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MINISTRY of FINANCE of the REPUBLIC of ESTONIA

REVIEW OF THE ESTONIAN FINANCIAL SYSTEM

January 2013

Tallinn

Introduction

The Estonian financial sector is financially strong and sound at present. Capitalisation in the banking sector is good and rapid deposit growth has provided sufficient funding for gradual increases in credit volumes. Despite the weaker external demand, the still buoyant economic activity has supported corporate revenues and stimulated the labour market. The financial position of Estonian households and businesses has also improved further, as their indebtedness has declined and their financial assets have increased. As a result, the Estonian economy has become more resistant to potential external shocks and has gained a solid foundation for balanced credit growth.

The risks to financial stability in Estonia are primarily related to the uncertainty caused by the European sovereign debt crisis and the poor growth outlook for the euro area. The financial markets have retained their high confidence in the Nordic parent banks throughout the euro area debt crisis and contributed to the strength of the Estonian banking sector. However, the weakened economic stance of the euro area may exert a negative impact on the loan repayment ability in the Nordic region through a contraction in external demand. Furthermore, the great dependence of the parent banks on market-based funding makes them vulnerable to possible unease on the financial markets.

The Estonian financial system is closely linked to the systems of the Nordic and Baltic countries, so efficient and effective cross-border cooperation with the neighbouring countries is highly important for safeguarding financial stability in Estonia. Effective cooperation should help Estonia in assessing macro-financial stability, taking timely preventive measures and building up buffers to preserve financial stability in the highly integrated regional banking market. The Estonian authorities consider the Nordic-Baltic cooperation in micro- and macro-prudential supervision to be an integral part of their everyday activities alongside their ongoing work on developing the financial safety net in the region.

The steps taken in recent years to strengthen the EU financial stability and supervision framework will make an essential contribution to financial stability in Estonia. The agreed establishment of the single supervisor for the euro area banks together with the implementation of the “single rule book” should ensure harmonised regulation and the convergence of supervisory practices for European banks. From a macro-prudential perspective the Estonian authorities find it necessary to have the tools to address country-specific risks, either cyclical or structural. Developing an effective framework for deploying macro-prudential instruments is one of the near term priorities of the authorities. Considering the financial sector’s structure in Estonia, it is essential to ensure the cross-border applicability of the tools. For this reason, it is important to have effective cooperation with other authorities in the EU and more specifically in the Nordic-Baltic region.

The Review is prepared by a joint expert team of the three authorities involved in safeguarding financial stability in Estonia: Eesti Pank, the Estonian FSA and the Ministry of Finance. Primary contributors to the Review include: Silver Karolin, Hanno Kase, Jana Kask, Kaspar Oja, Taavi Raudsaar, Evelin Viilmann (Eesti Pank), Ilja Hlebov, Gerle Reinumägi, Dmitri Sokolov (EFSA), Helen Korju and Kadri Siibak (Ministry of Finance). The team was led by Jana Kask, deputy head of the financial stability department of Eesti Pank.

The Review uses data available as at 25 January 2013

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1. Macroeconomic context

The Estonian economic situation remains strong. The recovery from the recession of 2008-2009 has been fast as GDP surged by 8.3% in 2011. The largest contribution to growth was provided by the export oriented industrial sector, which benefited from increasing foreign demand. Export-driven growth has lessened the economic imbalances that had grown up during the boom years by improving external balance significantly, bringing a better consistency between productivity and wages, and lowering indebtedness.

However, in the second half of 2011 foreign demand started to weaken as the situation in external markets worsened due to the sovereign debt crisis. The share of Estonian exports going to the most vulnerable countries is small, and therefore the direct impact of the crisis through the trade channel has been limited. Nevertheless, the low confidence and high uncertainty that have been caused by the crisis affect Estonia's other trade partners, including non-euro area partners.

Strong domestic demand has counterbalanced weaker exports. Increased employment and income growth have supported growing consumption, and at the same time investments have been very strong, with capital formation in fixed assets surging by another 30% in 2012q3, while both private and government investments have contributed to growth. Part of the rapid investment growth is a result of one-off measures, as a large share of the sales turnover from Assigned Amount Units (AAU) was invested in 2012. Although domestic demand has supported growth so far, the share of the exporting sector is large in Estonia and export growth is needed for balanced growth.

Industrial production started to grow in the second half of 2012 as industrial exports to non-euro area countries showed a steady increase. According to Eesti Pank's forecast, the export growth will compensate for the lower contribution of investments in 2013, while growth in external markets is expected to gradually resume. However, as foreign demand growth will remain below its historical average in the first half of 2013, the average growth for the year will be relatively low, close to the figure for 2012 (see Figure 1). Still, as the situation in external markets remains uncertain, it is not impossible that GDP growth in 2013 may be lower than in 2012.

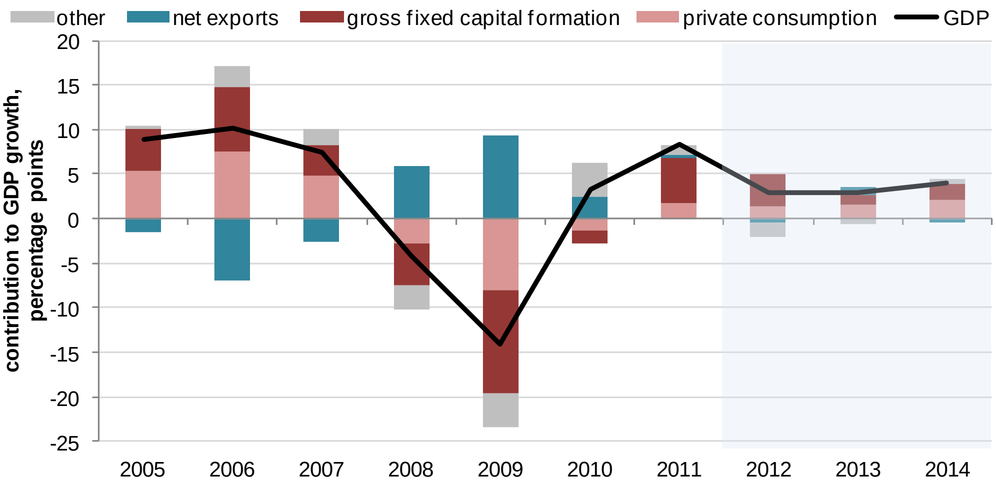

Figure 1. Gross domestic product by expenditure approach
Source: Statistics Estonia, Eesti Pank forecast

Economic growth has helped to heal the scars of recession. The unemployment rate has fallen significantly from its peak of 19.8% in 2010q1 to 9.7% in 2012q3. Unemployment has been decreasing due to an increase in employment, while participation in the labour force has also increased. The lower share of long-term unemployed indicates that the structural problems of the labour market are diminishing. Employment growth is slowing as employment is already high and the unemployment rate is close to equilibrium.

In recent years inflation has mainly been driven by external factors like food and energy prices. It is assumed that external price pressures will be lower in the coming years because of the weak external environment (see Figure 2). Estonian inflation will exceed the inflation target of the euro area as Estonian price and wage levels are converging with the levels in high income European countries. Inflation will accelerate temporarily in January 2013 due to rises in electricity prices.

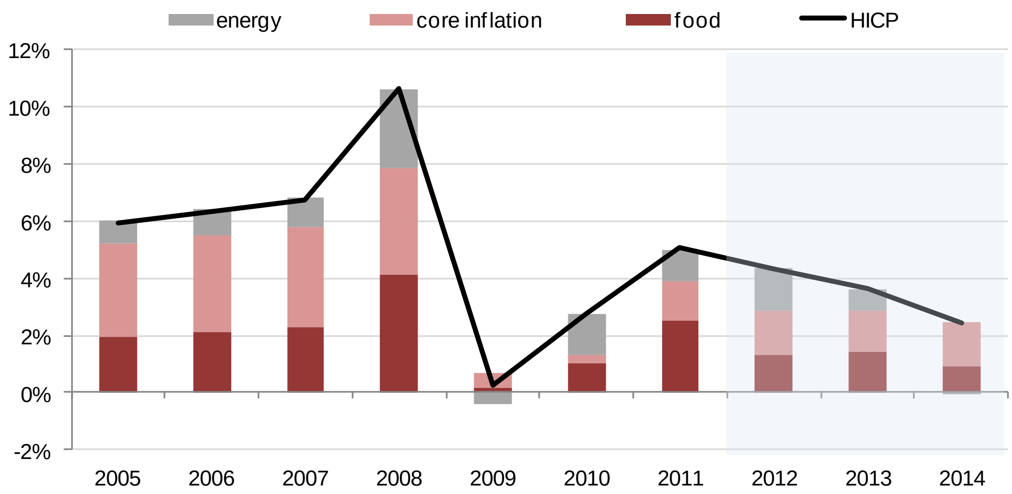

Figure 2. Consumer prices

Source: Eurostat, Eesti Pank forecast

Estonia's fiscal policy is solid. The general government budget deficit is small and the need for future consolidation measures is much lower than in most countries in Europe. According to projections by Eesti Pank, the budget deficit will be 0.5% of GDP in 2013 and close to zero in 2014. The Estonian government sector is a net-lender as general government debt is currently the lowest of any EU country and fiscal reserves exceed debt liabilities. In turbulent times the reserves accumulated in previous years can be used to finance government expenditure and smooth the cycle.

2. Indebtedness and credit growth

Real sector credit growth

After many years of unprecedentedly high credit growth the loan and leasing portfolio of banks started to decline in autumn 2008, and the subsequent deleveraging lasted for more than three and a half years. In April 2012 the lending stock started to grow again, while annual growth rate returned to positive territory some months later (see Figure 3). By the end of 2012, the credit stock was at a level last witnessed in the middle of 2007, though this is 16% less than at the peak in autumn 2008.

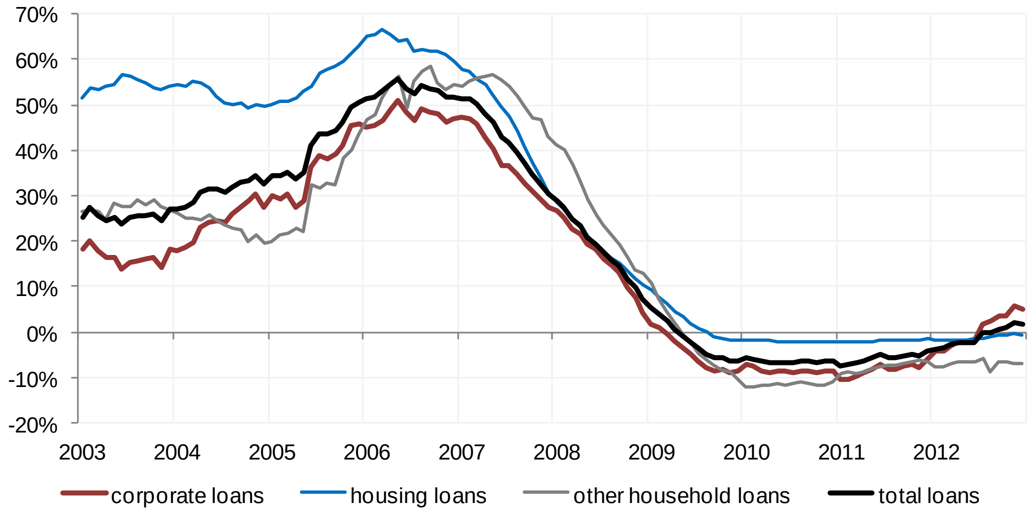

Figure 3. Annual growth of banks' loan and leasing portfolio
Source: Eesti Pank

The recent credit growth has mostly been driven by increased borrowing activity in the corporate sector. In 2012 the loan turnover in the corporate sector was up 22% on a year earlier. Although the rise was largely based on short-term loans for financing growth in business activity, growth in long-term loans also accelerated in 2012. New lending volumes to the household sector increased at an annual growth rate of less than 10% in 2012, while the growth was stronger in housing loans at 16% and in car leasing at 29%.

According to Eesti Pank's forecast, the growth in the loan turnover will slow to 12% in 2013 as the reference base becomes higher. As a large part of the loan turnover comes from the refinancing of earlier loans and the loan portfolio is being shrunk by write-offs of non-performing loans and by natural depreciation, the loan stock has grown much less quickly than loan turnover. In the next few years the loan and leasing portfolio of banks will grow by 4-5%, according to the forecast.

Private sector indebtedness

The future growth in private sector indebtedness is largely determined by past developments in borrowing. Over the last decade, two periods can be distinguished with rapid accumulation of debt in 2005-2008 and a remarkable deleveraging in 2009-2011.

Growth in indebtedness in 2005 – 2008. The global environment of abundant liquidity and low risk aversion contributed to the inflow of capital into Estonia and the other Baltic countries. Developments in the region gave plenty of reason for optimism, with expectations of a rapid equalising of income and prices with those of Western Europe. The accession to the European Union instilled confidence and lowered risk assessments. Competition between foreign banks over market share brought down the interest margins and led to relaxed lending standards, such as an increase in LTVs, long maturities for housing loans, and lower requirements for income. In consequence, the favourable global and domestic conditions led to a rapid accumulation of debt in 2005-2008, when credit growth significantly outpaced the growth of nominal GDP (see Figure 4).

As a share of GDP, private sector indebtedness peaked in the middle of 2010 at 167%. However, since the accumulation of the debt had actually already turned in autumn 2008, the continued increase in the ratio was caused by the deep fall in nominal GDP, and developments in the debt to GDP ratio in 2009-2010 should be assessed against this background.

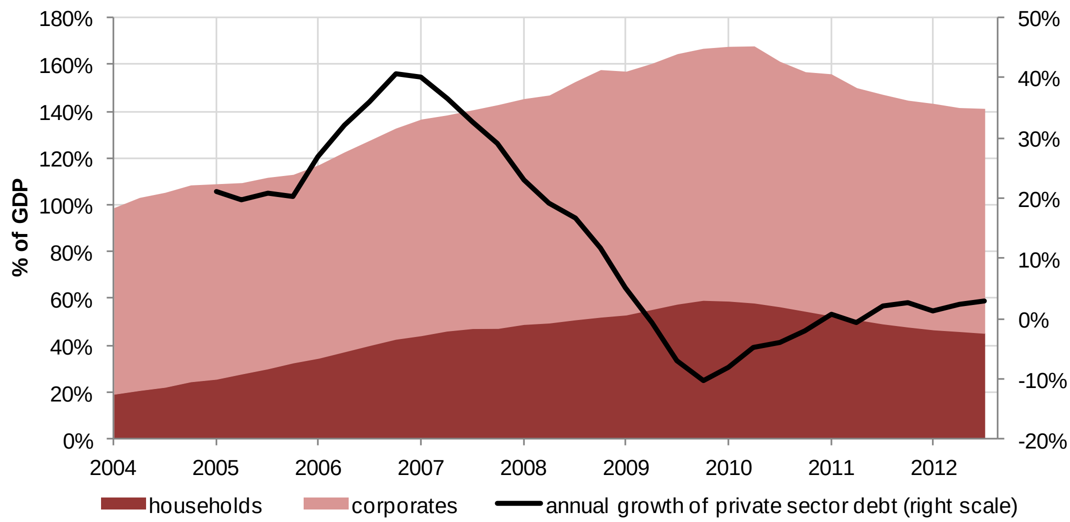

Figure 4. Private sector indebtedness
Source: Eesti Pank: Financial accounts; Statistics Estonia

In order to cool the optimism in the lending market and to support the reliability of the banking sector, Eesti Pank and the EFSA took several measures in 2005-2007. Most importantly the risk weighting on housing loans used for calculating capital adequacy was raised from 50 to 100 percent in March 2006. In addition, Eesti Pank raised the mandatory reserve requirement for banks from 13% to 15%, in September 2006. As a result of these measures, the capital and liquidity buffers of banks increased substantially and risks related to the financial sector decreased. However, the effect of the measures on credit growth remains unclear, although activity in lending started to retreat and prices in the real estate market to decline in late spring 2007. This shows that the adaptation to sustainable levels started before the impact of the Lehman event in autumn 2008.

Deleveraging in 2009-2011. A decline in banking sector leverage in Estonia was first noticed in the autumn of 2008, when the loan portfolio decreased in October for the first time in monthly comparison. Immediately after the culmination of the global financial crisis in the autumn 2008, banks substantially tightened their credit standards and loan conditions, raising loan margins by a factor of two and a half for instance, and restricted lending (see Figure 5). During the deep recession in 2009, banks focused on the quality of their portfolios, seeking solutions for non-performing loans. The high capitalisation of the banks allowed a relatively active restructuring of the loans. In 2010-2011, the credit standards were gradually loosened and several major banks were prepared to finance, under relatively favourable terms, many more creditworthy loan projects than they received applications for.

