

V. SAFEGUARDING FINANCIAL STABILITY

OVERALL FINANCIAL STABILITY FRAMEWORK IN ESTONIA

Safeguarding smooth and efficient financial system including institutions, markets and the infrastructure is one of Eesti Pank's main objectives. To accomplish that it is necessary to develop an appropriate financial stability framework, which involves relevant legal environment and financial sector policy, efficient supervision and reliable information about the financial sector.

The main goal of central banks in safeguarding financial stability is to avoid emergence of such disturbances that by extent and duration could significantly reduce economic activity and prevent the central bank from accomplishing its main objective, i.e. maintaining price stability. The efficiency of a monetary policy transmission mechanism largely depends on the functioning of major financial institutions and markets. The responsibility of the central bank in safeguarding country's financial stability arises directly from its role on maintaining price stability.

Safeguarding financial stability, Eesti Pank mainly focuses on securing smooth integrated performance of the financial system and minimising a threat of a systemic crisis. Devising its financial policy, Eesti Pank is guided by continuous and good expertise of monitoring and analyses. The international structure of the financial sector and modern rapidly changing operational environment require efficient cooperation with other authorities both in Estonia and abroad.

REGULATION AND BANKING POLICY

In 2004, activities of Eesti Pank in the banking law fell into two groups: improvement of the current legal environment and preparing of Estonia's position for draft amendments to the Capital Adequacy Directive.

Banking legislation was amended primarily due to Estonia's accession to the European Union. The *Riigikogu* adopted in two phases the **Amendments to the Credit Institutions Act** arising from the harmonisation of the Credit Institutions Reorganisation and Winding up Directive, from banking licence application procedures as well as from clarification of relationships between market participants and the Financial Supervision Authority.

One of the amendments worth outlining is the **introduction of the EU single passport principle** – a branch of a credit institution operating in another Member State shall be obliged to notify the other Member State instead

of applying for a banking licence. The amendment applies both to entry into operation of a branch of a Member State's credit institution in Estonia and a branch of Estonia's credit institution in another Member State.

For single financial supervision, amendments to the Credit Institutions Act, which amended the **procedures of licence application and notification of changes in qualifying holding**, were important. The procedure was aligned with the procedure applicable to other financial market participants under supervision.

Apart from amending banking sector legislation, also credit institutions' **prudential requirements** were modified. As regards credit and currency risk calculation, all the new Member States were listed in Zone A (low risk). This involved two major changes: firstly, marginal rates vis-à-vis currencies of these countries increased; secondly, risk weightings for claims of residents of these states in calculating capital adequacy ratio decreased. The 50% risk weighting ratio established for local governments and investment companies was reduced to the 20% level as provided for in the EU directive.

From the perspective of sustainable economic growth in the EU, international integration of financial markets has a very significant role to play. However, structural changes in the financial sector pose new challenges for financial supervision. It is essential to find solutions to arising issues in cooperation with other EU Member States in order to minimise risks without suspending financial market integration.

Drafting **new more risk-sensitive capital adequacy rules**, which will influence both Estonia's and EU banking law in future, Eesti Pank was responsible for preparing Estonia's position together with the Ministry of Finance and the Financial Supervision Authority. Current amendments to the Capital Adequacy Directive are based on capital adequacy framework (Basel II) initially elaborated by the Basel Committee on Banking Supervision at the Bank for International Settlements (BIS) and approved by representatives of G-10 central banks and supervision authorities on 26 June 2004.

For Estonia, the implementation date of the directive and the implementation of consolidated supervision were of primary importance. The draft presented to the European Parliament was a compromise: consolidated supervision will be the responsibility of the supervisory authority of the home country. Consolidated and unconsolidated supervision of a subsidiary bank's group is within the competence of the host country.

PREVENTION OF MONEY LAUNDERING AND TERRORIST FINANCING

For safe and stable financial sector, the national policy should ensure readiness to prevent money laundering and financing of terrorism. Relevant activities should derive from internationally approved requirements and best practice. Eesti Pank as an institution with the main task to ensure financial stability cooperates both with Estonian agencies and international organisations in order to prevent money laundering and combat terrorist financing. Eesti Pank takes part in coordinating national policy, drafting legislation and formulating Estonia's positions at the international level.

In Estonia, the **Money Laundering and Terrorist Financing Prevention Act**¹ adopted in 2004 regulates the prevention of money laundering and combating terrorist financing. The Act was amended pursuant to the Second EU Directive². The main amendments to be outlined are expansion of the undertakings within the scope of the Act, inclusion of prevention of terrorist financing, and updating of the registration of currency exchange service providers. Pursuant to this amendment, since spring 2004 Eesti Pank has not regulated the

¹ In 1999–2003, prevention of money laundering was covered by the Money Laundering Prevention Act and before 1999 by the Credit Institutions Act.

