V. ENSURING FINANCIAL STABILITY

A strong and efficient financial sector is an important prerequisite for stable economic growth. Financial institutions and markets operate efficiently if collecting deposits, providing liquidity, and channelling investments in an economy are carried out smoothly without major disruptions, thus leading to improved welfare in the society. Meanwhile one has to bear in mind that financial markets are capable of amplifying phases of the economic cycle, which is why achieving and maintaining financial stability is important also from the point of view of macroeconomic stability.

The principal aim of central banks in ensuring financial stability is to avoid emergence of such disruptions in the financial system which could significantly reduce economic activity and thus prevent the central bank from achieving its main goal – maintaining the stability of the currency. The efficiency of a monetary policy transmission mechanism largely depends on how well the main financial institutions and markets operate. Hence the activities of the central bank in securing financial stability arise directly from its function of maintaining the stability of the currency.

Also payment systems administered and overseen by the central bank require a strong financial sector and stable environment, and vice versa – the existence of reliable payment systems in turn is an important prerequisite for smooth operation of financial markets.

Ensuring financial stability does not mean that the central bank or other regulators restrict growth and profit opportunities of financial institutions but rather help them improve their business and risk management abilities. The central bank's financial stability assessment supplements supervisory risk assessment of individual financial institutions.

ORGANISATION OF ENSURING FINANCIAL STABILITY IN ESTONIA

A stable, safe, and developing financial system is one of the main objectives of the activities of Eesti Pank. For this purpose the central bank cooperates with the Ministry of Finance and the Financial Supervision Authority. At the end of 2002 the three institutions concluded a cooperation agreement. According to the division of tasks between Eesti Pank, the Ministry of Finance, and the Financial Supervision Authority, a range of duties clearly falls under the responsibility of one institution (e.g. the Financial Supervision Authority set up in 2002 handles supervision of banking, insurance, and securities sector), but there are areas where objectives can only be achieved through joint efforts.

An area that calls for broader coordination is the **financial sector safety net**[1]. In a narrower sense this involves a package of agreements and procedures covering three relevant issues: emergency liquidity assistance to banks, protecting the interests of small depositors and investors, and management of systemic crises.

Within the existing safety net the **Guarantee Fund**, founded in the middle of 2002 to take over the operations of the Deposit Guarantee Fund, performs the most specific functions. Besides the Deposit Guarantee Sectoral Fund the Guarantee Fund also includes the Investor Protection Sectoral Fund that was set up in support of small investors to cover risks from possible brokerage operations carried out in bad faith; and the Pension Protection Sectoral Fund whose aim is to cover possible risks of unit holders in second pillar pension funds. According to the Guarantee Fund Act, the upper limit of compensation paid on deposits and investments rose to 100,000 kroons from 40,000 kroons at the end of 2003.

The development of financial markets and international integration in particular call for a need to restructure also the financial safety net. This task is topical also in Estonia whose comparatively small banking market in international comparison has been divided between a few large foreign-owned banking groups. Therefore cross-border agreements between supervisory institutions and central banks are at least as important as the relevant domestic policy and work organisation. In the second half of 2003 Eesti Pank joined in the financial stability cooperation between Nordic and Baltic central banks with the core focus on extensive exchange of information between the countries.

While coordination of work between different institutions and division of labour plays an essential role in the safety net, there are areas where the responsibility for ensuring financial stability clearly falls on Eesti Pank. **The central bank has three main tasks: to issue banking decrees, support the structures and policies securing a strong financial sector (above all in payment systems), and handle monitoring financial stability.** The primary aim of Eesti Pank is to maintain and strengthen the reliability of the financial sector without directly interfering where possible.

To enhance financial stability, the central bank has to shape the attitudes and expectations of the society towards the financial system by drawing attention to related risks, raising general public awareness of the financial system as a whole, and helping to strengthen market discipline in the financial sector.

FINANCIAL STABILITY COOPERATION IN THE EUROPEAN UNION

In the European Union the **Banking Supervisory Committee** (BSC) operating at the European Central Bank and the **Banking Advisory Committee** (BAC) operating at the European Commission have evolved into the principal regular forums for tackling banking stability. The latter is to be replaced by II and III level banking committees in 2004.