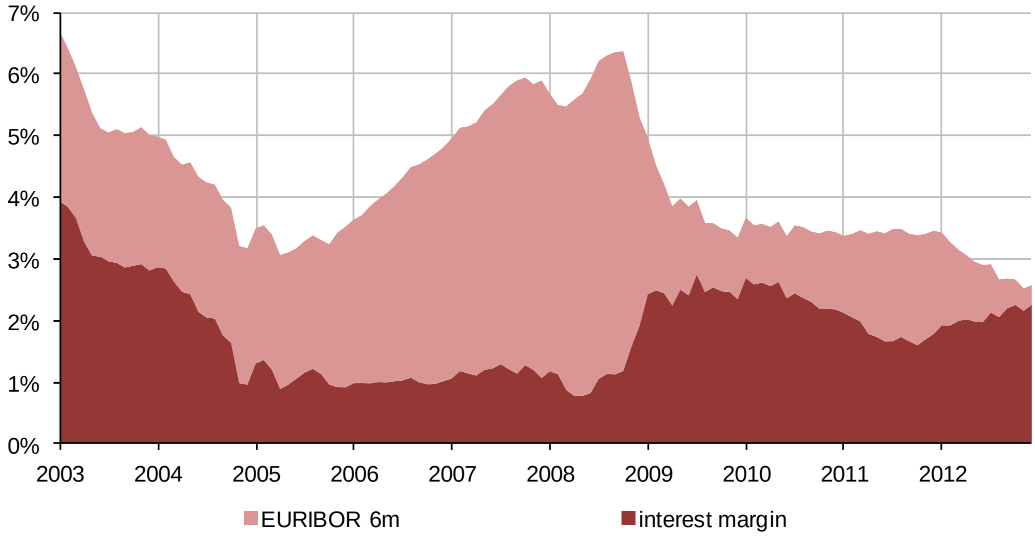

Figure 5. Weighted average interest rate on new housing loans
Source: Eesti Pank

The leverage of the banks operating in Estonia mainly decreased due to substantial changes in the financial behaviour of the non-financial sector. Indebtedness has decreased, the volume of deposits has increased, and the corporate debt-to-equity ratio has fallen, which together indicate that the private sector wishes to deleverage.

The financing structure of the Estonian corporate sector. Changes in the debt structure of the corporate sector explain quite a significant part of private sector indebtedness in Estonia. The most important source of corporate debt-based funding is domestic bank loans and leases. During the boom years the fastest growing area of corporate debt – real estate related financing – was primarily based on domestic bank loans. The deleveraging in 2009-2011 was mostly attributed to bank loans and leases, which accounted for almost a half of corporate debt at the end of the third quarter of 2012 (see Figure 6).

Given the large share of FDI in the Estonian economy, the limited domestic securities market (see Chapter 4, Estonian financial markets) and foreign investments abroad, borrowing from foreign residents has been an important source of funding for companies. Together with export-driven recovery and structural changes after the recession, the loans taken from abroad directly or through parent companies have gained even more importance during the last four years and accounted for around one third of total corporate debt by end of the third quarter of 2012. Corporate debt also contains intra-sector debt. If liabilities to other domestic non-financial firms are excluded, total corporate debt would be nearly 15 percentage points lower.

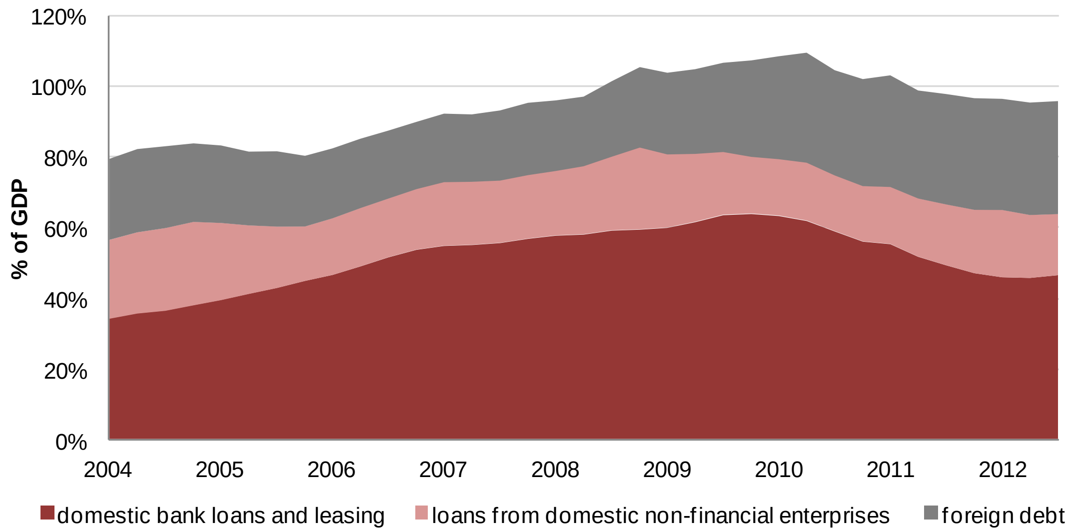

Figure 6. Corporate indebtedness by source
Source: Eesti Pank: Financial accounts

Indebtedness in 2012 - … By the end of the third quarter of 2012 the level of private sector indebtedness stabilised at 141% of GDP[1]. Given the high share of long-term loans in the banks' credit portfolio (the share of housing loans was 40% of total loans at the end of 2012 for example) and the need for investments in the continuing catching-up process, the ratio of private sector debt to GDP is expected to remain relatively stable or to increase slightly in the forthcoming years. Financial deepening will continue, but a rapid growth in indebtedness is not very likely since many structural factors evident in the boom years were one-off factors.

Developments in the real estate market

Activity in the Estonian housing market has increased somewhat since the economic recovery. In the last two years, the liquidity of the residential market has been improving and prices have been rising gradually. Although the relatively high growth rates in transaction volumes and prices indicate enhanced market activity, this can mainly be attributed to the post-crisis decline and the subsequent recovery from low levels. The residential market still operates at the level of 2005, which is approximately 40% below the peak of the real estate boom in 2007 (see Figure 7).

The rise in real estate prices has been partly caused by a change in the structure of transactions as better quality and more expensive properties have been bought and sold. Factors contributing to the changed structure of the transactions include the improved financial position of households and positive labour market dynamics, as well as low interest rates, favourable loan conditions from banks and a recovery of activity in the construction market.

[1] Household debt was equal to 45% of GDP and 86% of disposable income at the end of the third quarter of 2012.

Even so, Estonia has witnessed a drop in the supply side of the real estate market since the end of 2011 with the real estate supply decreasing by nearly 10%. The demand will fuel new developments, while the rise in constructions prices will be the balancing factor, preventing the initiation of rapid development.

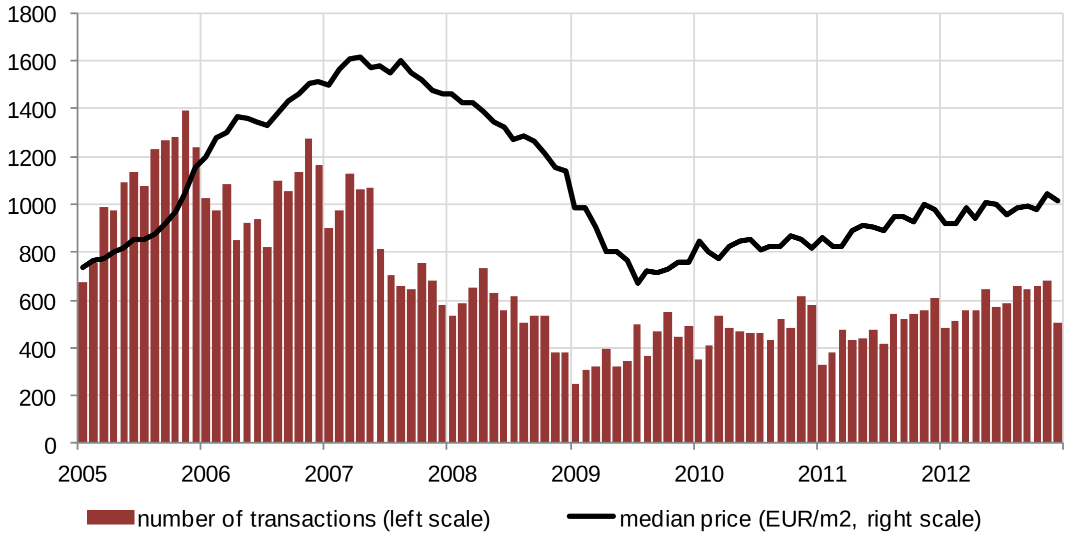

Figure 7. Number of transactions with apartments in Tallinn and median price
Source: Land Board

Real estate affordability has improved considerably from the years of rapid economic growth. According to the affordability indicator (the ratio between the median price per square meter of an apartment and average gross wages) used for analysing the pricing of the residential market, real estate affordability in Tallinn has been relatively stable (below 1) for almost three years (see Figure 8). In the boom years the ratio was more than twice as high.

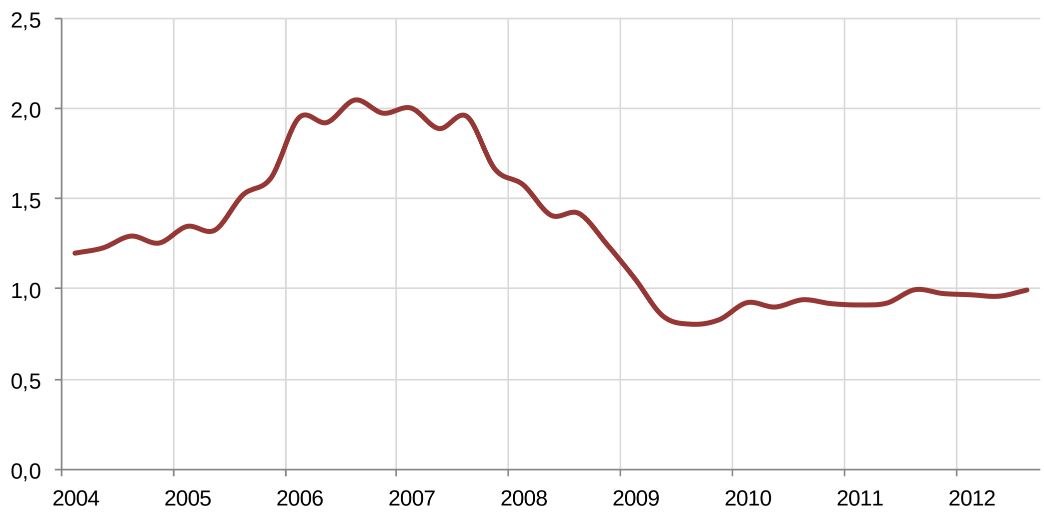

Figure 8. Real estate affordability indicator for apartments in Tallinn (median apartment price / monthly gross wage)
Source: Land Board, Statistics Estonia

3. Financial sector structure

<u>Size of assets</u>

The Estonian financial system is dominated by commercial banks. As at 30.09.2012, the ratio of banking sector assets, including branches of foreign credit institutions, to GDP was 114%. At the same time the investments by investment and pension funds accounted for 12% of GDP, while the capitalisation of the stock market was 9% of GDP. The size of the assets of other financial intermediaries, such as insurance companies, management companies, investment firms, was insignificant (see Figure 9).

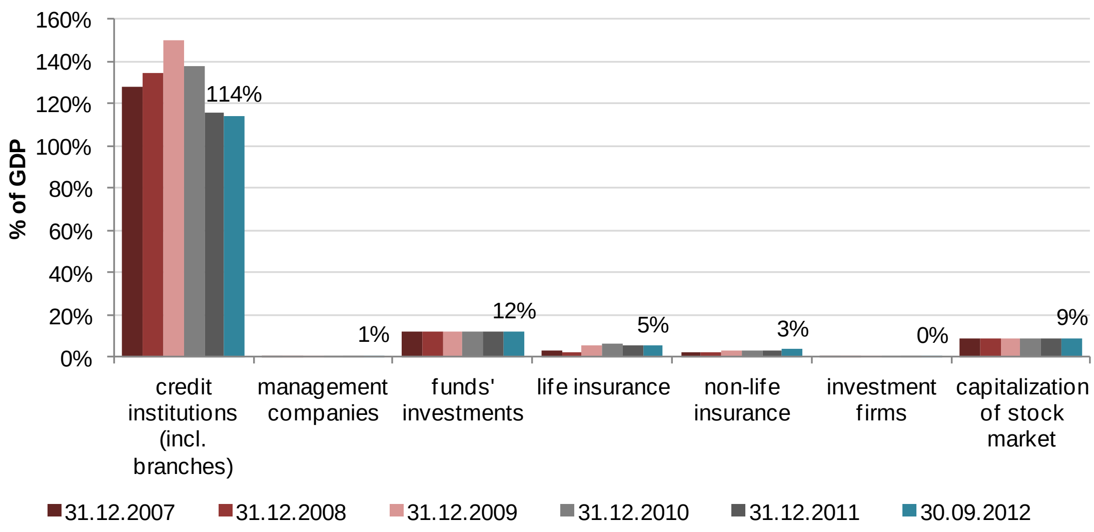

Figure 9. Size of financial sector assets (% of GDP)
Sources: Eesti Pank, EFSA, Statistics Estonia

<u>Number of intermediaries</u>

As at 31 December 2012, there were eight locally authorised credit institutions operating in Estonia, five of which were under the control of foreign owners, and eight branches of foreign credit institutions (see table 1). One bank had entered the Estonian banking market since 2010, DNB Pank, which is owned 100% by the Norwegian DNB Bank ASA. Previously, the banking business of this credit institution was operated via the branch Bank DNB A/S Estonian branch.

The total number of market participants in the life insurance business has remained unchanged in the last three years with a total of five institutions. The only difference was in 2011 when one company changed its status to become a branch. The total number of non-life insurance companies remained unchanged from 2011, meaning there were 13 companies as at 31.12.2012. Two fund management companies entered the market in 2011-2012 and a total of 18 companies were operating in Estonia by the end of 2012.

During the past two years payment service providers have emerged as a new sector supervised by the EFSA. The licensing process for these companies started in 2010 and by the end of 2012, the number of supervised entities in this sector had reached eight. The EFSA supervises the activities of payment institutions under the Payment Institutions and Electronic Money Institutions Act, which came into force on 22 January 2010. The EFSA has not issued a license to any Electronic Money Institution yet, so only cross-border E-money Services providers are operating in the Estonian market at present.

Table 1. Number of financial sector entities under the supervision of the EFSA

	31.12.2010	31.12.2011	31.12.2012
Credit institutions	**18**	**17**	**16**
Incl. branches of foreign credit institutions	11	10	8
Life insurance companies	**5**	**5**	**5**
Incl. branches of foreign life insurance companies	0	1	1
Non-life insurance companies	**14**	**13**	**13**
Incl. branches of foreign non-life insurance companies	5	4	4
Management companies	**16**	**17**	**18**
Investment firms	**8**	**7**	**5**
Payment service providers	**0**	**8**	**8**
Insurance brokers	**35**	**37**	**42**
Incl. branches of foreign insurance brokers	2	2	4
Operator of a securities settlement system	**1**	**1**	**1**
Regulated market operator	**1**	**1**	**1**

Source: EFSA

In addition to the financial intermediaries supervised by the EFSA there were 19 savings and loan associations (SLA) active in Estonia at the end of 2012. The activity of the SLAs is regulated by the Savings and Loan Associations Act[2]. By law, their scope of activities is limited to taking deposits from their own members and subordinating government loans and foreign aid funds to their members. The aggregated total assets of the SLAs have been very small and they had in total about 4,000 members at the end of 2012.

There are also a number of other financial institutions operating in Estonia, including consumer credit providers, which must be registered in the register of economic activities at the Ministry of Economic Affairs and Communications before they can commence operations.

<u>Foreign ownership and market shares</u>

The major financial institutions in Estonia – commercial banks, life and non-life insurance companies and fund management companies – are owned by Nordic investors from Sweden, Finland and Denmark. In all these four sectors, Sweden is the main owner by residency of the ultimate owner of the Estonian entity, with more than 50% of the equity (see Figure 10).

The foreign operations provided by some small Estonian credit institutions through their foreign branches have remained very small. The share of the loan portfolios of these branches in the total consolidated loan portfolio of the Estonian banking system was only 1.5% at the end of September 2012.

