V. FINANCIAL STABILITY ENSURING AND BANKING POLICY

Stable, safe and efficiently developing financial system is one of the primary objectives of Eesti Pank. The objective of the central bank is to ensure the stability of the financial system, a significant prerequisite being a stable and safe financial environment. The most important component in Estonia's financial intermediation is banking system. Therefore, in developing the financial environment Eesti Pank has focused on establishing and updating a framework for the development of the banking system in Estonia.

Consistent Banking Policy

Throughout the last ten years Eesti Pank has pursued the same guiding principles in developing stable and efficient financial environment. **The currency-board-based monetary system, openness and highly experienced and decision-committed strong core owners** – these principles have brought stability and transparency into Estonian financial environment.

The strategic objective – accession to the European Union and the accompanying international integration of Estonian financial markets has had an impact on central bank's policy in drafting and enforcing legislation and banking guidelines, but also set requirements for financial supervision and management quality in financial institutions. The upcoming EU accession has laid the stress in financial sector development on increasing efficiency through enhanced competition. It is important for Estonia to achieve such strength in financial institutions that allows the surviving in the international competitive environment accompanying integration with Europe.

In developing Eesti Pank's financial policy decisions, besides the two above-mentioned main factors **the necessity to take into account the specificity of transition economy**, which in some cases requires setting more stringent requirements and norms than would be necessary for stable economic development, has been crucial.

The most important key words in 2001 were improvement of capital adequacy framework and expansion of financial sector guarantee schemes.

Central Bank Ensuring Financial Stability

Financial stability can be based only on co-operation and concerted division of labour between Eesti Pank, the Ministry of Finance and Financial Supervison Authority. Eesti Pank as the central bank has a significant function to fulfil. As said above, the central bank is a guarantor of financial stability due to its function to uphold the stability of the currency. The objective of the central bank is to develop through financial sector policy a suitable environment for the financial system, but also to ensure efficient supervision over the financial sector as a whole.

Until end-2001 the responsibility for the financial sector was split between Eesti Pank and the Ministry of Finance in a way that Eesti Pank was responsible for the policy and supervision of the banking sector and the Ministry of Finance for the policy and supervision of the insurance and securities sector. Financial sector consolidation created a need to consolidate supervision under a unified supervisory agency – Financial Supervision Authority.

Relevant Regulatory Framework

Eesti Pank can safeguard financial stability enhancing the credibility of the financial system, reducing potential systemic risk to a minimum, promoting financial system efficiency and ensuring adequate transparency of the system. The efficiency and transparency of a financial system is based on **relevant regulatory framework complying with internationally approved rules and good practice and considering local needs**. Eesti Pank issues decrees regulating the operation of the banking system and elaborates Estonian banking policy. Ensuring financial stability the central bank also focuses on elaborating a regulatory framework for the banking sector. Similar to several other European central banks, Eesti Pank is also responsible for **regulation of payment and settlement systems and performing a supervisory role.**

Reliable Information about Financial Sector

A significant component in Eesti Pank's efforts to ensure financial stability lies in **provision of constantly available updated and reliable information on the Estonian banking sector.** Reporting for acquisition of information should neither be an additional load on banks nor inhibit their efficient performance, although the information received should be sufficient for assessing the current situation and potential developments in the financial system. Reporting packages have been prepared to gather required financial statistics. They consider international standards and good practice, as well as consumer demand and needs. The data gathered should be made available in order to provide adequate information on financial sector processes and use market discipline for enhancing financial sector stability.

Reporting by banks involves the structure of assets and resources by positions, a survey of off-balance sheet transactions, risk coverage and other data on bank soundness and structure. Most of the reporting is done on a monthly basis but on profit accumulation and consolidation groups on a quarterly basis.

Regular monitoring and analysis would help to take steps and decisions securing financial stability. Assessing the threat of a systemic risk, Eesti Pank keeps itself informed of financial sector developments, having an overview of sector performance and efficiency, most significant institutional changes, the role of financial intermediator, international integration and links of Estonian financial markets.