Bearing in mind the central bank's function of ensuring financial stability, the Banking Supervisory Committee operating at the ECB plays a central role in stability cooperation between the EU central banks. The committee comprising representatives of the NCBs and supervisory institutions of the Member States and the European Central Bank have three principal tasks: monitoring and assessment of the EU financial sector stability, analysis of the impact of regulatory and supervisory requirements, promoting cooperation and exchange of information to prevent and effectively handle financial crises. In order to perform these tasks different working groups and task forces have been set up by the Committee, and Eesti Pank has since May 2003 participated in two of them – the **Working Group on Macro-Prudential Analysis** (WGMA) and the **Working Group on Developments in Banking** (WGDB). The principal output of the Banking Supervisory Committee in 2003 was surveys of the EU financial stability and structural development in the banking sector. The most important tendencies and conclusions

[1] See the Strategic Development Plan of Eesti Pank for 2004–2006, II, 7.

pinpointed there were also publicised in separate publications. The most significant topics were credit risk transfer, the impact of corporate financial strength on banking stability, internationalisation strategies of banks, linkages between insurance and banking, and banking crisis management[2].

The main focus of the committees and working groups operating at the European Commission is on providing regulative framework that would support smooth operation of the EU financial sector. In the area of financial stability, the pivotal issues involve drafting the new capital adequacy framework for banks, also the topics of integration in the financial sector and management of banking crises. The issues related to financial sector policy are also discussed in the Economic and Financial Committee of the European Committee (EFC)[3].

FINANCIAL SECTOR REGULATION AND BANKING POLICY

Development of Banking Regulation

One of the relevant activities in ensuring financial stability is imposing secondary legislation on the financial sector[4]. Under the law, it is the task of Eesti Pank to impose lower-level regulative acts on banks. Besides, the central bank in cooperation with other institutions, above all the Financial Supervision Authority and the Ministry of Finance, participates in drafting proposals for amending the laws regulating the financial sector. Within the respective working groups, Eesti Pank has participated in drafting amendments to the Investment Funds Act, the Securities Market Act, the Credit Institutions Act, and a number of other acts.

A basis for amendments to the legal acts regulating the work of the financial system, particularly the laws, are amendments to the European Union directives. The draft acts that have been prepared and that affect credit institutions most are related to amendments to Estonian legal acts so that these would be in line with the directives on e-money institutions and reorganisation and winding-up credit institutions. In 2003, calculation of consolidated market and currency risk under the capital adequacy framework imposed on the banks with the Decree of the Governor of Eesti Pank was amended – it is no longer possible to net market and currency risk positions between subsidiaries. Meanwhile preparations began to adjust capital adequacy calculation rules because as of 1 May 2004 the claims of banks on the banks and governments of the new EU Member States must be treated according to a lower risk weight, which equals that of the old Member States.

Prevention of Money Laundering and Terrorism

For a safe operation of Estonia's financial sector it is important that the state policy should guarantee internal readiness to combat money laundering and financing terrorism and that this activity would proceed from internationally recognised requirements and practices. Eesti Pank's interest in preventing money laundering and combating terrorist financing arises mainly from the central bank's task to ensure financial stability, to which aim the central bank cooperates with national agencies as well as international organisations.

In Estonia, the **Money Laundering and Terrorist Financing Prevention Act** regulates the activities aimed at preventing money laundering and combating terrorist financing. Arising from the amendments to the European Union directive on the prevention of money laundering adopted in 2001, several adjustments to the act had been made in Estonia by the beginning of 2004 – the act covers a broader range of companies, the notion of money laundering has been specified, combating terrorist financing has been included, and the registration principles for providers of currency exchange services have been updated.

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[2] The term 'crisis management' covers management of the whole process related to handling a banking crisis.
[3] In the European Union, the highest-level forum handling financial stability is the Financial Stability Table, which is held in the framework of the sessions of the Economic and Financial Committee twice a year and the Council of Economics and Finance Minister of the European Unions (ECOFIN) once a year.
[4] See the Strategic Development Plan of Eesti Pank for 2004–2006, II, 6.

Besides domestic activities, the experts of Estonian state institutions, including Eesti Pank, have since September 2003 been involved in drafting the third European Union directive on preventing money laundering. On the EU level the **Money Laundering Contact Committee** (MLCC) operating at the European Commission handles adjustments and amendments to the legal acts on the prevention of money laundering. The main aim of drafting the new directive is to specify the recommendations for preventing money laundering in the European Union, which were revised by the **Financial Action Task Force on Money Laundering** (FATF)[5] in 2003.