[2] Savings and Loan Associations Act: http://www.legaltext.ee/text/en/X30055K3.htm

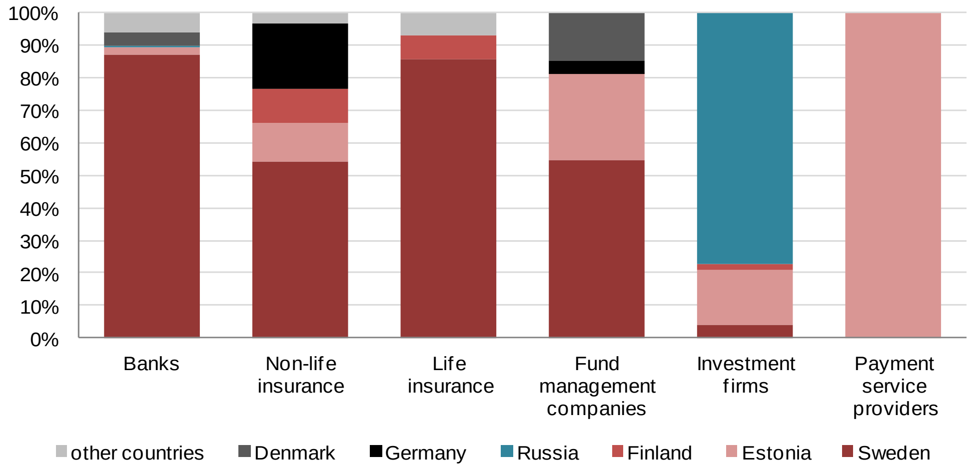

Figure 10. Ownership by residency of the ultimate owner (% of owners' equity)
Source: EFSA

The Estonian banking market is highly concentrated. As at 31.12.2012, the aggregate market share of the four major banks, Swedbank, SEB, Nordea branch and Danske branch, measured by total assets amounted to 87% (see Figure 11).

During the period of economic slowdown and recession in 2008-2009, retaining market share turned out not to be a priority for the two biggest market participants, who focused more on the quality of their portfolios. As a result, domestic banks and some smaller branches of foreign credit institutions gained some market share. Among the largest banks only Nordea continued its conventional growth, which allowed it to increase its market share by five percentage points over the past four years.

In 2012, the distribution of the banks' market shares was impacted by the appearance of a new credit institution in Estonia, AS DNB Pank, which was granted a licence on 31 August 2012. It remains the case that the branches of foreign credit institutions play an important role in retail banking in Estonia, as their aggregated market share accounts for approximately one third of the banking market. The combined share of foreign-owned banks in terms of total assets was 94%.

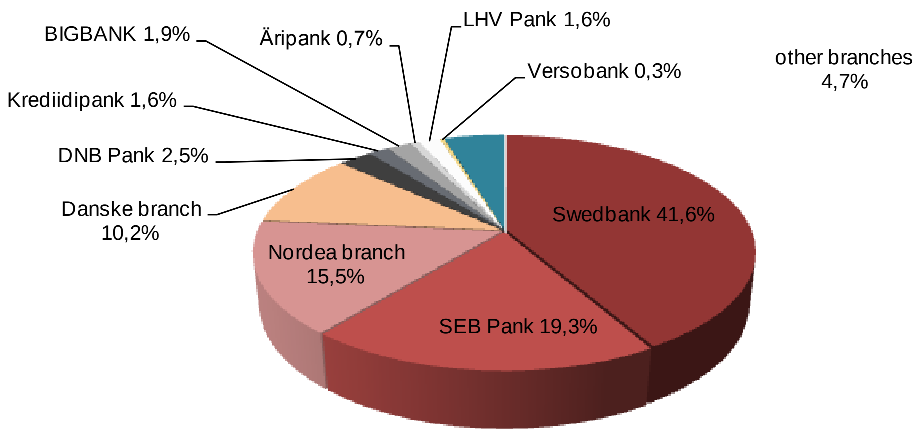

Figure 11. Banks' market shares by assets as at 31.12.2012
Source: EFSA

4. Estonian financial markets

The Estonian financial system is heavily bank-based and the role of domestic capital markets in allocating savings and investment has been very limited. An overwhelming majority of companies in Estonia are SMEs for whom bank-based financing remains the most efficient. At the same time a substantial share of the medium-size and large enterprises in Estonia are owned by foreign companies, which provide them with other alternatives for obtaining funds beyond the local financial sector. For this reason the financial markets of such a small country should be considered as a part of the larger regional financial market.

Debt securities market

Government bonds have not been the driving force of developments in the securities market in Estonia. This is mainly due to prudent fiscal policies, initially shaped by the currency board-based monetary policy framework that was used from 1992 to 2010. Estonian government debt is the lowest among the euro area countries at 9.6% of GDP at the end of third quarter of 2012, while there were no central government bond issues outstanding for the period 2000-2012. In addition to lacking any government bonds that could serve as a benchmark for corporate debt, the domestic market has remained too small for large issuances, and so large infrastructure companies have issued debt in international markets.

Throughout the years that the economy was expanding, the local bond market served as an alternative channel for market participants, mainly for hedging domestic currency risks and financing higher-risk investments. The local bond market capitalisation to GDP increased to 5.6% in 2007 (see Figure 12), but during the recession in 2009 the investor risk appetite fell sharply and the local bond market dried up. The Estonian bond market capitalisation has contracted by nearly a half since the period before the global financial crisis. At the end of December 2012, the total volume of bonds issued and registered in the Estonian Central Securities Depository amounted to 3.2% of GDP.

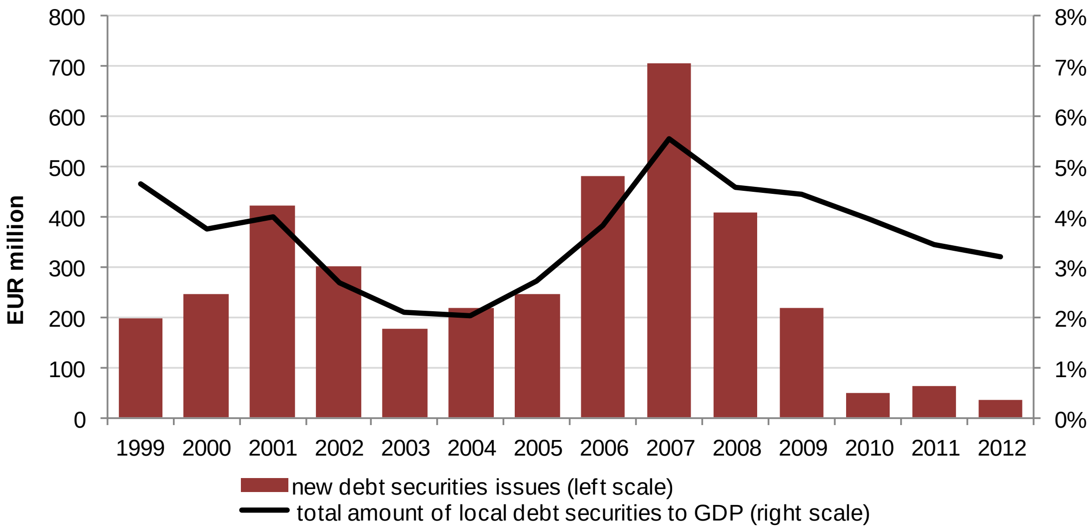

Figure 12. New local debt securities issues and total amount of local debt securities to GDP
Sources: ECSD, Statistics Estonia

After the euro was adopted in 2011, the role of the Estonian local bond market in hedging kroon risk disappeared, while the volumes in the primary market did not recover. In recent years only a handful of companies, most of them residents, and local governments have issued bonds. The issuance of new bonds and the activity in secondary market have dropped by nearly 95% from their peaks in 2007. As no bonds have been listed on the local regulated securities market since the end of June 2010 all secondary market transactions with local debt securities are carried out over the counter.

In recent years the structure of bond investors has seen no major changes. At the end of December 2012, credit institutions and financial institutions held 68% and non-financial companies 28% of the bonds issued. The share of resident investors has remained around 73%.

Stock market

The NASDAQ OMX Tallinn is the only regulated securities market in Estonia. Its predecessor, the Tallinn Stock Exchange (TSE), was founded as a private company in April 1995 by Eesti Pank, the Ministry of Finance and 20 other financial organisations, and it became operational in June 1996. From its launch the TSE was an electronic market in which a combination of an electronic dealer market and an order book market was used. Since a restructuring of ownership in the second half of 2000, the TSE has been the parent company of the Estonian Central Securities Depository, which settles stock exchange and OTC trades. In 2010 NASDAQ OMX became the sole owner of the NASDAQ OMX Tallinn Stock Exchange.

Like the debt securities market the local stock market in Estonia is one of the smallest in the EU (see Figure 13). At the end of 2012 the shares of 16 companies were listed on the NASDAQ OMX Tallinn. Since the beginning of 2010 the shares of two companies have been added to the NASDAQ OMX Tallinn list and the shares of two companies have been delisted. The total market capitalisation accounted for 11% of GDP at the end of 2012.

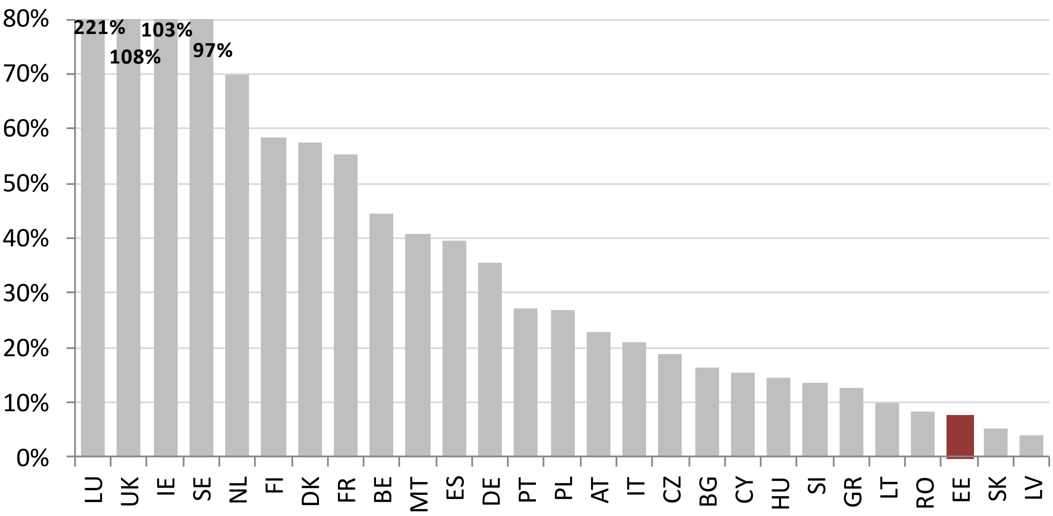

Figure 13.Total of quoted shares to GDP in EU countries, as at the end of 2011
Sources: ECB, Eurostat, Eesti Pank's calculations

The overall local share price index OMX Tallinn (OMXT) has been very volatile throughout its history. Due to the global financial crisis the OMXT fell by 63 percent in 2008. The decline reversed at the beginning 2009 and share prices increased for two years to regain their level of the beginning of 2008 (see Figure 14). As uncertainty increased among investors and the sovereign debt crisis deepened in the euro area, the OMXT lost 35% of its value by the end of August 2011, but in September 2011 there was a reversal in investors' sentiment and share prices started to climb again and have continued to do so since then. By the end of December 2012 the OMXT had returned to its level of the beginning of 2011.

Figure 14. OMX Tallinn index
Source: Nasdaq OMX

Since the beginning of the global financial crisis in 2008, the liquidity of the local stock market has decreased. The turnover ratio (total value of shares traded divided by the average market capitalisation) fell from 33% in 2007 to 10% in 2012. The average monthly turnover in 2012 was only 11.7 million euros, or less than one eleventh of the level in 2007.

The delisting at the beginning of 2010 of Eesti Telekom, the main Estonian telecommunications company, which accounted for 44% of total stock market capitalisation, shrank the domestic stock market significantly and increased the share of listed stocks held by Estonian investors from 34% to 61%. In the last three years the structure of investors has not seen any major changes. Residents still make up the majority of the investors, holding 58% of the shares at the end of December 2012. Among non-resident investors, Luxembourg and the Cayman Islands have taken the lead with 8% each, followed by the USA (4%), Finland (4%) and the Netherlands (4%).

5. Banking sector developments

Liquidity and funding

The volume of the banking sector's total assets has increased substantially over the past two decades. The more accelerated growth started from 2004, which coincides with Estonia's accession to the European Union, a major event that fostered financial deepening in Estonia. After more than four years of rapid growth, the size of the banking sector's total assets peaked in October 2008. The ratio of total assets to GDP reached its highest level a year later, reflecting a significant fall in nominal GDP. After the subsequent years of deleveraging the ratio had stabilised at 114% by the end of 2012 (see Figure 15). With some increase in loan activity the banking sector's total assets started to increase again slowly from spring 2012.

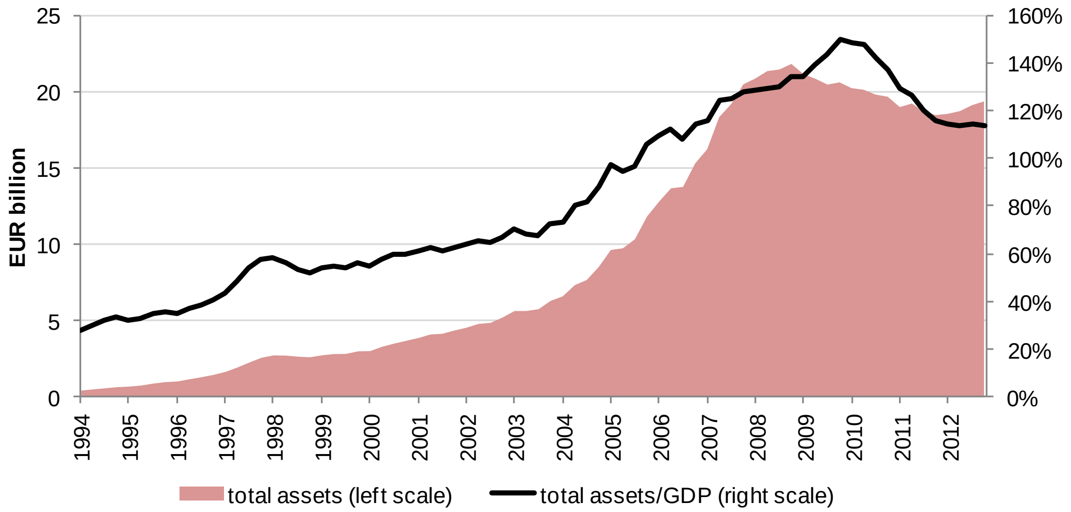

Figure 15. Banking sector total assets
Source: Eesti Pank, Statistics Estonia

For several years from the middle of 2006 until the end of 2010, the share of liquid assets in total assets remained relatively stable at around 18% (see Figure 16). Then in 2011, the adoption of the euro area monetary policy operational framework substantially changed the structure of liquid assets. The volume of liquid assets was affected not only by developments in deposits but also by the change in the operational environment.

Due to convergence with the euro area framework, the banks' minimum reserve requirement was gradually lowered during the second half of 2010 from 15% to 2% at the beginning of 2011. In January 2012 the minimum reserve requirement of the Eurosystem was lowered to 1%. The lowering of the reserve requirement released a substantial amount of mandatory reserves that were partially exchanged for claims against commercial banks (mostly parent banks). Although some banks reduced their total liquid assets by returning funds to the parent banks, the overall amount of liquid assets did not change much. On the contrary, an increase in deposits with low loan demand fuelled the growth of liquid assets. Since July[3] the share of liquid assets has remained fairly stable at around 24% of total assets.

