

ENSURING FINANCIAL STABILITY

The mission of Eesti Pank is to guarantee price stability in Estonia. Smooth functioning of the financial system is a necessary precondition for the central bank to carry out this mission. Ensuring the stability of the financial system is hence one of the most important functions that Eesti Pank has.¹ Eesti Pank assesses the risks to the financial system and takes measures to minimise the possibility of such risks materialising.

The results of the analysis of the stability of the financial sector and related risks are published twice a year in the Financial Stability Review. The review also includes assessments of the operability of and possible risks to the payment and settlement systems, which are the basic infrastructure underpinning the financial sector. To increase the transparency of the financial sector and provide market participants with the data they need, Eesti Pank publishes statistics on the operation of banks and leasing companies on a monthly basis. Since 2008, the data have been published with comments.

The Estonian financial sector and economy are globally integrated, making it essential that close domestic and cross-border cooperation be maintained with the institutions that have an influence on the sector's operational environment. The basis for cooperation between Eesti Pank, the Financial Supervision Authority and the Ministry of Finance is the Memorandum of Understanding (MoU), which was renewed in 2007. A committee of representatives of the three bodies has been set up to exchange information and coordinate operations. In addition to providing a framework for daily operations, the MoU lays out the tasks and foundations for joint operation in an emergency, such as a systemic financial crisis. However, although the operability of the financial intermediation system is a broad goal and is in the interest of the society, the main responsibility for the sustainability of each individual bank lies

with the owners and management of the bank.

In addition to its domestic operations, Eesti Pank also cooperates with the national central banks of other EU countries as a member of the European System of Central Banks to ensure financial stability and participates in shaping positions on various EU financial sector policy matters. Eesti Pank works especially closely with the Nordic and Baltic States as a result of regional integration. Since 2006 Eesti Pank has been part of the cooperation network of Nordic and Baltic central banks, where information on the functioning of the financial systems and their operating environment is exchanged regularly. In 2009, preparations were completed for the signing of a new agreement between Nordic and Baltic banking supervisory authorities, central banks and ministries of finance on ensuring cross-border financial stability. The agreement sets out the principles of cooperation and information exchange and the common code of practice for acting in a crisis situation.

Financial sector analysis and financial stability assessment

The tightening of the global financial environment in the second half of 2008 also affected the banks operating in Estonia. It became especially difficult to obtain long-term funds on financial markets and this then affected companies' and households' access to and cost of credit. Both domestic and external demand were very weak throughout 2009, and so companies and households limited consumption and investment. However, for an economy to function, the non-financial sector must have sufficient access to credit even in a recession. Although in the coming years there is no reason to expect a return to loose pre-crisis credit standards, banks are still willing to fund viable projects. Borrowers may also benefit from lower loan interest rates, as a

¹ Ensuring financial stability is one of the principal functions of the central bank (for more details see pp 20).

consequence of key interest rate cuts, and the general decline in prices.

An increase in corporate and household indebtedness in the years of strong credit growth and a decrease in income during the subsequent economic decline highlighted the lessening loan repayment ability of the non-financial sector and the resulting impact on banks' capitalisation. Economic processes in 2009 meant that an increase in loan losses was quite expected. It is essential to assess the ability of banks to cope with growing losses since losses from lending activity reduce the capital of banks. The banking sector can protect itself against less favourable times by accumulating reserves in good times, which the banks operating in Estonia also did during the economic expansion. Higher reserve requirements compared to the EU minimum requirements helped banks accumulate necessary buffers and as a result, direct state support for financial institutions was not needed in Estonia.

Eesti Pank conducts regular banking sector stress tests on the basis of economic forecasts and the methods of analysis are constantly being improved. The results of the stress test, carried out on the basis of the latest economic forecast by Eesti Pank,² confirm the resilience of the banks operating in Estonia.

According to assessments at the end of 2009, the risks to Estonia's financial stability have lessened over the year and the banking sector has sufficient buffers. However, external risks are still higher than usual and the income level and solvency of Estonian companies and households remain low compared to a year earlier. Given the increased debt burden, the factors fundamental for the development of the Estonian econ-

omy in the coming years will be the flexibility of the economy and the ability of companies and households to adjust to the requirements of the changing economic structure.

Cooperation with European central banks was focused on the impact of loan losses on the capitalisation of banks and overall financial stability in the European Union.³ In addition, the funding structures and related policies of the European banks and the impact of banks' remuneration schemes on financial stability were analysed.

