Financial Committee. The so far most extensive exercises (with 76 institutions participating) included testing various processes regarding domestic and cross-border information exchange, systemic crisis assessment, decision-making and cost distribution.

The results of the EU crisis exercise confirmed that current cross-border financial crisis management still has some shortcomings. For instance, problems occurred in the distribution of crisis-related costs among cross-border banking groups. Assessments of crisis solutions and situations evoked different understandings as well. Thus, the development of the cross-border crisis framework remains a priority in the EU financial sector policy. For the elaboration of the principles and procedures of solving crises and the principles of sharing costs, a high-level EU working group was formed. Eesti Pank is participating in the process of elaborating systemic crisis assessment principles via a task force composed of banking supervision authorities and central bank representatives.

Another crucial component of the Estonian financial safety net is the **deposit guarantee schemes**. Deposit insurance is mandatory for banks operating in Estonia since 1998, and from July 2002 it is managed by the Guarantee Fund. Apart from the Deposit Guarantee Sectoral Fund, the Guarantee Fund comprises the Investor Protection Sectoral Fund and the Pension Protection Sectoral Fund. In 2006, the upper limit of coverage for deposits was 200,000 kroons per depositor and by end-2007 it will reach the level provided for in the EU directive (20,000 euros, i.e. 313,000 kroons).

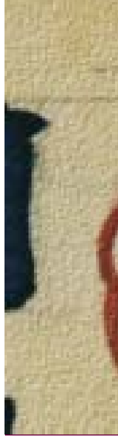
The role of Eesti Pank is to provide analytical support to the Guarantee Fund in determining the amount of appropriate contributions for guaranteed deposits. Given the accelerating growth rate of deposits in 2006 and the necessity for guaranteeing a sufficient amount of funds in the ex-ante funded deposit insurance scheme, the Supervisory Board of the Guarantee Fund decided to raise the quarterly contribution from 0.09% to the maximum allowed level of 0.125% of guaranteed deposits. This step takes into account the objective of sectoral funds in terms of volume, an increase in the upper limit of coverage and the growth pace of deposits.

Banking legislation

In 2006, the **national transposition of the new European Union directive laying down the principles for capital adequacy calculation** was completed, involving considerable amendments to the existing Credit Institutions Act and the elaboration of a new regulation on prudential ratios.

The provisions of the directives on the minimum capital requirements of credit institutions derive from the new procedure for calculating capital adequacy (Basel II) elaborated by the Basel Committee on Banking Supervision operating at the Bank for International Settlements (BIS). Both Basel II and EU directives are based on three pillars. The first pillar establishes a more risk-sensitive methodology for calculating capital requirements. The purpose of the second pillar is to emphasise the importance of banks' internal assessment of risk management and capital needs. The third pillar aims to help guarantee a sufficient level of capital adequacy by means of market discipline and wider public disclosure requirements.

The Credit Institutions Act lays down general rules for calculating the minimum capital requirements and a framework for interpreting the second and third pillar's principles. The importance of internal assessments and self-control has significantly increased in the new framework, whereas that of normative regulations has decreased. An important innovation is the opportunity for banks to calculate their capital needs on the basis of internal risk assessments. Furthermore, pursuant to the new framework apart from the credit risk and market risk also the operational risk has to be taken



into account in calculating the new minimum capital requirements.

For determining the rate of capital requirement on the basis of the new capital adequacy framework, detailed rules were laid down in a regulation of Eesti Pank. The focus of the regulation is on the first pillar of the new capital adequacy framework. Its main difference from the EU directive is that **in Estonia the capital requirement for credit risk as well as market risk will remain at the current level of 10%** (see background information "Measures adopted by Eesti Pank in 2006").

As the changes are extensive and the enforced rules very different than before, in 2007 credit institutions may choose whether to calculate capital requirements according to the existing or the new procedure.

Payment systems oversight

Regarding the oversight of payment systems, the most significant activity of 2006 was the **assessment of the compliance of Estonia's payments and securities settlement systems with the requirements of the Eurosystem**. In all EU Member States whose currency is the euro or who want to join the euro area, systemically important settlement systems have to comply with the principles of the Eurosystem and these systems must be officially recognised as eligible for the Eurosystem. The settlement systems that belong to the scope of the Trans-European Automated Real-Time Gross Settlement Express System (TARGET), i.e. the Real-Time Gross Settlement (RTGS) systems operating in the Member States, as well as the systems used for the settlement of claims and liabilities arising from central bank's monetary policy operations and liquidity providing transactions, are regarded as systemically important settlement systems.

The European System of Central Banks (ESCB) assessed the following systems: the EP RTGS system managed by Eesti Pank and the securities settlement infrastructures, which, more precisely, is an arrangement created in conjunction with international central securities depositories for concluding transactions between Estonia's central bank and commercial banks, as well as the securities settlement system managed by the Estonian Central Depository for Securities (ECSD). According to the ESCB, **all the above-mentioned systems were eligible for the Eurosystem**.

Regarding the RTGS system managed by Eesti Pank, most attention was paid to the legal basis of the system, its compliance with the security requirements of TARGET and the definition of settlement finality in the system's rules. Proceeding from the assessment given by the overseer, Eesti Pank has made or will soon make all appropriate changes.

The arrangement created for transactions with international central securities depositories was assessed to be compliant with the standards, but prior to its adoption the Governing Council of the European Central Bank must approve it as a possible arrangement to be used as an exception in the Eurosystem.

Even though Eesti Pank is not currently using the domestic securities settlement system managed by the **Estonian Central Depository for Securities** (ESCD) to conduct central bank transactions with securities as collateral, at the request of the ESCD the system managed by the ECSD was also assessed. As a member of the Eurosystem the central bank will only use the securities settlement system managed by the ESCD if it settles securities eligible as collateral for Eurosystem credit operations. According to the assessment, the securities settlement system managed by the ECSD is eligible for the Eurosystem, but there are time limits on conducting transactions for securing intraday settlement finality. Furthermore, in order to be fully compliant with the requirements of the Eurosystem, the ECSD must apply ESCB guidelines in risk management and arising from the operational requirements of TARGET.