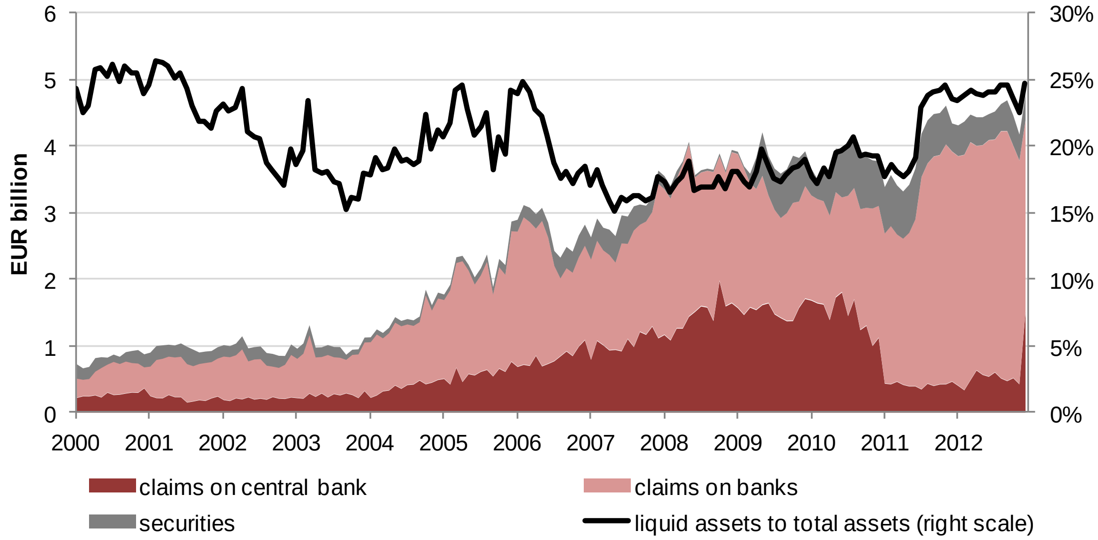

Figure 16. Banking sector liquid assets
Source: Eesti Pank

The structure of banking sector liabilities has changed significantly over time. Until 2003 around 75% of the banks' total liabilities were deposits. During the period of rapid credit growth, a large proportion of the funding was provided by the parent banks and the share of deposits in total debt liabilities fell below 50% (see Figure 17).

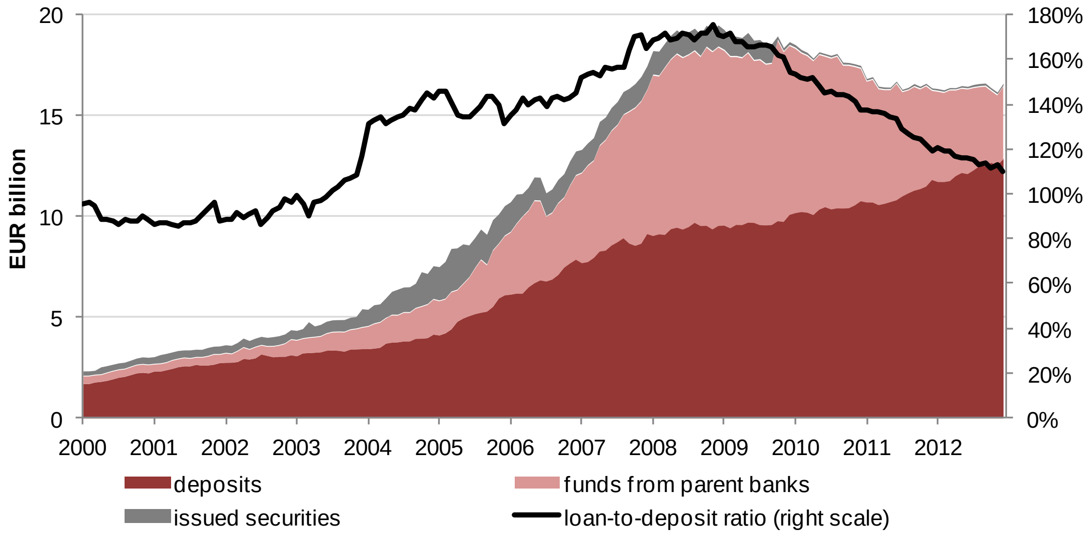

Figure 17. Banking sector liabilities and loan-to-deposit ratio
Source: Eesti Pank

[3] A substantial increase in liquid assets in July 2011 was partially caused by a structural change that took place in the balance sheet of Swedbank owing to the sale of its subsidiaries to its parent bank in Sweden.

The turning point came with the economic slowdown when lending growth turned negative and deposits started to increase. The narrowing deposit gap allowed banks to reduce funds from their parent banks and at the end of 2012, deposits constituted 78% of total debt liabilities. This means that dependence on market-based funding mediated by parent banks has significantly decreased. At the same time the loan-to-deposit ratio has dropped from the boom period high of 175% to 110% at the end of 2012.

The liquidity and capital of the major banks are still managed more or less centrally by their parent banks, which is why the financial situation of the banks operating in Estonia is shaped by the risk assessments issued to their parent banks and the changing regulatory capital and liquidity requirements. In Estonian legislation, there are currently only requirements for liquidity risk management and no quantitative liquidity requirements are set domestically[4]. In conjunction with the adoption of the EU regulation and directive CRR/CRD IV the liquidity requirements will also be introduced in Estonian regulations.

Credit quality

The ratio of loans overdue by more than 60 days to total loans started to increase in 2007, reaching its peak of 7.6% in August 2010 (see Figure 18). While this was relatively high when compared to its position in the past and to the same data from many other countries, the volume of non-performing loans appeared somewhat smaller than was predicted during the economic crisis[5]. The worse consequences for the real sector were avoided by robust revisions in corporate business plans and budgets and by timely restructurings of loans by banks. Most importantly however, low interest rates partly helped to compensate for the loss in nominal income of borrowers.

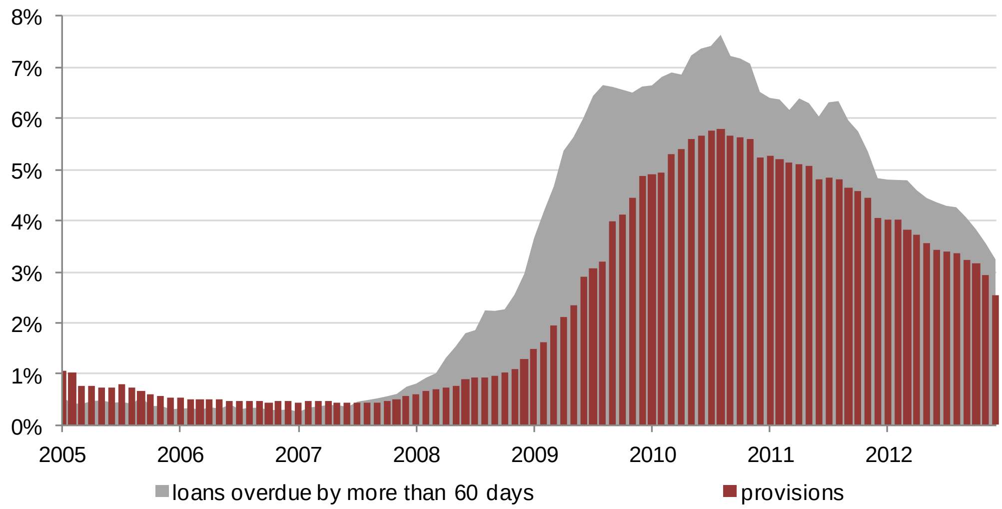

Figure 18. Loans overdue by more than 60 days and provisions (% of total loans)
Source: Eesti Pank

[4] Until the adoption of the euro in 2011, the high reserve requirement of 15% of liabilities in the currency board framework also fulfilled the role of regulative liquidity buffer.
[5] For example in Spring 2009, Eesti Pank forecast an increase in the NPL ratio to 9% of the loan portfolio in its baseline scenario, and to 10.5% in the risk scenario. (see Financial Stability Review 1/2009)

The provisions for loan losses have been fairly conservative through the observed period. Provisions have also been made for restructured loans and temporary payment leaves. This has lead to a high provisioning ratio, which has been around 80% for the past two years.

As the economy has recovered, the volume of non-performing loans has gradually declined. At the end of 2012, the ratio of loans overdue by more than 60 days to the loan portfolio was 3.2%. Although loan repayment ability has improved due to the improved macroeconomic situation in Estonia and low base interest rates, a large portion of the decrease in non-performing loans has come from write-offs. The cumulative gross write-offs between 2008 and 2012 amounted close to 4% of the average loan portfolio for that period. In 2011-2012, about 70% of the decrease in overdue loans may be attributed to the write-offs of uncollectible receivables.

Two thirds of overdue loans consist of loans to the real estate sector, such as loans to real estate and construction companies and housing loans (see Figure 19). During the past two years and more, the levels of non-performing loans have fallen in each sector, but the largest falls came in the real estate and construction sector and in housing loans. The same loan segments contributed the majority of write-offs.

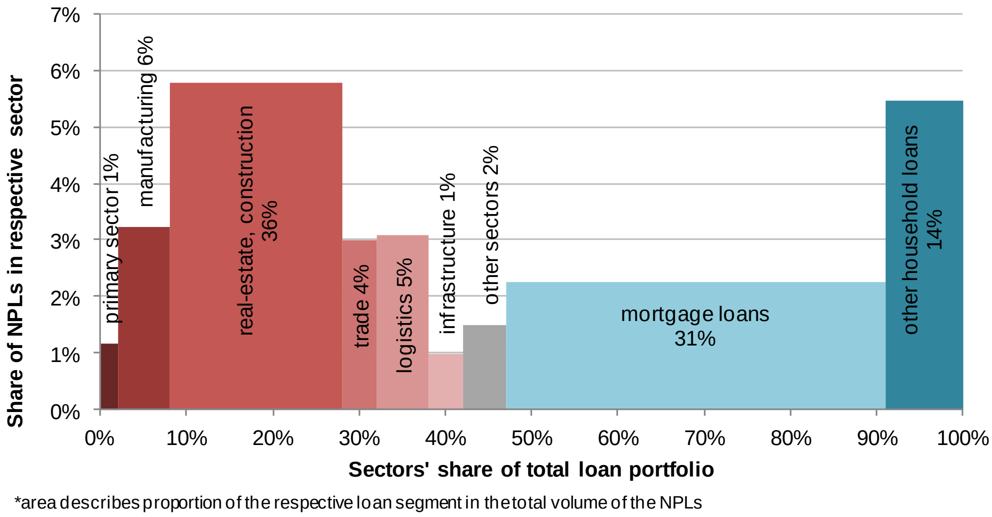

Figure 19. Loans overdue by more than 60 days by loan segment as at 31.12.2012

Source: Eesti Pank

Profitability

The cumulative net loan losses for the period 2008 to 2012 were 5.3% of the total loan stock. The only non-profitable quarters for the period from 2000 onwards were the five consecutive quarters from Q1 2009 to Q1 2010, and profitability started to recover from the second quarter of 2010 (see Figure 20). In 2010 some banks already started to reduce the provisions they had established in previous periods for loan losses, and this contributed quite significantly to the net profit, which increased close to 2% in ratio to total assets for some quarters in 2011-2012, even without the one-off profit of Swedbank in the third quarter of 2011[6] .

[6] The net profit of the third quarter of 2011 was largely affected by the revenue from the sale of Swedbank's subsidiary banks in Latvia and Lithuania to the parent bank, which constituted more than 50% of the annual net

Since the vast majority of loans issued in Estonia are indexed to the Euribor, the low base interest rates in 2012 started to erode banks' earnings from interest income, which had so far been mitigated by the growth of deposits and related reduction in funding costs. In the next few years, banks' profits will be positively affected by the relatively higher loan margins of the new loans granted after the boom period, but the impact will remain relatively modest in the near future.

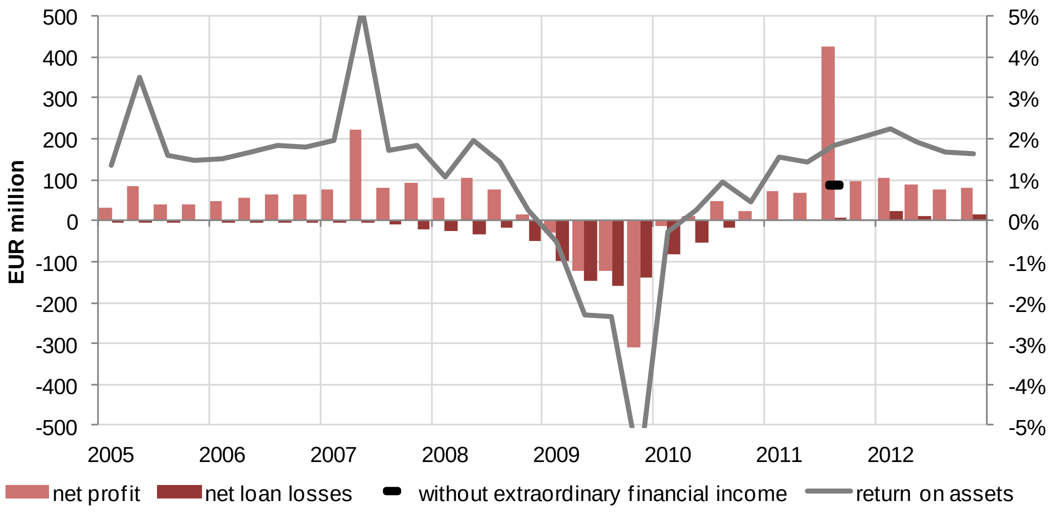

Figure 20. Banking sector net profit and net loan losses
Source: Eesti Pank

Since the economic recession, banks have significantly cut administrative expenses and improved their cost-income ratio. Some of the improvements have come from directing customers towards electronic banking, which has allowed the banks to reduce their networks of bank offices substantially. In 2011 the euro changeover led to a one-off significant increase in administrative costs that was partly offset by the general cost-cutting in banks. By now, the structural changes necessary for adapting to the conditions of the post-boom period have been largely completed and further improvements in the cost-income ratio will be modest.

Capitalisation

The Estonian banking sector is well capitalised. In the third quarter of 2012, the banking sector capital adequacy ratio reached 23.9% (see Figure 21), while most of the banks had double the minimum capital requirement of 10%. In 2012, capital was mostly increased through increased retained earnings. The capital adequacy ratios were also positively influenced by the decrease in risk assets. Since the Tier 2 capital has largely been reimbursed, the share of Tier 1 capital in own funds has increased to 99% and the banking sector core Tier 1 capital ratio reached 23.7% by the end of the third quarter of 2012. All the banks fulfilled the minimum requirement of 10% with Tier 1 capital only.

profit of the banking sector. See the Financial Stability Review 2/2011 box "The impact of changes in Swedbank's legal structure on the aggregate balance sheet and capital of the Estonian banking sector".

Even during the recession, which caused substantial loan losses in 2009-2010, all banks in Estonia were able to remain sufficiently capitalised, with no incidents of capital adequacy falling below the required minimum level. This was to a large extent the positive outcome of the earlier countercyclical measures[7] that ensured high capital buffers.

In the near future banking sector capitalisation is expected to remain high. The capital buffers of larger banks are further supported by the conservative approach taken by the Swedish authorities in imposing higher capital requirements on systemically important banks.

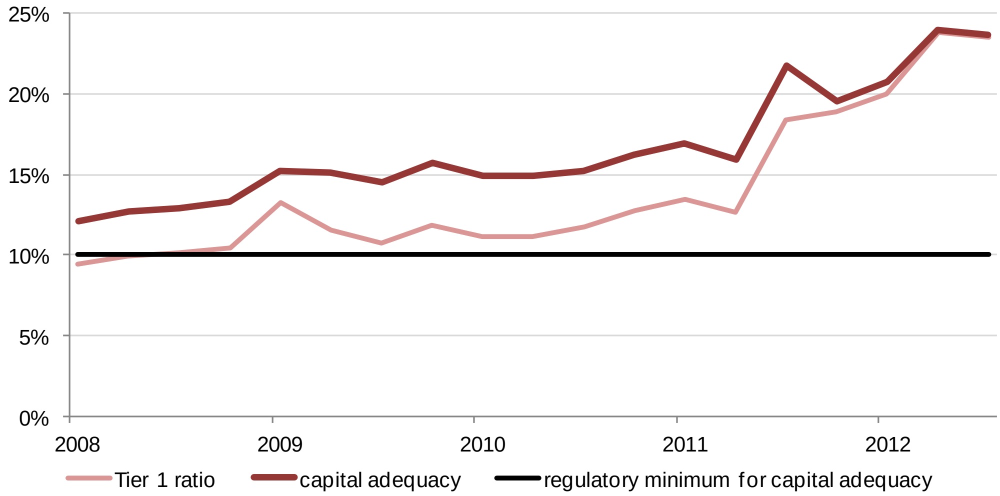

Figure 21. Banking sector capitalisation
Source: Eesti Pank

Stress testing

In order to assess possible risks to the financial system, the Financial Supervision Authority and Eesti Pank both conduct stress tests[8]. The FSA conducts bottom-up stress tests, while Eesti Pank conducts top-down stress tests[9]. The results of the latter are published as part of the Financial Stability Review of Eesti Pank. The results of the tests are shared between the institutions, and the results of the bottom-up stress tests of the EFSA are added to the results from the tests conducted by the Swedish FSA in order to give a broader view of potential risks that would be left uncaptured by isolated stress tests.