Measures adopted to ensure financial stability

At the beginning of 2009, governments in Europe and elsewhere continued taking measures to ensure the functioning and liquidity of the banking sector and to avoid further deepening of the economic crisis. The measures taken by the EU Member States were based on the common action plan agreed upon within the framework of the EU Council of Economic and Finance Ministers (ECOFIN).

Given the integration of Estonia's banking sector with that of Sweden and the risks arising from changes in the global economy, Eesti Pank further reinforced cooperation with the Swedish central bank by entering into a precautionary arrangement with Riksbank in February 2009 to secure financial stability and promote confidence in the financial markets. The contract amount was for up to 10 billion Swedish kronor in exchange for Estonian kroons. The precautionary arrangement enhanced the capabilities of Eesti Pank to provide liquidity under the currency board agreement used in Estonia. The arrangement with Riksbank provided supplementary assurance during the period of uncertainty in

² 2009 autumn forecast.

³ In 2009, the European Central Bank summoned the Task Force on Credit Cycles, in which Eesti Pank also participated.

the global financial sector, in addition to the high liquidity and capital buffers of the Swedish banks' branches and subsidiaries in Estonia. The contract was not acted upon in 2009 as it was not required during the year.

State intervention in ensuring the functioning of the financial market should be temporary, so when the global financial sector had stabilised, discussions about the gradual reduction of state support of the financial sector started. Given the uncertain economic situation and the possible cross-border impact of the withdrawal of support measures, reducing such measures requires coordination and an exchange of information between countries. For this reason, Member States agreed at ECOFIN about the general principles for ending crisis measures.

At the same time, work to reinforce financial markets supervision and regulation continued. Most notably, the banks' capital adequacy framework and the EU financial stability framework were further improved (see also below). Stronger regulation and capital requirements are intended to increase banks' resilience and reduce the risk that the difficulties of one bank may pose a threat to overall financial stability.

In 2009, the European Commission established an expert group to draft legislation for tightening the capital requirements of the banking sector. Legislative amendments included stricter conditions for trading portfolios, securitisation and management remuneration. Future plans include the introduction of a requirement to hold additional capital buffers and amendments to the financial accounting rules, to reduce the cyclical impact of banks' activities. Preliminary proposals for amendments also included an additional capital requirement on housing loans issued in a foreign currency. The proportion of euro loans in Estonia is quite high, primarily for housing loans. However, given Estonia's globally integrated financial sector, its euro-based currency

board system and the expected adoption of the euro, there is no reason to consider euro-based loans a risk factor that calls for more restrictive regulation.

Alongside its cross-border cooperation, Eesti Pank engaged in ensuring domestic financial stability and improving the crisis management framework in 2009. In March, the Riigikogu approved amendments to the State Budget Act, the Foundation of and Participation in Legal Persons in Private Law by the State Act, the Riigikogu Rules of Procedure Act and the Riigikogu Internal Rules Act. The amendments aimed to improve the state's ability to manage a financial crisis, thereby ensuring financial stability.

Given the uncertainties in the economy and financial markets, in 2009 Eesti Pank decided to retain the 15% reserve requirement and 10% capital adequacy requirement for the credit institutions operating in Estonia. The baseline scenario of the 2009 autumn forecast of Eesti Pank suggests the economic crisis will ease and the prospect of the adoption of the euro will boost the confidence of foreign investors in the Estonian economy. This, in turn, will allow a possible reduction of the strict reserve requirements for banks in 2010.

Changes in the EU financial stability framework

The increasing cross-border activities of financial groups and the lessons learned from the financial crisis underline the need for closer international cooperation in financial supervision and crisis prevention. Last year, one of the most important initiatives in the financial sector was negotiations on reforming the EU supervision framework. Discussions started also on improving cooperation between Member States in financial crisis management and the harmonisation of the legal framework.

One of the most important proposals was the establishment of a European Systemic Risk Board (ESRB) and European financial supervisory authorities. It is expected that amendments to the supervision framework will be approved in 2010 and the new supervisory authorities should start work in 2011. The ESRB will be responsible for assessing potential risks to financial stability arising from the developments in macroeconomic environment and the financial system, and for issuing risk warnings and recommendations for mitigating risks. The Governor of Eesti Pank will be a member of the ESRB General Board, and will have the right to vote. The main objectives of the European System of Financial Supervisors (ESFS)⁴, which will replace the current supervisory committees, are to ensure the smooth functioning of the financial system and financial markets and to improve cooperation in supervision.