Financial System Safety Network – System of Security Measures for Minimising Systemic Risk

The system of security measures that has been developed for the protection of the financial system should ensure smooth functioning of the system as a whole if some single financial intermediary is exposed to risks. In other words, the system of security measures should preclude the realisation of systemic risk. Consequently, Eesti Pank's actions for the sustained financial stability focus on the **creation of the system of security measures capable of minimising systemic risk**. In the long-term this is the least costly solution for the society to guarantee secure and smooth functioning of the financial system.

The system of security measures consists of clearly defined principles of compensation of small depositors' savings or the deposit guarantee scheme, systemic risk prevention measures and, in case of a crisis, co-ordinated action principles for the quick and competent solution of problems through joint efforts of the central bank and the government. Although most components of the modern security measures' system already exist, the entire safety network will have to be improved and updated as the financial sector continues to develop.

Main Development Trends in Ensuring Financial Stability in 2001

Amendment of Regulatory Legislation

Capital Adequacy Framework for Banks

For better monitoring of new risks emerging in connection with the development of the banking sector, the existing **method for calculating capital adequacy of credit institutions** that has been in use since 1999 and served as the basis for banking risk management and banking supervision, has been updated. One of the aims of the modification was to harmonise the capital adequacy regulation with the updated EU directives, to rectify imprecise and potentially misinterpreted wording and definitions and make corrections in order to bring the regulation in harmony with other national legal acts.

Analysing the existing method for calculating capital adequacy, a number of legislative amendment proposals to the Credit Institutions Act were drafted. Riigikogu approved the necessary legislative amendments to the new adequacy calculation scheme in autumn 2001 and the new guidelines for capital adequacy calculations were affirmed by the Decree of the Governor of Eesti Pank in January 2002. This normative act will enter into force after the test period on July 1, 2002.

The most significant change in the capital adequacy calculation method is the possibility to apply offsetting to instruments of similar maturity and other similar characteristics in order to minimise their exposure to credit risk. Another adjustment concerns calculation of risk for previously not included commodities (oil, various metals, raw materials etc) and their derivatives in accordance with the EU directive requirements. For better assessment of country and transfer risks, credit institutions' reporting requirements were amended. The latter concern the country of origin risks specific to the banks' partners and customers.

The new capital adequacy calculation guidelines will bring the supervision techniques of risk calculation and assessment by credit institutions and their consolidated groups to an up-to-date, internationally recognised level. The regulation conforms fully to the updated EU directives.

In addition to the specification of the adequacy calculation framework and other prudential ratios, the calculation method of subordinated loans was modified with the amendments to the Credit Institutions Act, also the operating licence granting and withdrawal procedure was changed. Pursuant to the law, the Financial Supervision Authority has the right to withdraw the licence of a foreign branch of an Estonian credit institution if operations of the branch do not meet the statutory requirements or the branch fails to meet the reporting requirement.

Improvement of Guarantee Schemes

For the purpose of improving the safety network of the financial sector, but primarily for enhancing trust of small depositors and investors in the financial sector, a draft law on **Guarantee Fund Act** was prepared in 2001 with the participation of the Ministry of Finance and Eesti Pank. Riigikogu passed the act in the beginning of 2002. It signified an important step in the evolution of the system of security measures created for the strengthening of the financial system. The deposit guarantee system was launched in Estonia in 1998. With respect to the Directive 94/19/EEC on deposit quarantee schemes, Estonia and the European Union have agreed that the marginal rate of insured deposits will be gradually increased and should meet the EU minimum requirement level – 20,000 euro – by the year 2007.