<u>Bottom-up stress tests conducted by the EFSA</u>

As one of the early warning systems, individual banks' stress testing is conducted at least once a year by the EFSA as part of the supervisory review and evaluation process (SREP) dialogue. Although the primary purpose of the EFSA's stress test is to assess banks' ability to meet the minimum

[7] Risk weights on housing loans were raised from 50% to 100% in capital adequacy calculations, effective from March 2006.

[8] The IMF also conducted stress tests of the Estonian banking system as part of the FSAP update. IMF (2009).

[9] The credit risk model used for stress-testing is described in more detail by R. Kattai in "Credit Risk Model for the Estonian Banking Sector", Working Papers of Eesti Pank No 1/2010 and "The links between private sector indebtedness and banking sector vulnerability: An Estonian case study".

requirements under various stress scenarios, the broader aim is to challenge the banks' own stress testing activities in order to improve their risk and capital management processes.

Several stress scenarios were analysed during the SREP performed in the first quarter of 2012 in parallel with the banks' internal capital adequacy assessment process (ICAAP). Benchmark stress tests included one macroeconomic scenario based on Eesti Pank's risk scenario and a specific stress test tailored for the individual risk profile of each bank. The results led to the conclusion that in general the banking sector is resilient to potential risk realisations (see Figure 22). Even so, some weaknesses concerning smaller banks were confirmed. As the potential weaknesses had already been identified earlier during the regular supervision, the capital injections needed to strengthen resilience have been made within the year.

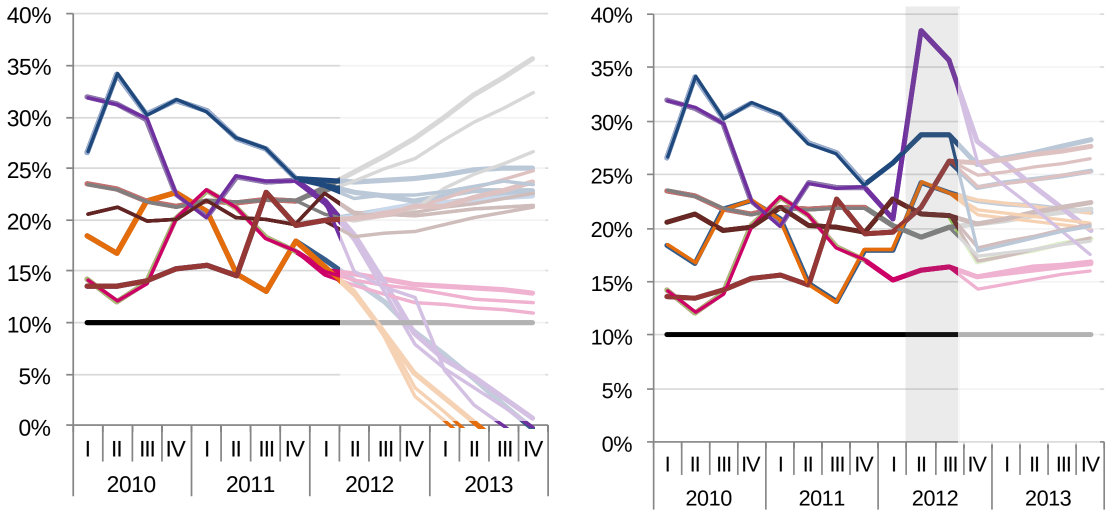

Figure 22. The impact of stress tests on capital adequacy ratios for seven banks under Estonian jurisdiction. Left side graph: stress tests evaluated during SREP. Right side: update in Q4 2012, same risk scenarios with actual developments during past 6 months (additional capitalisations, improved profitability and realised losses).
Source: EFSA's stress testing exercises.

Top-down stress tests conducted by Eesti Pank

The latest stress test, which was carried out in September 2012, considered a foreign demand shock, modelled to be similar to the events of autumn 2008. Under the stress scenario, GDP drops significantly, while it shows moderate growth in the baseline scenario[10]. As a result of this shock, the loan repayment ability of companies and households deteriorates and the share of non-performing loans in the loan portfolio reaches 6.5% in the last quarter of 2013 (see Figure 23). The share of consumer credit loans overdue by more than 60 days exceeds the level of the last crisis, though the ratio is lower for household housing loans and for loans granted to companies. According to the stress test, banks seem to be less vulnerable to shocks similar to the events of autumn 2008.

[10] The macroeconomic forecast of Eesti Pank was updated after the stress test was conducted. The baseline scenario is based on the 2012 spring forecast of Eesti Pank.

Despite the lower sensitivity, overdue loans will still increase substantially if the stress scenario materialises, and this means that banks will have to make additional loan loss provisions. Although banks' profits before loan losses will decrease, they are expected to remain higher than the additional provisions needed. In this case the materialisation of the adverse scenario will have no significant effect on banking sector capitalisation.

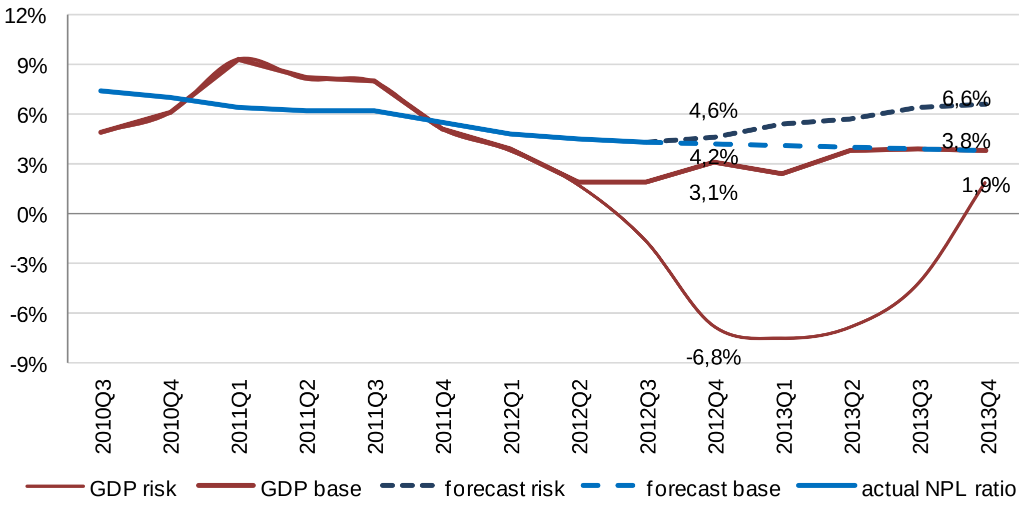

Figure 23. Predicted NPL ratio and real GDP growth under the stress scenario
Source: Eesti Pank, Financial Stability Review 2/2012

6. Other financial intermediaries

Insurance

In both the life and the non-life insurance sectors there has been a continuing tendency for business to reorganise towards pan-Baltic structures. By now three out of the four licensed life insurance companies and all the major non-life insurance companies have merged their subsidiaries in all three Baltic countries into one company with a head office in Estonia. The main reason for merging the Baltic subsidiaries was to optimise the regulatory capital requirement and achieve organisational effectiveness.

As a result of their pan-Baltic business structure, 32% of the business of Estonian companies in 2012 was done outside of Estonia in the non-life insurance sector and 40% in the life insurance sector. The large share of foreign operations has important implications for supervisory arrangements and makes cross-border cooperation between supervisory authorities essential.

In 2010 and 2011 both sectors experienced a significant decrease in demand as a result of the economic downturn in Estonia. In the non-life insurance sector the decline stopped in 2012 when the sector witnessed significant growth of 9% as car sales picked up and the demand for motor vehicle insurance increased (see Figure 24). More than half of the non-life insurance business is connected to motor vehicles.

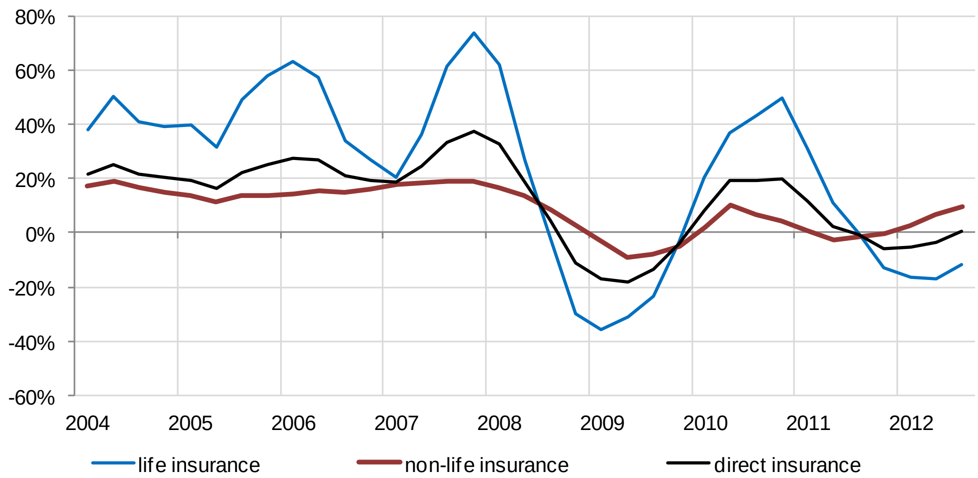

Figure 24. Annual growth of insurance premiums collected by Estonian insurance companies
Source: EFSA

In the life insurance sector the decline continued in 2012 at the pace of 12% on a year-on-year basis. The life insurance sector continues to suffer from low demand for investment and saving insurance products. Life insurance in Estonia was historically highly dependent on unit-linked insurance products where clients assume all investment risks and long-term saving products with a guaranteed rate of return. In 2006-2008 unit-linked products accounted for over 60% and guaranteed rate products 25% of total products sold (see Figure 25). The demand for unit-linked products decreased sharply during the global financial crisis and has stayed low largely due to the high uncertainties and high risks associated with the general outlook of capital markets.

Due to the difficulties of meeting the guaranteed rate of return in the current low yield environment, only one insurance company continues to offer insurance products with a guaranteed rate and the rest of the sector has stopped offering such products. In addition, the tax benefits offered for unit-linked products were abolished in 2010, which further added to the decline in the interest of customers for life insurance products.

Sales of term life insurance improved and growth reached 11% in 2012, but this insurance market segment is still too small to compensate for the decline of such big segments as unit-linked and guaranteed interest rate products. The outlook for the life insurance sector will most likely remain negative until the confidence of consumers in the capital markets and investment products returns.

The creation of a pension system with prepaid funding in 2002 will create an additional market for defined benefits pension insurance products, but the system is still too young to create any significant volumes in the medium term.

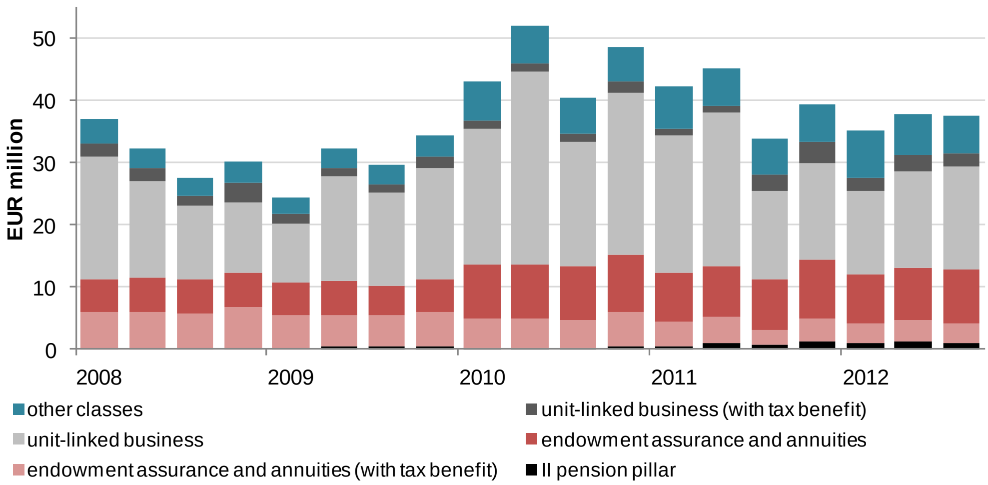

Figure 25. Quarterly premiums of life insurance by line of business
Source: EFSA

In spite of the sharp decline in business volumes, both sectors operated profitably: the return on equity was stably above 10% in both sectors in 2009 to 2011 and reached 20% in 2012 (see Figure 26). This was made possible by significant cost-cutting and reorganisation in all the insurance companies, which increased the efficiency of operations.

Despite the relatively high competition on the non-life insurance market, the market participants kept prices at a reasonable level and refrained from letting prices drop below the fair level justified by the risk level of their products. The loss ratio was always below 65% throughout the economic downturn.

In the life insurance sector, which depends much more on the yield earned on investment portfolios, profitability was more volatile. After the emergence of the global financial crisis in autumn 2008, the life insurance companies significantly reduced the level of market risk in their investment portfolios. As a result, profitability stabilised to a great extent.

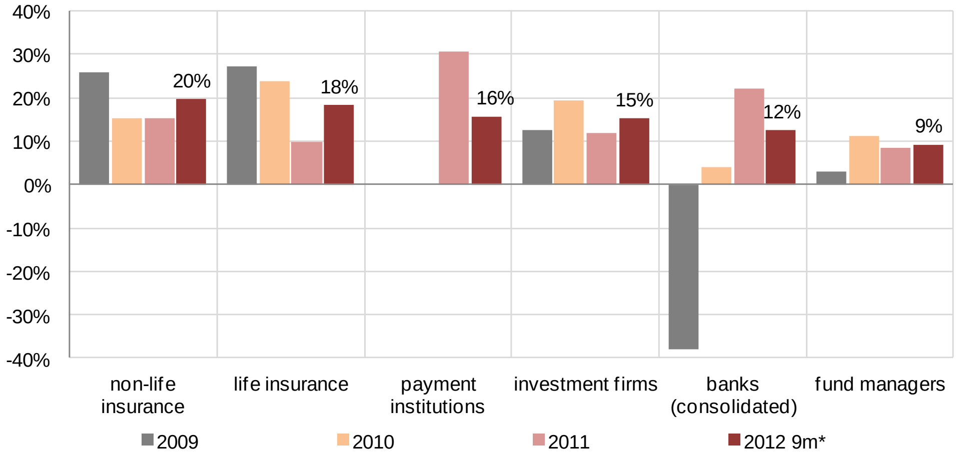

Figure 26. Annualised return on equity across financial intermediaries
Source: EFSA

The non-life insurance sector has followed quite a conservative investment policy during the last few years, since the return on investments has never been a significant source of income for this segment. As a result, the high volatility in the capital market had only a small impact on non-life insurance.

The life insurance sector incurred significant losses in 2008, after which all the life insurance companies changed their investment structure from equities towards deposits and traded fixed income instruments (see Figure 27). Thanks to their cautious investment policies the life insurance companies were only modestly affected by the EU sovereign crisis. The market risk is smaller now, but the extremely low yields on the capital markets mean that life insurance companies are having difficulties when trying to meet the guaranteed rate of returns on the contracts they sold earlier.

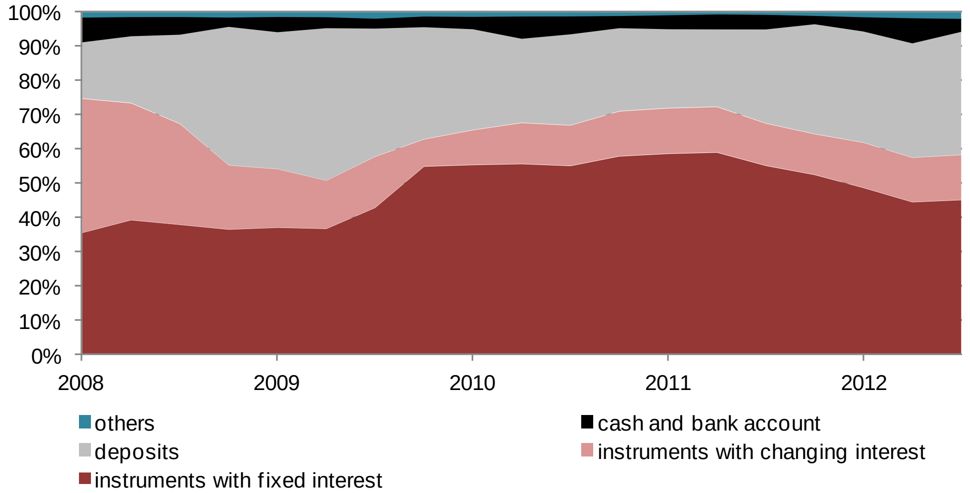

Figure 27. Investment structure of life insurance companies
Source: EFSA

All the significant insurance companies are well capitalised (see Figure 28). Since the companies have had positive results, their solvency position has improved. Under the Solvency I regime most companies have had and continue to have a capital buffer. Estonian companies are quite well capitalised under the Solvency I regime.