In addition to supervision, safeguarding financial stability requires efficient crisis management. However, managing cross-border crises and coordinating activities is complicated, because countries have different interests and different legal systems, and also the timing of crisis measures may differ. In order to harmonise the principles of crisis management, consultations on the reform of the EU crisis management framework started last year, in line with the action plan approved by ECOFIN. The reforms are aimed at a more uniform approach to the prevention and management of crises, which would comply with the principles of the European single market and

enhance cross-border financial integration.

Eesti Pank considers efficient cooperation between supervisory authorities and other institutions to be a priority in cross-border supervision and crisis management. Cooperation between supervisory authorities is most efficient when the interests of all Member States are appropriately taken into consideration, and the rights and obligations of countries are in balance. This means that the impact of the decisions of the European supervisory authorities on the financial stability of each country should be taken into consideration, and the decisions should not entail excessive costs for the Member States.

Improvement of securities market infrastructures

One of the strategic goals of Eesti Pank is to develop the infrastructure of the financial system. To this end, Eesti Pank has been participating in the TARGET2-Securities (T2S) project, a single shared platform for settling securities in the Eurosystem. In 2009 the specification phase of the T2S platform continued (see Figure 1).

In order to facilitate the management of the project, in spring 2009 the ECB Governing Council assigned a new management body, the eight-member T2S Programme Board⁵, to manage the project and submit proposals to the ECB Governing Council regarding strategic T2S issues while considering the interests of all

2006	2007	2008	2009	2010	2011	2012	2013	2014
Preparations		T2S platform specification		T2S platform development		Testing	Migration	

Figure 1. T2S project phases

Source: European Central Bank

⁴ The European System of Financial Supervisors consists of the three European supervision authorities – the Committee of European Banking Supervisors (CEBS), the Committee of European Securities Regulators (CESR) and the Committee of European Insurance and Occupational Pensions (CEIOPS) – and Member States' financial supervision authorities.

⁵ The T2S Programme Board has received a mandate from the ECB Governing Council and is responsible for the implementation of the T2S programme. Its responsibilities include daily management of the T2S programme and management of relations with T2S clients and external stakeholders. The T2S Programme Board also reports on the T2S programme to the ECB's decision-making bodies.

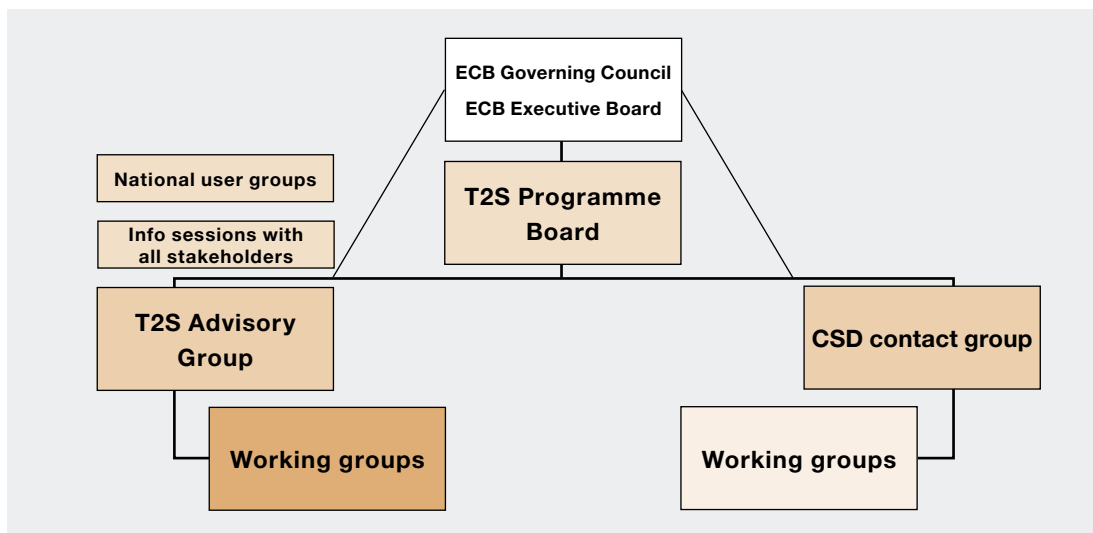


Figure 2. T2S project governance during the specification phase

Source: European Central Bank

stakeholders⁶. The project specification phase addressed the following issues:

- amendments to project governance with regard to the termination of the specification phase (see Figure 2);
- pricing of the project;
- general functionality of the T2S platform;
- legal issues.

