ENSURING FINANCIAL STABILITY

The stability of the financial system is secured when the smooth functioning of the entire system is ensured. One of the missions of Eesti Pank is to safeguard the stability of the Estonian financial system. For this purpose, Eesti Pank monitors and analyses the functioning of the financial sector and assesses the threats to it. If necessary, the central bank takes measures to minimise the risk of such threats materialising.

Eesti Pank works with the Ministry of Finance and the Financial Supervision Authority in ensuring the reliability of the Estonian financial system and the appropriateness of the regulation underpinning the financial sector. The principles of cooperation and the division of tasks are set out in the Memorandum of Understanding concluded in 2007. A committee of representatives of these bodies has been set up to organise day to day cooperation.

The Estonian financial sector is globally integrated, with the development and performance of the local financial system depending largely on events in the outside world. It is thus essential to maintain cross-border cooperation with the institutions that have an influence on the sector's operational environment. As a member of the European System of Central Banks (ESCB), Eesti Pank participates in the joint activity of the central banks of EU countries. Eesti Pank also formulates and expresses Estonia's positions on the EU financial stability framework and financial sector policy matters.

Above all, the Estonian financial system is interlinked with the financial systems of its neighbouring countries. Productive cooperation with the central banks of Nordic and Baltic countries is thus very important. In August 2010, the ministries of finance, central banks and financial supervision authorities of the Nordic and Baltic countries entered into an agreement on the prevention and management of financial crises. A cross-border financial stability group, the first of its kind in Europe, was set up in the autumn, consisting of representatives of the signatory bodies. The main objective of regional cooperation is to ensure the smooth functioning of the financial system, prevent the spread of financial crises and minimise the overall costs related to the financial crisis.

Financial sector analysis and financial stability assessment

The main output of the financial stability analysis conducted by Eesti Pank is the biannual Financial Stability Review. In addition to the results of analyses, the Financial Stability Review also contains the central bank's assessment of financial stability. The scope of the review was clarified more precisely in 2010, so the review now focuses expressly on the processing and assessment of financial stability risks.

According to Eesti Pank's financial stability assessment published at the end of 2010, the threats endangering financial stability did not increase in Estonia during the year, but neither was the risk level lowered by tensions brewing in the global economy and financial markets. The direct effect of the threats posed to the Estonian financial system by the unstable external environment was mitigated by the incorporation of the major banks operating in Estonia within Nordic banking groups. The permission to accede to the euro area and to join the Organisation for Economic Co-operation and Development (OECD) added to the reliability of the Estonian financial environment in the eyes of the outside world. The improved outlook for economic growth gradually lowered the credit risk related to Estonian private individuals and companies. The improvement in loan quality facilitated the growth in profitability and the capitalisation of banks.

Eesti Pank conducts banking sector stress tests to evaluate the performance of the financial system. These tests are based on macro-scenarios, with the methods themselves being continually improved. According to regular stress tests conducted in 2010, the banks had sufficient capital buffers to cover contingent risks.

Eesti Pank started preparing the Lending Review in the autumn of 2010. The biannual review analyses the need for financing of Estonian private individuals and companies, and the availability of funds and the lending terms and conditions, matters which were previously addressed in the Financial Stability Review. The new output focuses on specific funding-related issues and provides a higher-quality input for economic forecasts.

From 2011, further lending market analysis will be provided in the Bank Lending Survey. With Estonia's accession to the euro area, Eesti Pank incurred the obligation to poll on a quarterly basis the banks that are most active in the local lending market on the changes experienced and expected in credit demand and credit supply. The results of the survey conducted in the euro area will be used for the preparation of monetary policy decisions and in analysis of the effect of the measures applied. In 2010, the specialists of Eesti Pank agreed with the European Central Bank on the implementation of the survey and the technical solutions for communicating the data from it.

Within the ESCB, Eesti Pank and other central banks, along with the supervision authorities contributed to the preparation of the EU financial stability assessments. The most important subjects for Estonia's financial stability among those addressed by the European Central Bank and the Member States in 2010 included the fall in financial leverage and the risk level of foreign currency loans. Eesti Pank emphasised the need to address the decrease in financial leverage, in addition to financing restrictions, from the point of view of the demand and need for credit in the real economy. As regards foreign currency loans, Eesti Pank noted that the risks related to credit growth must be analysed comprehensively, with the same principle also being applied to the preparation of risk-mitigation measures.

Financial sector policy and regulation

Events in the global financial system have created a need to enhance supervision and improve regulation of the financial sector. The key subjects addressed by the European Union in 2010 included the launch of the financial sector supervision reform, the termination of state aid measures, the organisation of cross-border cooperation, crisis management, and the raising of the capital requirements for banks. Eesti Pank participated in the discussions as a member of the ESCB in the Economic and Financial Committee.

The crisis management measures related to the EU financial sector safety net were developed further. The ultimate objective is to create a framework that would allow for a swift and smooth reorganisation or dissolution of financial vehicle corporations that are facing problems, on a uniform basis. Estonia drew attention to the crisis management of cross-border groups in the discussions. Special attention was also paid in 2010 to covering the costs of the crisis. In June, the European Council agreed on the principle that the banking sector must contribute to covering the costs of the crisis, with the Member States thus required to set the charges and taxes for the banks. Eesti Pank has supported the general principle that the costs of the banking crisis should, first and foremost, be borne by the banks themselves. Nonetheless, emphasis must be laid on preventing double taxation, harmful competition and other factors that endanger the single service market. Overall, the framework must facilitate the efficient functioning and stability of the single European financial market.