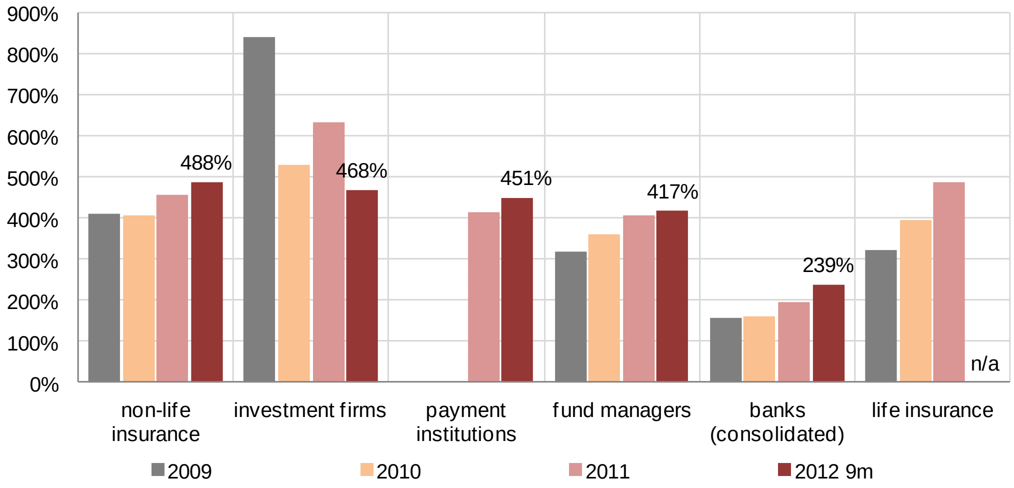

Figure 28. Surplus of capital over minimum requirement (100% is required minimum)
Source: EFSA

Investment and pension funds

Within the last two years the aggregated volume of investment and pension funds in Estonia has increased by 19%, which is a very positive change compared to the sharp decline which happened during the global financial crisis of 2008. The main growth took place in 2012. By now the aggregated volume of investment and pension funds has reached 2 billion euros, which is still below the highest watermark set at 2.4 billion euros in 2007 (see Figure 29).

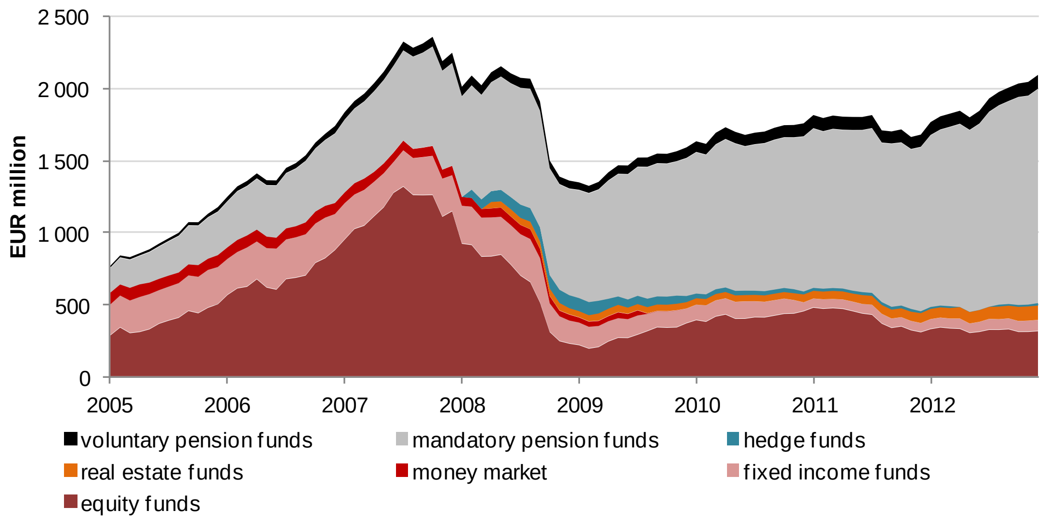

Figure 29. Volume of investment funds by type
Source: EFSA

The structure of the Estonian fund market is characterised by a continuously increasing share of mandatory pension funds and decreasing share of equity funds. The share of mandatory pension funds amounted to over 70% of the total market by the end of December 2012. At the same time the share of equity funds dropped to 15% of the total market. The volume of voluntary pension funds has remained marginal and this shows that the propensity of households to invest in financial instruments without a guaranteed rate of return is very low.

There were 72 active investment and pension funds in Estonia as at 31.12.2012 (see table 2).

Table 2. Number of active investment and pension funds in Estonia

	31.12.04	31.12.05	31.12.06	31.12.07	31.12.08	31.12.09	31.12.10	31.12.11	31.12.12
Equity funds	8	14	18	27	30	30	30	27	26
Hedge funds	0	0	0	0	3	1	1	1	2
Fixed income funds	5	6	5	7	8	6	4	3	3
Real estate funds	0	0	0	0	3	4	5	5	5
Mandatory pension funds	15	15	15	15	19	21	23	23	23
Money market funds	2	2	1	1	1	0	0	0	0
Voluntary pension funds	7	7	7	7	12	12	12	13	13
Total	37	44	46	57	76	74	75	72	72

Source: EFSA

The annual performance of most of the investment and pension funds was negative in 2011. The biggest losses were in equity funds where performance was between -50% and -2%. The performance of funds was much better in 2012, but the growth in NAV has not been big enough to cover the drop in NAV in 2011 in most of the equity funds and in some of the pension funds.

In Estonia, there are no restrictions on the geographical allocation of the assets of investment and pension funds, though there are certain restrictions that limit the exposure in currencies other than the euro. Although there are no geographical limits, the majority of the assets of the funds are allocated inside the European Union. At the end of September 2012, nearly a half of all assets were invested in issuers registered in Western Europe, roughly one quarter were invested in Estonia and 13% in Eastern European countries (see Figure 30). The amount of assets invested in southern European countries, such as Portugal, Italy, Greece and Spain, was negligibly small and amounted to less than one per cent of total exposure.

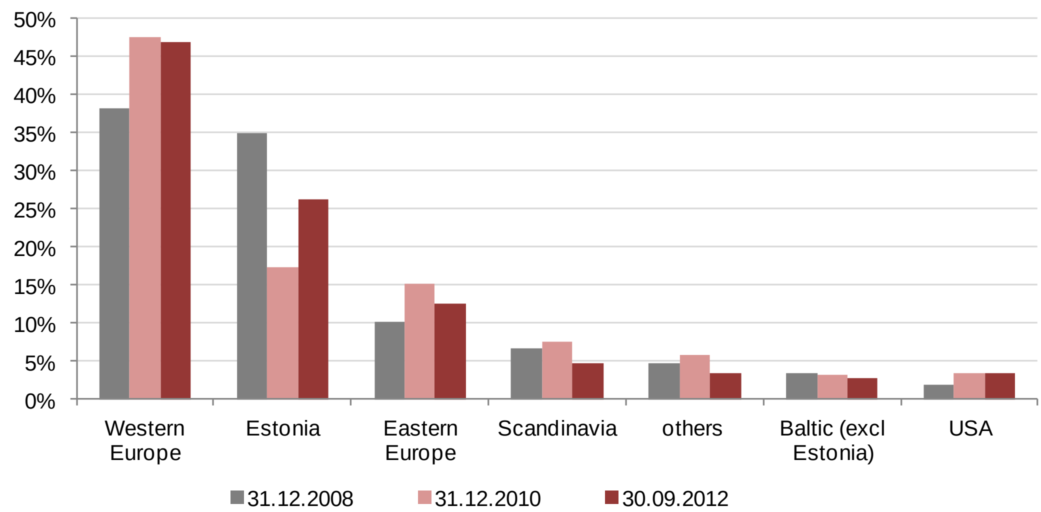

Figure 30. The geographical distribution of assets of investment and pension funds, % of total portfolio
Source: EFSA

The actual geographical distribution of assets cannot be measured precisely because the ultimate location of the assets can be different from the officially reported residency. For instance investments outside of the European Union were in reality bigger because a part of the investments went into investment funds that were registered in Western Europe but in reality focus on investing outside of the EU. Similarly, the 3% of the total assets of Estonian investment and pension funds that are placed with other Estonian investment funds are most likely to be ultimately invested outside of Estonia. Furthermore, the reason why Estonian assets have historically been a large share of assets is that the pension and investment funds keep the uninvested cash part of their portfolios in Estonian banks, with 11% of total assets there in September 2012.

The most popular investment instruments were equity funds and bonds (see Figure 31). With the sharp decline in the volume of the Estonian equity funds after the financial crisis of 2007 the amount of direct investment in equity has significantly decreased. The pension funds and increasingly even the Estonian equity funds prefer to invest in equity indirectly using equity funds registered elsewhere in the EU.

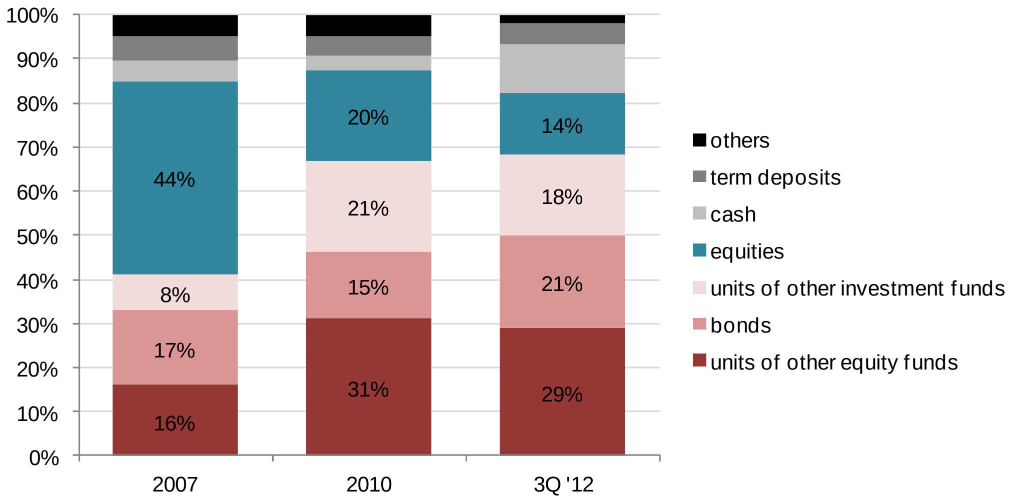

Figure 31. Assets of investment and pension funds by type of assets, % of total portfolio
Source: EFSA

Other intermediaries

Investment firms

The profitability of Estonian investments firms has been relatively stable throughout recent years, showing a solid ratio of average return on equity of 15% at the end of September 2012 (see Figure 26). Most of the revenue is earned as income from handling financial instruments, and as interest income. In 2012, 95% of the sector's revenues were earned by two investment firms that were active internationally, leaving the others with minimal revenues and market shares. Smaller investment firms have been negatively affected by the weakness of the local market for investment services.

The outlook for the investment firms operating in Estonia remains negative because of the uncertainty in the markets and very low demand for investment services. On the other hand, the number of companies handling international clients is likely to rise as there are many potential entrants.

Fund management companies

The range of services that fund management companies provide is relatively large. Besides managing the funds they own, the fund management companies also offer management services as outsourced activities. In addition, fund management companies offer securities portfolio management and investment consulting services and safekeeping services for clients' units or shares. As in previous years, managed funds make up the majority of managed assets.

The profitability of fund management companies has remained relatively good, with annualised return on equity at 9% in the first nine months of 2012. However, net profits have been in decline in recent years, mostly because of changes in the value of the investments held by the fund management companies. The sector of fund management companies still has considerable surplus funds above the required solvency margin (see Figure 28). The coverage of the required solvency margin was 417% at the end of September 2012 (408% in 2011 and 362% in 2010). Several companies increased their surplus net funds by retaining profit.

Payment institutions

The first payment institutions were granted authorisation in April 2011 but some of the companies were already providing their services before. The number of payments increased rapidly in 2012, as a company executing payments for smaller amounts entered the market (see Figure 32). Before that, the average value of payments was outstandingly high.

As at September 30, 2012 there were eight authorised payment institutions in the market, most of which operated with high profitability. The relatively high number of new applicants in this sector shows that the market for payment service providers is not full yet. The main concern about payment institutions is their weak money laundering prevention policy, which is exacerbated by the poor application of due diligence measures. The EFSA has revoked the authorisation of one payment institution due to the suspicion of money laundering.

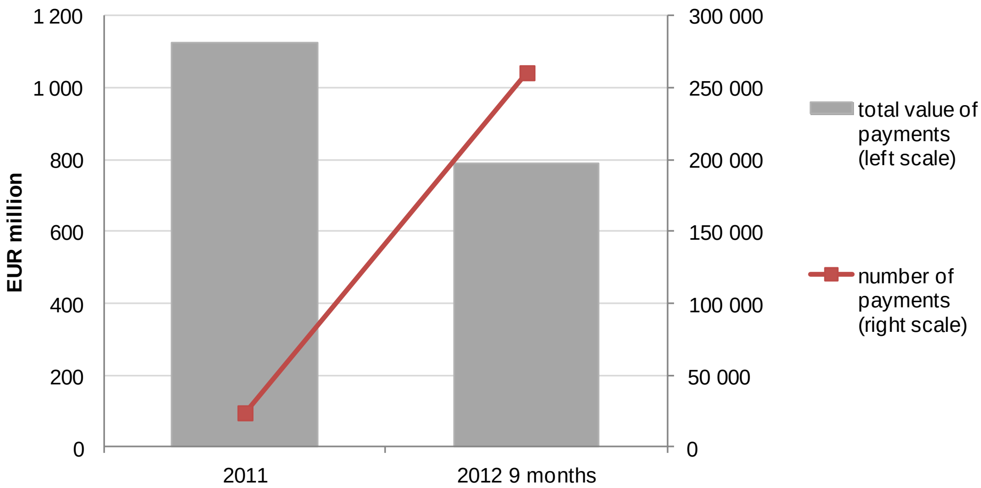

Figure 32. Value and number of payment transactions executed by payment institutions
Source: EFSA

7. Framework for safeguarding financial stability

Institutional set-up, division of responsibilities and coordination

The framework for safeguarding financial stability mainly involves three institutions – the Ministry of Finance, Eesti Pank and the Estonian Financial Supervision Authority (see Table 3). The authorities work together under a legally defined cooperation agreement, and their activities are coordinated by the Joint Committee.

Table 3. Division of responsibilities between the authorities involved in safeguarding financial stability in Estonia

Ministry of Finance	Eesti Pank	Estonian Financial Supervision Authority (EFSA)
Financial policy making and the legislative framework	Macro-prudential supervision	Micro-prudential supervision
Insurance sector and securities market secondary regulation	Banking sector secondary legislation	Technical guidelines
Crisis management	Emergency liquidity assistance to credit institutions	

<u>The Ministry of Finance</u>
The main functions of the Ministry of Finance are to advise the Government of the Republic on matters of budget, taxation, macroeconomics and financial and governance policy; to make proposals; and to develop and implement financial policy.

The responsibilities of the Ministry of Finance for safeguarding financial stability mainly concern financial policy and the legislative framework for the financial market. The responsibilities include preparing and coordinating the country's positions and the legal acts for the government and coordinating the activities and arrangements of state institutions, along with financial supervision and the institutional development of the financial markets, and supervision of accounting standards, auditing, pension reform, grants and state aid.

<u>Eesti Pank</u>
Eesti Pank is the central bank of the Republic of Estonia and a member of the European System of Central Banks. As a member of the Eurosystem since the beginning of 2011, Eesti Pank has participated in the formulation and implementation of the single monetary policy. The main objective of the Eurosystem is to maintain price stability within the euro area.

Safeguarding financial stability is one of the key functions of Eesti Pank under the Eesti Pank Act. The main responsibility of Eesti Pank is macro-prudential policy. Macro-prudential policy aims to reduce the build-up of systemic risk and to increase the resilience of the financial system. The macro-prudential policy of Eesti Pank covers both systemic risk analysis and assessment and the implementation of measures. The availability of regularly collected banking sector data is largely ensured through the joint database shared by Eesti Pank and the EFSA.

Eesti Pank's main financial stability analysis is released twice a year in the Financial Stability Review published since 2003. The review also includes the central bank's assessment of financial stability and covers related policy measures. In addition to its systemic risk analysis and assessment, Eesti Pank issues secondary regulations for the banking sector. Eesti Pank works with the Financial Supervisory Authority and the Ministry of Finance to ensure that the macro-prudential policy is operational and effective. This cooperation is essential since some of the macro-prudential instruments lie outside the perimeter controlled by the central bank.