In addition to the T2S Programme Board, a CSD (Central Securities Depositories) Contact Group will be established, which will be subject to the T2S Programme Board and consist of the representatives of CSDs and the T2S Programme Board.

The Advisory Group, which was established during the preparation phase in 2007 and consists of around 80 experts from central banks⁷, CSDs⁸, representatives of users and observers, continued work also in the T2S specification phase.

It was decided that a single price list will be established for the project for all participants, regardless of their moment of accession, and that there would be no discounts for CSDs. The ECB Governing Council approved the general functional specifications of T2S and defined five eligibility criteria for the CSDs wishing to participate in the T2S platform.

In summer 2009, a Memorandum of Understanding was signed by the CSDs interested in the Eurosystem and the T2S platform. By now, 28 CSDs in 26 European countries have signed the MoU⁹. Although the T2S platform was originally intended mainly for securities settlement with the euro on the cash side, it is now developing into a multi-currency settlement platform. Danish, Swedish and Norwegian markets have decided, with the support of their central banks, to use T2S for settlements in their domestic currencies.

⁶ Including central banks, CSDs and end-users of the T2S platform, who are mainly credit institutions.

⁷ Central banks of the Eurosystem and those central banks, which have declared to the ECB their interest in adding their national currency to the currencies of the T2S platform.

⁸ CSDs that have signed the MoU with the Eurosystem.

⁹ The list of signatories of the MoU is available at <http://www.ecb.europa.eu/paym/t2s/html/nl0509.en.html>. In autumn, the Norwegian CSD (VPS) also signed the MoU.

At the beginning of 2009, the T2S Estonian National User Group (EENUG) was set up to establish the needs of the Estonian market and formulate the positions. The responsibility of the EENUG is to represent the country's interests to the T2S project team working at the European Central Bank, to the T2S Advisory Group and to the market participants in Estonia. The most important decision adopted by the T2S EENUG in 2009 was the joining of the Estonian CSD with the MoU between the Eurosystem and CSDs, so that it could join the T2S platform for euro settlements. Adding the Estonian kroon to the T2S currencies was considered but was not found economically reasonable due to the high integration of Estonia's market, even if Estonia has not become a member of the euro area by the time the T2S platform is launched.

The EENUG was also a partner in the Nordic-Baltic cooperation measures and contributed to the development of the T2S by participating in pan-European consultations on T2S issues.

Payment and settlement systems oversight

In 2009, there were no such incidents in the operation of the Estonian interbank payment and settlement systems that could have threatened the stability of the financial sector. The functionality and principles of the systemically important payment and settlement systems (TARGET2-Eesti, EP RTGS and ESTA) have been structured so as to minimise the chances of any risks actually materialising.

In addition to Eesti Pank and the credit institutions that joined TARGET2-Eesti in May 2008, the Estonian Central Securities Depository (ECSD) also became a member of TARGET2-Eesti on 3 August 2009. The membership of the ECSD and the introduction of euro settlements for settling claims resulting from securities trans-

actions affect the operation of both TARGET2-Eesti and the securities settlement system, which is why in 2009 the central bank analysed the impact of the ECSD's project for settlement systems.

The ECSD's euro settlements project in TARGET2 introduced services in two stages:

- 1) national services, which do not include the settlement of financial claims and liabilities resulting from the purchase and sale transactions of securities (transfers primarily related to investment fund units and dividend payments), were launched on 3 August 2009;
- 2) the settlement of financial claims and liabilities resulting from the purchase and sale transactions of securities in Estonia was implemented on 4 January 2010.

Along with the introduction of national services, in particular stage 2 services, the ECSD intends to eliminate the drawbacks that have been outlined in the oversight assessments of Eesti Pank in previous years and that have so far prevented the settlement risks being fully hedged. To this end, the following measures will be applied:

- 1) real-time delivery versus payment (DVP) for securities transactions;
- 2) an integrated settlement model where settlement system participants (account managers) transfer funds to the ECSD's payment module account opened in the TARGET2-Eesti settlement system, which may be used as a collateral account for performing settlements;
- 3) amended the ECSD's data processing rules.

Eesti Pank finds that the solution offered by the ECSD is reasonable and appropriate in terms of its operation, technology and oversight.