In addition to the deposit guarantee scheme, the new legislation established also investment protection and pension protection schemes. Pursuant to the law, the latter will be set up as sectoral funds, with their own separate accounting, varied contribution and repayment principles. The goal of the investor protection scheme is to increase the sense of security among small investors who invest primarily in securities. The pension protection scheme has been designed to compensate losses caused by violations of the second pillar, ie the mandatory contribution-based pension fund unit managers. This is a critical precondition for the successful launch of the pension reform. Amendments and adjustments were made also in the deposit guarantee scheme that has been in use since 1998. These concerned primarily the calculation method of periodic monetary contributions into the fund.

Establishment of Unified Financial Supervision Authority

The highlight of 2001 in the field of financial sector supervision was **the passing of Financial Supervision Authority Act** by the Riigikogu on May 9, 2001. The law provides for the establishment of the unified Financial Supervision Authority (FSA), whereas the commencement of its activities in 2002 was the real challenge for the former supervision institutions – Banking Supervision, Insurance Supervision Authority and Securities Inspectorate. The combining of expertise, skills and experience of the above institutions, laid the foundation for the integrated financial sector supervision.

Preparations for the inception of the Financial Supervision Authority began already in the second half of 2001. In order to achieve better synergy, the new FSA was established as an agency with its own budget and autonomous competence which operates by Eesti Pank and reports to the Riigikogu. The Chairman of the Management Board of the Authority is the Minister of Finance; Members of the Board include representatives of Eesti Pank, Ministry of Finance and financial sector experts. Budgetary independence from the government and central bank is ensured through the application of the funding scheme which obliges subjects of supervision to finance activities of the supervision agency by paying a supervision fee in the amount proportional to their licence-defined minimum capital requirement share and the share calculated on the basis of their assets.

The scope of supervisory functions of the agency covers credit institutions, insurance providers, investment funds, pension funds, management companies and principal fields of activity of the above institutions – receipt of deposits, lending, insurance and securities brokerage. Moreover, the FSA is responsible also for the supervision of the securities market. The goal of financial supervision as defined in the Financial Supervision Authority Act is to enhance the stability, reliability, transparency and efficiency of the financial sector, to reduce systemic risks and to prevent the abuse of the financial sector for criminal purposes, with a view of protecting the interests of clients and investors by safeguarding their financial resources and thereby supporting the stability of the Estonian monetary system. The FSA organisational structure is line with its statutory functions and responsibilities: it consists of capital, markets and funds, insurance and general supervision divisions.

The FSA short-term objectives are the completion of the merger of existing supervisory institutions, development of the organisation, approximation of financial supervision methods and processes. It is essential to create a framework for co-operation between Eesti Pank and Ministry of Finance. The framework should define procedures for the drafting of financial sector regulations, for collection of reports and information exchange as well as rules of conduct and communication for potential crisis management situations.

International Assessment of Estonian Financial Sector Supervison

In 2000 the International Monetary Fund and the World Bank organised financial sector stability assessment missions to Estonia within the FSAP framework, in 2001 the EU and its Member States assessed administrative capacity of the Estonian financial sector supervision[1] and anti-money laundering situation[2]. The focus was mainly on the extent to what various financial supervision authorities observe universally recognised principles in their work. The focal point was on changes that have taken place during the year.

The mission paid much attention to the assessment of systemic risk management and to the possibilities for minimising risks, also to the financial sector capabilities for systemic crisis resolution. In the conclusions regarding administrative capacity it is said that Estonia has the legal framework and adequate resources necessary for the financial sector crisis management policy.

Financial Sector in Estonia against the Background of Other Accession Countries' Financial Sector Development

At the 2001 meeting of the Governors of central banks of EU member and accession countries the focus was mainly on the development of financial sector. The development of financial markets of the accession countries was compared in terms of strength and problems, similarly to the Frankfurt preparatory meeting where experts from central banks participated.

In general documents of the meeting a positive impact of financial sector development on the economic growth and convergence was stressed, which is reflected both in saving and intermediation for investments and mutual levelling of financial risks. The background information compiled by Eesti Pank emphasised the relations between financial deepening and nominal and real convergence in the last decade, which should characterise the supporting role of the financial sector in the development of the economy.