Estonian Financial Supervision Authority (EFSA)

The Estonian Financial Supervision Authority is a financial supervision institution that operates at Eesti Pank, but autonomously and with a separate budget. The EFSA conducts supervision on behalf of the state and is independent in its activities and decisions.

The Financial Supervision Authority conducts state supervision over the banks, insurance companies, insurance intermediaries, investment firms, management companies, and investment and pension funds, and also over the payment service providers, e-money institutions and securities market that have been authorised by the Financial Supervision Authority.

The main objectives of the EFSA are to:

- protect the interests of clients and investors by safeguarding their financial resources, by helping to ensure the stability and quality of services of the companies providing financial services, and ensuring that financial institutions are able to meet their obligations;
- support the stability of the Estonian financial system by increasing the credibility and transparency of the financial sector, and ensuring the functioning of an efficient, fair and competitive financial market;
- help to avoid systemic risks,
- prevent the abuse of the financial sector for criminal purposes.

The work of the EFSA involves explaining what the risks are for customers and providing information and support to them in choosing financial services.

A four-member Management Board manages the daily work of the EFSA. The term of office of members of the EFSA management board is three years and the chairman is appointed for four years. The management of the EFSA is monitored by the Supervisory Board, which consists of six members, two of whom are members by virtue of office – the Minister of Finance and the Governor of Eesti Pank – and four of whom are appointed members. Two of the appointed members are appointed and removed by the government at the proposal of the Ministry of Finance and the other two by the supervisory board of Eesti Pank at the proposal of the governor of Eesti Pank. The Minister of Finance is the Chairman of the Supervisory Board by virtue of office.

Domestic cooperation

The Ministry of Finance, Eesti Pank, and the EFSA work closely to safeguard the reliability and stability of the Estonian financial system and to ensure the appropriateness of the financial sector regulation. For this purpose, a permanent high-level Joint Committee of representatives of these bodies was set up in December 2007. The committee usually meets every quarter.

The principles of cooperation and the division of tasks between the three authorities are set out in the Memorandum of Understanding[11]. The memorandum covers general issues of cooperation on a daily basis, such as cooperation in the European Union decision-making process and international communication, the development of financial sector legislation and technical guidelines, the operation of a safety net for the financial sector, the exchange of information about the situation and risks in the financial sector, and communication with the public. In 2006, a separate Memorandum of Understanding for the management of financial crises was signed between the parties.

To provide for more effective cooperation and exchange of information, a memorandum of understanding was signed between the EFSA, the Police Board and the Office of the Prosecutor General in 2009. There is also an agreement between the EFSA and Eesti Pank on the monitoring of the securities system signed in 2011. The EFSA has online access to the Tallinn Stock Exchange (TSE) systems, and can thus monitor trading activity directly without having to rely on the TSE to conduct monitoring.

International cooperation

Given the high foreign ownership in the Estonian financial sector, effective and efficient cross-border cooperation plays an important role in safeguarding financial stability in the country. Cross-border cooperation in different areas and at all levels has progressed remarkably both in the Nordic-Baltic region and in the EU as a whole in the past couple of years.

<u>Nordic-Baltic cooperation in crisis management; the role of the NBSG</u>

The agreement on cross-border financial stability, and crisis management and resolution between the finance ministries and other ministries, central banks, and financial supervisory authorities of the Nordic and Baltic countries (Denmark, Estonia, Finland, Iceland, Latvia, Lithuania, Norway and Sweden) was signed in 2010. The day to day work is done in the **Nordic-Baltic Stability Group (NBSG)** and its subgroups. The NBSG consists of representatives from the financial supervisory authorities, the central banks and the finance ministries (or other ministries) from all eight countries.

The main objectives of the NBSG are to ensure the exchange of information and the smooth functioning of the financial system; to prevent potential financial crises from spreading; and to minimise the overall costs related to financial crises. Four working groups have been set up to achieve this:

1) **Working Group on Burden Sharing (WGBS)**. The WGBS is responsible for developing and updating criteria and models for ways of sharing of net budgetary resolution costs.
2) **Monitoring Working Group (MWG)**. The job of the MWG is to develop a common framework that can be used for assessing the potential impact of a particular shock. The working group also makes the preparations for the NBSG discussions on current financial stability risks, and

[11] http://www.eestipank.info/pub/en/yldine/pank/finantskeskkond/stabiilsus/lepe_1207.html

runs joint stress test if it is decided that they are needed, and it participates in the preparation of crisis simulation exercises.

3) **Institutions and Systemic Importance Working Group (ISIWG)**. The main objectives of the ISIWG are to agree on which financial groups are particularly important, and on how these groups are present in the countries, and to create the database needed for financial and other relevant information regarding these financial groups.
4) **Resolution Tools Working Group (RTWG)**. The RTWG is tasked with identifying legal and other possible obstacles to coordinated decision making and agreeing on workable joint crisis management tools and crisis resolution mechanisms.

<u>Nordic-Baltic cooperation in macro-prudential supervision</u>

Since 2003, Eesti Pank has been a participant in the cooperation network of Nordic and Baltic central banks. There is a long tradition in the region of regular workshops on financial stability for central bank experts. These annual workshops address the results of analyses and assessments, and discuss current financial sector policy issues.

In 2011, the Nordic-Baltic cooperation moved to a new level when the **Nordic-Baltic Macroprudential Forum (NBMF)** was set up, consisting of central bank governors and the heads of the financial supervision authorities. The high-level group meets twice a year to discuss the macro-prudential issues that are most relevant for the Nordic-Baltic region. The meetings are preceded by daily work in a subgroup and its work streams, which mainly cover various technicalities concerning the implementation of macro-prudential tools.

Given the large market share of some Nordic banking groups in Estonia, assessment of the risks to financial stability and the development of appropriate measures requires bilateral cooperation between the parent banks and central banks, on top of multilateral cooperation. For this reason regular meetings are held between experts from Eesti Pank and Riksbank for sharing financial stability assessments and discussing other topical issues.

<u>Cross-border cooperation in micro-prudential supervision</u>

By 2012, the EFSA had signed 26 **cooperation agreements (Memoranda of Understanding)** with the supervisory authorities of 14 different countries. The MoUs are listed on the EFSA´s website: http://www.fi.ee/index.php?id=2574.

In recent years the EFSA has signed several supervisory agreements covering specific group supervision and the **Colleges of Supervisors** were established under the agreements to supervise the banking groups. The agreements state that the Colleges are permanent but flexible structures for cooperation and coordination among the competent authorities, and they provide a framework for those authorities to do the work required of them by regulations.

The functioning of the Colleges is generally organised at two levels:

- a general multilateral level for all the competent authorities – normally used for sharing information on group-wide issues, for general discussion of the overall supervisory policy and planning, or for projects that concern a large number of authorities;

- a core multilateral level for a limited number of authorities who supervise the main activities of a group.

The daily work of the colleges includes regular information exchange, joint supervisory evaluation and joint on-site inspections, and the adoption of joint decisions in various group-based cases. Where there are several entities under supervision, the supervisors organise regular meetings with the management of a financial group to cover the various risk areas related to that group. The management of the group presents its plans for the future and its evaluation of the economic environment and potential impacts of that environment on the work of the supervised entity. The EFSA uses the information exchange to get a thorough picture of the activities of the parent companies of supervised entities and of the situation of the financial groups that operate in Estonia.

Currently the EFSA is a member of the supervisory colleges of the groups of the following credit institutions: Citadele, Danske, DnB, Nordea, SEB, and Swedbank, where regular meetings are held by the supervisors. The EFSA also participates continually in the supervisory colleges of seven insurance groups: If, Mandatum, Munich RE, Nordea Life, OP-Pohjola, SEB and Vienna Insurance Group. In the insurance sector the EFSA continues to prioritise its work with the Latvian and Lithuanian supervisory authorities, as Estonia is the home country of several insurers operating in these countries.

In addition to its close daily work with the Nordic and Baltic financial supervisory authorities, the EFSA has also promoted cross-border cooperation with supervisory authorities from the Central and Eastern Europe (CEE) in recent years. In order to ensure better consistency and soundness of common interests the **national authorities from the CEE established a Forum of cooperation** in the financial sector. Shared discussion topics cover inter alia cooperation between home and host supervisors and issues related to EU financial regulations.

The EFSA also participates actively in the work of the **Group of Banking Supervisors from Central and Eastern Europe (BSCEE Group).** In recent years, the focus of the work has mainly been on the exchange of information among financial supervisors in crisis management and crisis prevention.

<u>European System of Financial Supervision (ESFS)</u>

The EFSA and Eesti Pank work day to day with other EU authorities within the framework of the European System of Financial Supervision (ESFS). The new institutional architecture for the EU's financial supervision was launched on 1 January 2011. It consists of three EU financial supervisory authorities (ESA) and the European Systemic Risk Board (ESRB). The three ESAs – the European Banking Authority (EBA), The European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA) – act as micro-prudential regulatory agencies in their own fields, while the ESRB has been tasked with macro-prudential oversight in the EU. In addition, the Joint Committee of the ESAs was established to ensure cross-sectoral consistency between the ESAs.

The governor of Eesti Pank and the chairman of the EFSA are members of the General Board of the ESRB, with the governor having a voting right in the board. In the ESAs the highest decision-making body is the Board of Supervisors, which is composed of the heads of national supervisory authorities, and the ESA is run by the management board, which is composed of six members appointed by the

Board of Supervisors. While the EFSA is a voting member in each ESA Board of Supervisors, Eesti Pank participates only as an observer in the Board of Supervisors of the EBA. The chairman of the EFSA is also a member of the ESMA management board.

The main work in the framework of the ESFS is done through several committees and working groups. At the end of 2012, EFSA representatives were members of 51 different committees or working groups. Eesti Pank participates in one permanent committee at the ESRB (the ATC, the Advisory Technical Committee) and two working groups.

Crisis management framework

The responsibility for managing financial crises lies with the Ministry of Finance, Eesti Pank, and the Financial Supervision Authority, which have signed a mutual cooperation agreement for managing any systemic financial crisis[12]. The agreement defines a systemic financial crisis as a situation in which the functioning of the financial system is seriously impaired by liquidity or solvency problems for one or several credit institutions, disturbances in the payment and settlement systems, the failure of financial markets or similar events.

The agreement is designed to support the management of any systemic financial crisis so as to minimise the damage that might be caused to society and to the creditors of the credit institution that is experiencing solvency problems. The Ministry of Finance, Eesti Pank and the EFSA have developed their own internal contingency plans for the roles given to them in the agreements among the parties. The Ministry of Finance takes the leading role in resolving any financial crisis. Cross-border financial crises are managed in coordination with the authorities of other countries, and the coordination of a cross-border financial crisis is subject to the bilateral or multilateral agreements between the three Estonian authorities and their counterparts in other countries.

If the Minister of Finance, the Government of the Republic, or the Parliament have decided to rescue or re-structure a credit institution amid signs of a systemic crisis, the Ministry of Finance must arrange the legislative proceedings for allocating the financial funds using the legally-defined procedure and scope of application. Contributions in the form of equity capital can be made to rescue or re-structure a credit institution, or to grant loans and guarantees for loans, or to invest in a financially troubled institution in some other legally permissible form. The main role of Eesti Pank is to ensure sufficient liquidity for the Estonian banking system by providing emergency liquidity assistance to banks.

The State Budget Act stipulates two ex-ante financing measures, the Stabilisation Reserve Fund and the Cash Reserve Fund/Liquidity Fund, which may be used for financial crisis resolution among other events (see table 4).

- The State Budget Act provides that the Stabilisation Reserve Fund can be used for handling or preventing a financial crisis that could cause difficulties or serious failures of the liquidity or solvency of the credit institutions operating in Estonia or substantial failures in the payment and

[12] https://www.fi.ee/failid/Koostoolepingud/Finantskriiside_haldamise_kokkulepe_EN_2006.pdf

settlement systems. The Stabilisation Reserve Fund is a pool of assets formed from state budget funds and other receipts.

- In addition the Ministry of Finance manages liquid budgetary funds through the Cash Reserve Fund or Liquidity Fund. The Cash Reserve Fund may also be used for managing risks, including financial risks, that affect the state's obligations and contingent liabilities.

Table 4. Summary of the possible public financial sources and measures

Source / measure	Who can decide	Time frame
1. Financing measures (sources)		
1.1. Ex-ante		
Stabilisation Reserve Fund[13]	Parliament	1 day up to 2 or 3 weeks
Liquid funds[14]	Ministry of Finance	
DGS	Cannot be used as a source	
Separate resolution fund/scheme	Not established yet	
1.2. Ex-post		
Borrowing facilities/bonds (budgetary loan)	Government	4- 8 weeks
2. Resolution measures		
2.1. Financial tools/instruments		
Injection of deposits	Ministry of Finance / Government / Parliament	1 day up to 2 or 3 weeks
Loan given by state	Government / Parliament	
Liability guarantee	Parliament	
Re-capitalisation (capital injection)	Government / Parliament	
2.2. Other measures		
Privatisation (expropriation)	Government	within 1 – 2 days

Source: Ministry of Finance

As an ex-post resolution financing measure, the government can decide to take a budgetary loan by entering into a loan agreement or issuing government bonds. The maximum permitted balance of a budgetary loan is set in the annual state budget. If it is necessary to exceed the sum set in the annual state budget the parliament must give its approval. In principle, the same also applies if it is necessary to recapitalise an ailing bank. A state guarantee or liability guarantee can be given only by the parliament.

The government can make decisions within 1–2 days but the parliament may take up to 2–3 weeks. However, in extraordinary situations the parliament can pass decisions within three working days.

[13] If the Fund is large enough

[14] Depending on the liquid funds available at the given moment

The Guarantee Fund

The Guarantee Fund is a legal person in public law founded by the Guarantee Fund Act on 1 July 2002 to replace the Deposit Guarantee Scheme, which had operated since 1998. The purpose of the Fund is to guarantee the protection of funds deposited by clients of credit institutions, customers of investment institutions and unit-holders of mandatory pension funds, and to support the transfer of pension contract portfolios, or second pillar annuities, from one life insurance provider to another.

The Fund is composed of several sectoral funds: 1) the Deposit Guarantee Fund (DGF); 2) the Investor Protection Sectoral Fund; 3) the Pension Protection Sectoral Fund; and 4) the Pension Contracts Sectoral Fund (Annuity Protection Sectoral Fund). The assets of the Fund are divided into the rights to be exercised and obligations to be performed for each sectoral fund, and the other assets of the Fund. The Fund must keep separate accounts for the assets of each sectoral fund. The rights or obligations of one sectoral fund may not be acquired or transferred to another sectoral fund.

Although the Fund improves the reliability and stability of the financial sector and is therefore an essential part of the Estonian crisis management framework, the Fund does not have any role in the resolution and insolvency framework. Estonia has not set up a special resolution fund or any other special scheme for financial crises.

The highest directing body of the Fund is the Supervisory Board of the Fund. The Supervisory Board consists of eight members appointed by parliament; the government at the proposal of the Minister of Finance; the Governor of Eesti Pank; the EFSA; and the organisations representing credit institutions, investment institutions, pension fund management companies, and insurance providers. The Fund is managed and represented by the Director, who is subordinate and reports to the Supervisory Board.

The Fund has the right to obtain the information it needs from the EFSA to carry out its duties of the Fund and the EFSA can likewise get information from the Fund. The fund participants and the trustees must submit reports to the Fund through the EFSA.

From 1 January 2011, deposits of up to 100,000 Euros are fully covered. The guarantee limit and the amount of compensation payable are calculated for each depositor in a credit institution. This means that the deposits are not all guaranteed separately, but the total deposits of a depositor in each credit institution are guaranteed. All deposits are guaranteed, regardless whether they are demand, savings, time or other deposits, and irrespective of their currency. Starting from the beginning of 2011 deposits from large companies are also covered by the DGF.

The Fund operates on a pre-funded basis by collecting non-refundable single and quarterly contributions from participants. Credit institutions make a single contribution of 3,200 euros within one month of receiving notification of the resolution to issue authorisation to the credit institution. In addition, the Guarantee Fund Act grants the Supervisory Board the right to set rates for quarterly contributions and gives the maximum rate of 0.125 per cent of the guaranteed deposits. The contribution rates are reviewed annually by the Fund’s Supervisory Board. The current quarterly contribution rate since the third quarter of 2011 is 0.047 per cent of the guaranteed deposits.