² Directive 2001/97/EC of the European Parliament and of the Council of 4 December 2001 amending Council Directive 91/308/EEC on prevention of the use of the financial system for the purpose of money laundering.

activity of providers of currency exchange services and they are obliged to register themselves in the register of economic activities in order to start or continue operation. In future, the role of Eesti Pank as a regulator of this field will disappear and credit and other financial institutions will be subject to internal procedures for prevention of money laundering and terrorist financing established by the Minister of Finance.

At the international level, Eesti Pank together with other Estonian agencies participated in **drafting the Third EU Anti-Money Laundering Directive**. For Estonia, the **approval of the second assessment mission report of the Council of Europe** was also important. The approved report confirmed that prevention of money laundering and combating terrorist financing in Estonia is in compliance with international principles and best practice. Relevant regulation and supervision of Estonia's financial system was singled out as positive.

FINANCIAL STABILITY: MONITORING AND ANALYSIS

Since autumn 2003, Eesti Pank publishes a biannual **Financial Stability Review**, which reflects developments influencing Estonia's financial sector stability. The review includes evaluations and projections of financial sector developments, being an important input for Eesti Pank's economic policy analyses.

In order to evaluate developments and risks of financial sector market segments (banking, securities market, investment and pension funds, insurance), it is necessary to monitor Estonia's corporate and household behaviour as regards the allocation of financial assets and the loan servicing ability. In 2004, a central topic in the financial stability analysis was sustained **high household loan demand**. Several times in its economic policy comments Eesti Pank drew attention to risks accompanying soaring loan burden and stressed the necessity to actively increase risk awareness and risk hedging among all parties – the lender, the borrower, and the state.

Further **integration with international financial markets** was another important keyword of recent developments in the financial sector. Both in 2004 and in future Eesti Pank's analyses focus on the significant share of foreign banks in influencing Estonia's macroeconomic processes and financial stability. In order to assess banks' performance and risks, further efforts to improve forecasting and strength analysis systems were made.

Together with other EU central banks and supervisory authorities, Eesti Pank participates in analyses and evaluations of EU financial stability and financial sector structure. In 2004, reports on EU financial stability and on EU banking structures were released in cooperation. Essential topics studied involved implications of EU cross-border banking, risks to household borrowing, risk management strategies of banking groups, and outsourcing of services. Financial stability and banking structure analysis in new Member States was under special attention. In 2005, the framework for interest risk analysis and the mortgage financing analysis will be developed further.

CRISIS RESOLUTION FRAMEWORK

One of the features of a developed financial system is recognition at the national level of how to deal with financial crises. The framework for crisis management covers arrangement in three areas: deposit insurance, central bank's emergency liquidity support, and procedures, guidelines and agreements for crisis resolution.

In 2004, Eesti Pank initiated a national **interagency discussion on drafting financial crisis management principles**. The main emphasis is on distinct distribution of roles and exchange of information as prerequisites to achieve a quick and efficient solution in case of liquidity or solvency problems of a financial institution.

Banking crisis resolution is even more complicated if the troubled bank operates in more than one country. One of the main tasks facing the EU in financial stability is to elaborate crisis resolution principles and agreements in the coming years. The first step in organising crisis management was a **cooperation agreement between EU central banks and supervision authorities** in March 2003. The multilateral agreement is aimed at ensuring cooperation and exchange of information in case of an EU cross-border financial crisis; in June 2004 institutions from new Member States, including Eesti Pank and the Financial Supervision Authority, joined the agreement. As successful crisis resolution often requires also government intervention, a supplementary agreement is going to be signed at the EU level in 2005, covering crisis management coordination between central banks, supervision authorities and finance ministries.

Deposit insurance is mandatory for banks operating in Estonia. Since July 2002, deposit insurance has been the responsibility of the Guarantee Fund, which is also responsible for placing contributions. Compensation limits for 2004 and 2005 are up to 100,000 kroons; by end-2007 they will reach the level provided for in the EU directive (20,000 euros, i.e. 313,000 kroons). The role of Eesti Pank is to provide analytical support in determining the amount of appropriate contribution for guaranteed deposits. Apart from the Deposit Guarantee Sectoral Fund, totalling 849 million kroons in end-2004, the Guarantee Fund comprises the Investor Protection Sectoral Fund (total volume of 1.6 million kroons in end-2004) and Pension Protection Sectoral Fund (1.3 million kroons).

OVERSIGHT OF PAYMENT AND SETTLEMENT SYSTEMS

Like in other fields, the year 2004 in the oversight of payment and settlement systems was primarily a year of EU accession. Accession impacts were, first and foremost, evident for economic agents who had to make numerous external payments. The EU accession provided **access to trans-European settlement systems**. As a result, most credit institutions decreased fees for internal payments within the EU.

For Estonia, an important line of activity in 2004 was tackling shortcomings discovered during the assessment of the Real Time Gross Settlement System (RTGS)³ launched in 2003.

In cooperation with credit institutions preparations to develop an interbank retail payment settlement system were started. The aim is to enhance competition in the banking market and facilitate use of more efficient payment methods. The application deadline is set for early 2006 and, as a result, interbank payment settlement should accelerate and interbank direct debit would become operational.

³ An access framework should be amended and disclosed.