In connection with the introduction of additions to the laws governing the financial sector, the amendments to the Capital Requirements Directive for the banking sector (the CRD-II), adopted by the European Parliament in 2009, were transposed into the national law in 2010. These amendments addressed the enhancement of cross-border cooperation between financial supervision authorities, tightening up the requirements for securitisation and the concentration of exposures in banks. In the next stage of revision of the Capital Requirements Directive (the CRD-III), the European Union approved the supplementary amendments which serve to strengthen the requirements for the trading book, disclosure of securitisation exposures and remuneration policies. These additions must be transposed by the Member States by the end of 2011.

The development of the prudential ratios of the banking sector continued on a global scale with the preparation of the Basel III framework. The new regulatory framework establishes stricter requirements for the own funds held by credit institutions, lessening the amplification of the economic cycle, and it tightens up the liquidity requirements. Following the recommendations of the Basel Committee on Banking Supervision, the European Commission continued to develop further the prudential ratios of banks, proposing the amendment of the Capital Requirements Directive (the CRD-IV) scheduled to be prepared by the middle of 2011. Eesti Pank has supported the strengthening of the banks' capitalisation and harmonisation of the minimum requirements within the European Union. Alongside the needs of the common market, the position of each Member State and the specific risks to its financial stability must be considered.

The protection of depositors, investors and pension fund shareholders forms an integral part of the safety net for the financial sector. In 2010, the European Commission made proposals for amendments to the Deposit Guarantee Schemes Directive and the Investor Compensation Schemes Directive, initiating negotiations with the Member States. The ultimate aim is to harmonise further the EU deposit guarantee systems, simplifying and reducing the scope of deposit guarantees and the payout methods. These proposals have also been supported by Eesti Pank.

In December 2010, the Riigikogu adopted a law to enhance the protection of depositors, raising the minimum coverage level to 100,000 euros and reducing the term of payout to 20 working days. Entering into force on 1 January 2011, the law adds the deposits of large companies to the list of guaranteed deposits. In consideration of the deposit growth forecast, the Supervisory Board of the Guarantee Fund raised the quarterly contribution to the Sectoral Fund from 0.025% to 0.047% at the recommendation of Eesti Pank. The higher rate will apply from the second quarter of 2011.

An amendment to the law was passed in 2010 to prevent financial crises occurring, and to enhance the efficiency of the management of them, by extending the rights of the Financial Supervision Authority to intervene in and inspect the activities of banks in an emergency or crisis. As an important amendment, the state was granted the right to consider expropriating the shares held by the owners of banks operating in Estonia. This is an extreme measure, only to be applied if the other planned measures fail to secure the stability of the national financial system.

To provide an alternative to bankruptcy for private persons, the Riigikogu passed the Debt Restructuring and Debt Protection Act, which allows the debts of natural persons temporarily facing financial difficulties to be restructured. Eesti Pank submitted its views on the draft act twice, expressing concern that the entry into force of the act in the proposed form may urge banks to stop lowering interest margins and to restrict the loan supply. The act will enter into force in the second quarter of 2011.

An important step was taken in the implementation of the EU supervision reform and the reduction of systemic risks with the establishment of the European Systemic Risk Board (ESRB) and three supervisory authorities after tense negotiations between the Council of the European Union, the European Parliament and the European Commission. The first official meetings of the ESRB and the new supervisory authorities took place in January 2011. The new EU financial stability framework serves to improve the sense of security and create the conditions for successful prevention of financial crises in the future.

Changes in the EU financial stability framework

Immediately after the eruption of the global financial crisis, the European Commission set up a high-level working group led by Jacques de Larosière. The working group was charged with the task of preparing recommendations for improving financial supervision within the European Union so as to protect the interests of the citizens and restore confidence in the financial system. The group proposed establishing a system of financial supervision authorities in order to enhance the efficiency of cooperation between the supervisory authorities. The working group also proposed setting up a body for conducting macro-prudential supervision over the risks endangering the EU financial system. Negotiations were immediately launched for the implementation of the reforms. At the end of 2010, the Council of the European Union and the European Parliament agreed on the launch of the supervision reform.

The new EU supervisory framework entered into force on 1 January 2011. Three separate supervisory authorities were established for the purpose of enhancing cooperation in banking, securities markets and insurance supervision: the European Banking Authority, the European Insurance and Occupational Pensions Authority and the European Securities Market Authority. The EU supervisory authorities are composed of the national supervisory authorities, and representatives of the EU institutions. The new supervisory authorities have more options and obligations in organising pan-European financial supervision and preparing regulations than they had under the earlier cooperation framework. The European supervisory authorities have been charged with contributing to the preparation of and binding implementation of common standards, promoting a common supervisory culture, settling supervisory disputes and applying EU law in the Member States consistently.

The reform significantly expanded the role of central banks in safeguarding financial stability. Given the central banks' experience in macro-prudential supervision, the European Systemic Risk Board was set up with the European Central Bank. The ESRB is composed of the Governors of NCBs, the President and Vice-President of the European Central Bank, a member of the European Commission, the chairs of the European supervisory authorities and the chairs of the Advisory Scientific Committee and the Advisory Technical Committee. The representatives of the national supervisory authorities, and the President of the Economic and Financial Committee are members without voting rights. Eesti Pank is represented at the General Board of the ESRB by Governor Andres Lipstok.

The European Systemic Risk Board is responsible for the macro-prudential supervision of the EU financial system. Among other things, the ESRB must monitor and evaluate the functioning of the EU financial system and the systemic risks endangering the system. If the ESRB identifies a significant risk, the ESRB will issue a warning and, if necessary, recommendations for remedial action. These warnings and recommendations will, if necessary, be issued to the entire European Union, or to one or several Member States or supervisory authorities.