The maximum target level is 3% of guaranteed deposits. The Supervisory Board may stop further payments into the Fund, once the target ratio is reached. The maximum contribution level should be used only when there has been major payout from the funds or during the initial phase when the fund is being built up. As at 30 September 2012, the DGF stood at 168.2 million euros, which is 2.0% of covered deposits.

The target level of the Investor Protection Fund is 2 million Euros and the deadline for achieving the target is 2020. These parameters were both set in November 2007 and have remained unchanged since then. The Pension Protection Fund target level was set in 2009 at 0.19% of the net asset value of all pension funds to be achieved by 2013.

Recent changes in legislation and regulations

Changes in 2009

The **amendments to the State Budget Act relating to financial crisis management by the State** came into force on April 6, 2009. This law clarifies that the state's stabilisation reserve can be used to address a financial crisis. The law also speeds up decision-making procedures for parliament during a financial crisis, by permitting single decisions to be taken in one reading instead of the customary two or three. Finally, the law includes a number of other minor technical amendments which may facilitate crisis management by the state.[15]

On July 10 2009, amendments to **the Investment Funds Act, the Insurance Activities Act, the Credit Institutions Act, the Securities Market Act and the Estonian Central Register of Securities Act** came into force. This Act transposes Directive 2007/44/EC of the European Parliament and of the Council into Estonian law where it concerns the procedural rules and evaluation criteria for the prudential assessment of acquisitions and the increase of holdings in the financial sector, by clarifying the procedure and evaluation criteria for persons who acquire, hold and increase a qualifying holding in a bank or other financial institution.

On July 24 2009 **the Emergency Act** entered into force, under which the Ministry of Finance organises the continuous operation of the functioning of payments and settlements, including the collection of state taxes, as a vital service. Eesti Pank organises the functioning of payments and settlements, including securities payments and the availability of cash, as a vital service.

On 10 November 2009 the **State Export Guarantees Act** entered into force. The reason this act was drafted was to establish new principles for granting state guarantees for exports, in order to enable the state to grant medium and long-term export guarantees. This insurer is subject to the Commercial Code and Insurance Activities Act together with exceptions provided by the State Export Guarantees Act and is subject to the supervision of the Financial Supervision Authority because a large part of its activities fall outside the scope of the State Export Guarantees Act.

[15] Parliament also considered, but postponed, granting greater budgetary discretion to the government for the purpose of financial crisis management.

On 15 November 2009 the **Act amending the Commercial Code and other Acts** entered into force. This Act transposes into Estonian law Directive 2007/36/EC of the European Parliament and of the Council on the exercise of certain rights of shareholders in listed companies, which simplified the exercise of shareholders' voting rights. Some amendments were made to regulations for those public and private limited companies that are not active on regulated markets, in order to simplify the management of such companies. This gave shareholders the right to participate in a general meeting through an electronic means of communication for example, and shareholders and partners of such companies became better able to exercise their rights because draft resolutions are now published before the general meeting.

<u>Changes in 2010</u>

On 22 January 2010 the **Payment Institutions and E-Money Institutions Act** entered into force. The draft transposed into Estonian law Directive 2007/64/EC of the European Parliament and of the Council on payment services in the internal market, including the supervisory regime for payment intermediaries, operational requirements, the list of authorised activities, and similar issues. The current regulations on e-money institutions were also amended. The draft defined the categories of payment service providers who may provide payment services on the territory of the European Union or only in Estonia. Payment institutions and e-money institutions operating and established in Estonia are supervised by the EFSA. The Law of Obligations Act was also amended to incorporate Titles III (Transparency of conditions and information requirements for payment services) and IV (Rights and obligations in relation to the provision and use of payment services) of the Directive and specify requirements for the provision of payment services in terms of consumer protection.

On 26 February 2010, the **Act amending the Financial Supervision Authority Act, the Investment Funds Act, the Insurance Activities Act, the Credit Institutions Act, the Law of Obligations Act and the Securities Market Act** entered into force, harmonising the special regulation of the financial sector following the commitment made by Estonia to the World Trade Organization (WTO) under the General Agreement on Trade in Services (GATS) to harmonise the special regulation of the financial sector. This commitment made by Estonia creates the obligation for Estonia to open its market to companies from other WTO countries.

The Act extended the possibilities for the cross-border provision of financial services to banking and investment services as well as to insurance activities and intermediation both for companies from the Estonian financial sector in non-EEA countries and for companies of non-EEA countries in Estonia. Investment firms and fund management companies from third countries had already received the right to provide cross-border services in Estonia earlier.

On 1 July 2010 the **Act amending the Commercial Code and other laws** entered into force, enabling the transition to the Euro from 1 January 2011. All provisions that stipulated the mandatory use of Estonian kroons were amended. These amendments were made in the Credit Institutions Act, the Securities Market Act, the Estonian Central Register of Securities Act, the Code of Civil Procedure and the State Fees Act. The rules regulating the institution of a private limited company were simplified by this Act; the Act also permitted private limited companies to be established without any down payments, lowered the formal requirements for documents under company law and the obligation to involve an auditor, and abolished the statutory right to pre-emption in case of a transfer and time limits to the term of office of a member of a Management Board.

On 1 July 2010 amendments to the **Savings and Loan Associations Act** entered into force which clarified the requirements for membership and the requirements ensuring the financial soundness of savings and loan associations and allowed savings and loan associations to provide payment services under the Payment Institutions and E-Money Institutions Act. A savings and loan association is a financial institution which makes transactions mostly with its members.

On 31 December 2010 amendments to **the Financial Supervision Authority Act, the Investment Funds Act, the Credit Institutions Act and the Securities Market Act** entered into force. The amendments transposed into Estonian law Directive 2009/111/EC of the European Parliament and of the Council on banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements, and crisis management. New rules came in to regulate international cooperation between supervisory authorities and informational requirements, various joint decision-making procedures and cooperation in colleges of supervisors.

Changes in 2011

On 1 January 2011 amendments to **the Financial Supervision Authority Act, the Credit Institutions Act and the Guarantee Fund Act** came into effect to improve the responsiveness and effectiveness of financial supervision in a crisis. The amendments to the Credit Institutions Act gave the Financial Supervision Authority additional legal bases for applying specific on-site supervisory measures and for getting necessary information from supervised entities as a matter of urgency in emergencies or crisis situations. It also entitles the state to consider the expropriation of a holding in a credit institution for specific reasons, if this is necessary for ensuring financial stability and only if this could not be achieved through the application of other measures (*ultima ratio*). This procedure must be considered as a potential measure for restructuring the credit institution in order to ensure financial stability and for restoring the sustainable functioning of the market without recourse to direct state aid measures.

The other amendments to the Financial Supervision Authority Act mostly concerned the entry into force of administrative acts (precepts and decisions) enacted by the Authority. While the previous legislation provided for the application of provisions of the Administrative Procedure Act to the Authority's administrative legislation, the amendments lay down several special provisions which allowed the supervisory procedure to be sped up.

The amended requirements of the Credit Institutions Act improved the liquidity management of credit institutions and extended the Authority's powers in order to improve the efficiency of supervisory activities.

Furthermore, the amendments harmonised Estonian national legislation with the amendments in Directive 94/19/EC: Directive 2009/14/EC of the European Parliament and of the Council amending Directive 94/19/EC on the coverage level and the payout delay of deposit-guarantee schemes. The new Directive raised the deposit guarantee limit from the current 50,000 EUR to 100,000 EUR for each depositor in a single credit institution.

On 3 April 2011 the amendments to the **Investment Funds Act and to other related acts** entered into force. The amendments transposed into Estonian law Directive 2010/76/EC of the European Parliament and of the Council on capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies and Commission Recommendation 2009/385/EC on the regime for the remuneration of directors of listed companies. The amendments improved the responsiveness of remuneration policies in the financial sector, improved market conduct rules for financial services that carry investment risks, and clarified prohibitions of market manipulation.

The **Debt Restructuring and Debt Protection Act** that came into force on 5 April 2011 allows natural persons with temporary solvency problems to restructure their debts and overcome their solvency problems while avoiding bankruptcy procedures. The Act sets out a new court procedure that allows the debts of a natural person to be restructured by the deadline for the underlying obligations being extended, repayment by instalments allowed or the obligations reduced. Natural persons propose solutions for repaying their debts, and the creditors and the court evaluate these proposals. Approval of the debt restructuring requires the debtor to have or be due to have an income that will allow the debts to be repaid, and the intention of avoiding bankruptcy proceedings.

The rules for the debt restructuring procedure and bankruptcy procedure were harmonised concurrently with the Debt Restructuring and Debt Protection Act. Amendments made in the Law of Property Act, the Code of Civil Procedure, the Code of Enforcement Procedure and the Taxation Act set out the relationships arising from a pledge and improved the position of a pledgor. Amendments to the General Part of the Civil Code Act shortened the limitation period of claims arising from an execution document against a debtor. Amendments to the Law of Obligations Act specified the calculation principles for default interests.

The Act Amending the **Securities Market Act and Other Acts** came into effect on 30 June 2011, transposing Directive 2009/44/EC of the European Parliament and of the Council amending Directive 98/26/EC on settlement finality in payment and securities settlement systems and Directive 2002/47/EC on financial collateral arrangements for linked systems and credit claims. The amendments aimed to improve and clarify the regulation on clearing and settlement systems, the concept of an interoperable system and the responsibility of system operators. The definition of financial collateral and the provision of financial collateral were amended. Under the amendments, credit claims can be deemed to be financial collateral, except for any claim which arises from a consumer credit contract or a credit contract with a micro or small-sized company.

The Act Amending the Law of Obligations Act and Other Acts came into effect on 1 July 2011, transposing Directive 2008/48/EC of the European Parliament and of the Council on credit agreements for consumers. The Directive aims to ensure the common internal market for consumer credit and the high level of consumer protection in the European Union. It harmonised the requirements for consumer credit contract advertisements, pre-contractual and contractual information and the calculation of the Annual Percentage Rate of Charge, and it supplemented and elaborated the regulation on the right of consumers to withdraw from a contract, the right to repay credit before its deadline, and the right of consumers to withdraw from contracts that are economically related to the consumer credit contract and from ancillary contracts. The Consumer Protection Act and the Advertising Act were amended concurrently with the Law of Obligations Act.

Together with the Act Amending the Law of Obligations Act and Other Acts, the Regulation of the Minister of Justice came into effect on 1 July 2011, establishing the forms for Standard European Consumer Credit Information. The creditor must present the Standard European Consumer Credit Information to the potential borrower during pre-contractual negotiations. This Regulation transposed the Standard European Consumer Credit Information, which was designed to ensure that consumers are informed before they sign a contract and was provided in Annexes II and III of Directive 2008/48/EC. The Regulation is applied in conjunction with the provisions of the Law of Obligations Act that were drafted in order to transpose the new Consumer Credit Directive (2008/48/EC).

The Act Amending the Payment Institutions and E-Money Institutions Act and Related Acts came into effect on 18 July 2011. It updated the regulation of the issuance and use of electronic money and transposed Directive 2009/110/EC of the European Parliament and of the Council. The Act harmonised the requirements for electronic money institutions and other issuers of electronic money, simplified and extended the definition of electronic money, and established the new framework for institutions that issue electronic money. The minimum capital requirement of electronic money institutions was lowered to 350,000 euros. The Act described the basis for the issuance and return of electronic money and the right of consumers to exchange the electronic money back into ordinary money was increased.

The Act Amending the Commercial Code and Related Acts came into effect on 12 November 2011, transposing Directive 2009/109/EC amending Council Directives 77/91/EEC (Capital Requirements Directive), 78/855/EEC (Mergers Directive) and 82/891/EEC (Divisions Directive), and Directive 2005/56/EC (Cross-Border Mergers Directive). The Act made it possible for companies to meet the obligation of providing merger and division documents to shareholders through disclosure on the company's website, and for listed companies through the central information recording system. Based on amendments made in the Mergers and Divisions Directive, the regulation allowed a waiver of general meeting decisions, if the merging company owns at least 90% of the shares of the merged public limited company or units of merged private limited company or the acquiring private or public limited company owns 100% of shares of merged or divided private limited company or public limited company in cases of division. In addition, the Act amended and elaborated the obligation to present an interim balance sheet after the merger or division of public limited companies.

Changes in 2012

The Act Amending the Taxation Act and Other Acts came into effect on 1 January 2012. The Act transposed the requirements of the Council Directive 2010/24/EU concerning mutual assistance for the recovery of claims relating to taxes, duties and other measures and Council Directive 2011/16/EU on administrative cooperation in taxation and the repeal of Directive 77/799/EEC. It supplemented inter alia the provisions of the Credit Institutions Act on banking secrecy with a paragraph stating that a credit institution may lift banking secrecy at the request of a tax authority, if the inquiry specifies the unique identifier of the customer affected. For the sake of legal clarity, this amendment ensured the conformity of the provisions of the Credit Institutions Act on banking secrecy with the Taxation Act.

The new Code of Administrative Court Procedure that came into effect on 1 January 2012 increased the efficiency of the legal protection provided by the administrative court. Unnecessary formal and content requirements regarding the lodging of an appeal were abolished and the Code simplified the rules for amending the appeal and for changing the type of appeal. It enabled the court procedure to be sped up in administrative matters, granted stronger powers to courts for holding court hearings in the absence of one party and for hearing matters as written proceedings.

On 30 March 2012 the amendments to the **Investment Funds Act and to other related acts** entered into force. The Act transposed the requirements of Directive 2009/65/EC of the European Parliament and of the Council on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS); and Commission Directives 2010/43/EC and 2010/44/EC by Directive 2003/41/EC of the European Parliament and of the Council of 3 June 2003 on the activities and supervision of institutions for occupational retirement provision; and Directive 2010/78/EU of the European Parliament on the powers of the European Supervisory Authorities.

On 1 July 2012 the **amendments to the Securities Market Act** entered into force. The amendments transposed into Estonian law Directive 2010/73/EU of the European Parliament and of the Council. The amendments to the law simplified and clarified the requirements for the prospectus when securities are offered to the public or admitted to trading and completed the transparency requirements concerning information about issuers whose securities are admitted to trading on a regulated market.

<u>Ongoing EU legislative initiatives</u>
Strengthening of the European financial services framework is one of the main steps to be taken to ensure the proper and sound functioning of the EU single market. Most of the latest legislative initiatives of the EU relating to the financial sector are designed to contribute to the establishment of a single rule book for EU financial services, which means a harmonised approach should be taken in all member states or regulations should be applied directly. This also includes the technical standards developed by all the three ESAs and adopted by the Commission as decisions or regulations. The initiatives that will most affect the Estonian financial system in the near future are:

- The finalisation of the **revised directive and new regulation on capital requirements for credit institutions and investment firms (CRR/CRD IV),** which is part of the legislative implementation of the Basel III Agreement for credit institutions and investment firms, is expected in the beginning of 2013. The directive should be implemented into Estonian law during the year after its adoption, while the regulation will be directly applicable.
- Similarly, work will be carried forward on insurance, with the **Omnibus II Directive** proposing specific changes to legislation mainly for insurance (*Solvency II Directive*) and also for securities (*Prospectus Directive*).
- Agreement is also foreseen on the proposals for a further revision of the Regulation on credit rating agencies (***CRA III***), on the revision of the **Transparency Directive**, on the revised rules on

markets in financial instruments (***MiFID/MiFIR***), and on the revised rules on market abuse (***MAR***).

- Further work is still needed on the crisis management framework in the financial sector, which aims to put in place an EU framework for crisis management in the financial sector and to enlarge the toolkit available to authorities for dealing with the orderly resolution of failing financial institutions (***proposal for the Recovering and Resolution of Credit Institutions and Investment Firms***).
- A final decision on the establishment of the **Single Supervisory Mechanism** (SSM) is expected in early 2013 and the SSM should to be fully functional from 1 March 2014. The ECB will be responsible for the overall functioning of the SSM. The ECB will have direct oversight of systemically important banks in the euro area. Estonia's two biggest banks by market share, the subsidiaries of Swedbank and SEB, will come under the direct supervision of the ECB.
- The Mortgage Credit Directive (**MCD**) will be most probably also be adopted in 2013. The MCD will establish rules on advertising, pre-contractual information, advice, creditworthiness assessment, and early repayment for mortgage credit agreements. Because Estonia already applies the Consumer Credit Directive (2008/48/EU) requirements for mortgage credit agreements, there will be no significant change for consumers. However, there will be a licensing regime for nonbank mortgage credit providers and mortgage credit providers will also be subject to financial supervision.
- The Directive on Alternative Investment Fund Managers (**AIFMD**) is expected to be transposed by 22 July 2013, and the level 2 delegated acts of the Commission to be adopted in order to enforce the new regime for fund managers who manage assets exceeding 100 or 500 million euros.

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