The following characteristic features of Estonian financial sector were underlined:

- the structure of financial sector in accession countries in terms of financial intermediation is of the continental European type, ie banking is dominating. In Estonia universal banking is also present, ie large banking groups offering various financial products and services;
- the development of banking sector has been largely the same in the accession countries; it is characterised by problems arising from time to time, privatisation, mergers and attracting of foreign strategic investors. Unlike other countries the development of Estonia has been somewhat quicker and partially pioneering;
- stronger banking with high capitalisation and liquidity achieved in recent years is a result of complicated development. On the one hand, the process is characterised by weaker banks dropping out of the market and, on the other hand, by constant improvement of supervision and regulative acts which has been the primary political goal in ensuring financial stability in Estonia;
- the development of money and securities market in the candidate countries has been slightly more modest than that of banking. The smallness of markets determines the need for integration. A good example here is the consolidation of the trading in the Tallinn Stock Exchange with the Helsinki Stock Exchange;
- Estonia differs from other candidate countries in respect of money market as well – under currency board arrangement Estonian banks have started to use the money market of the euro area for liquidity management. At the same time, the Estonian kroon money market has been internationalised, as Nordic banks are involved;
- the deepening international integration is characterised by the financing structure of Estonian economy. Estonian financial sector competes with international institutions since many companies incorporate funds from their parent companies in the form of direct investments or bigger enterprises directly from international markets.

[1] Peer Review
[2] See Arrangements for Combating Money Laundering and Terrorism in Estonia, p 59.

Arrangements for Combating Money Laundering and Terrorism in Estonia

The existence of the efficient financial regulation system and its effective implementation is critical for the prevention of using the national financial system for money laundering or financing of terrorism purposes. In Estonia Money Laundering Prevention Act was enforced in 1999 and amended in 2000. The act fully conforms to the currently existing EU requirements in this area.

According to the Money Laundering Prevention Act, Eesti Pank is obliged to establish the procedure for the implementation of internal security measures of credit institutions. Pursuant to the decree of the Governor of Eesti Pank, credit institutions are obliged to set up relevant structural units and enforce necessary and adequate rules and procedures for the identification of unusual or suspicious transactions or operations. Credit institutions are obliged to investigate all unusual and suspicious transactions or actions and to notify the Financial Intelligence Unit of the transactions or operations that exhibit features of transactions or operations described in the respective sample list.

Pursuant to this act, one of the important functions of the FSA, launched in 2002, is to minimise the risk of abusing the financial sector for money laundering purposes.

Following the September 2001 terrorist attack against the United States, the Banking Supervision informed credit institutions and other market participants of the US government resolutions and forwarded information about individuals connected with terrorist organisations against whom the USA had applied sanctions and had asked assistance from the authorities of other countries. Also information derived from the resolution of the European Council concerning individuals associated with the organisation and abetting of terrorist acts was forwarded. Market participants assured that none of the listed individuals or organisations had accounts with Estonian credit institutions nor had made payments through them.

In December 2001 the EU mission assessed the compliance of the Estonian financial sector supervision arrangement, regulations and practice with the EU norms and requirements in the field of anti-money laundering. With regard to Eesti Pank’s sphere of governance, the mission concentrated mostly on the activities of the inter-institutional co-ordination committee charged with the alignment of the Estonian legislation with the requirements of the EU Directive on Prevention of Money Laundering, the up-to-dateness of Eesti Pank’s regulation concerning money laundering safeguards and supervision of currency exchange bureaux. The mission stated that Estonian authorities are aware that money laundering entails potential risks to the financial stability and are willing to prevent the use of the Estonian financial system for money laundering purposes. The report stresses good co-operation of the state authorities and private sector (especially in banking). Eesti Pank’s guidelines and its role in setting up anti-money laundering safeguards in the banking sector were also highly acclaimed. According to the report, the problem is the lack of direct control over the activities of currency exchange bureaux and insufficient staffing and technical equipment level of the Financial Intelligence Unit.