MEASURES ADOPTED BY EESTI PANK IN 2003 TO REDUCE FINANCIAL SECTOR RISKS

Amendments to regulative acts and operational standards are closely related to the need to contain the risks associated with the development of banking. This task was included as an objective also into the Strategic Development Plan of Eesti Pank[6]. The last three years have been marked by more extensive engagement of external funds on behalf of the banks and more active borrowing by private persons. The associated threats compelled Eesti Pank to adopt some measures in 2003 and to inform the public of possible problems. In order to manage credit growth based on overly optimistic expectations and extremely favourable interest rates the aim was to reduce active offering of loans by banks and unsoundly high expectations of private persons.

Eesti Pank together with the Financial Supervision Authority drew the banks' attention to the threats accompanying fast credit growth. They stressed the need to inform the clients of the risks associated with borrowing while pointing out possible future rises in loan-servicing costs. The banks were advised to apply conservative down payment requirements consistently when granting loans while considering the smallness of Estonia's market where realisation of major or large quantities of collateral might bring down prices throughout the market. Besides the aspects of down payment, the banks were advised to carefully consider the future incomes and interest rate sensitivity of the borrowers and to carry out stress tests.

The government was advised to review the current policy instruments that promote retail borrowing. For example, guarantees extended by the Estonian Credit and Export Guarantee Fund, KredEx, enable to take out housing loans at a down payment of just 10%, instead of the standard 34%. Besides, the state provides the opportunity to deduct housing loan interests from taxable income. Meanwhile the level of interest rates in Estonia is one of the lowest compared to that of the EU Member States. State support measures available to the borrowers were topical three or four years ago when the banks were not active in granting housing loans. By 2003 these measures had largely lost their relevance.

MONITORING AND ANALYSIS OF FINANCIAL STABILITY

Object of Analysis

Financial sector monitoring plays an important role in spotting financial sector risks. Meanwhile one has to differentiate between micro-prudential analysis, which tackles the risks of individual financial institutions, and macro-prudential analysis, which covers the financial system in its integrity. In Estonia, institution-based risks are analysed and assessed by the Financial Supervision Authority while macro-prudential estimates are within the competence of Eesti Pank.

The object of macro-prudential analysis has significantly changed along with the establishment of large financial groups and broadening internationalisation of financial markets. Even though the assets of banks account for some two thirds of the assets of financial intermediaries, the analysis also covers other important financial markets (securities market, insurance, investment funds) and how these are related to banking sector risks. Besides the operations

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[5] FATF is the principal international association focusing on money laundering prevention, and it makes recommendations in the areas of policy and methods. See Annual Report of Eesti Pank 2001, p. 42.
[6] See the Strategic Development Plan of Eesti Pank for 2004–2006, I, 3.

in the Estonian financial sector, Eesti Pank also analyses and evaluates cross-border risks within banking groups, e.g. liquidity risks arising from ownership structures and risks arising from activities of foreign subsidiaries.

In the monitoring process, Eesti Pank has paid considerably close attention to **analysing non-financial sector vulnerability,** particularly in recent years. Rapid growth in the level of indebtedness in the economy along with changes in the financial conduct of the non-financial sector have considerably changed the structure of banks' balance sheets. **Since loans extended to the non-financial sector constitute a significant source of income for the banks, the capability of households and businesses to earn income and service loans has a direct impact on the financial strength of the banks.** The capitalisation of the banking sector may be strong and risks well managed, but the risks accumulating as a result of fast financial deepening in the non-financial sector may later emerge also in banking.

In order to strengthen financial sector monitoring and analysis and support qualitative assessments, Eesti Pank pays increasingly more attention to **stress-testing** and the **forecasts assessing financial sector development.** Since the principal preliminary indicator of stability in the financial sector focusing on traditional banking is the vulnerability of the non-financial sector, the financial conduct of households and companies accounts for a significant part of Eesti Pank's research in the field of financial stability.

Cooperation in Financial Stability Monitoring and Analysis

A very broad spectrum of analysis calls for close national and international cooperation so as to secure the quality of the analysis. In Estonia the principal cooperation partner of Eesti Pank is the Financial Supervision Authority that possesses the necessary micro-level data for the overall banking sector analysis drafted by the central bank.

In the European Union the principal output of macro-prudential analysis is the **European Financial Stability Survey**, which is completed mainly in cooperation with the ECB and NCBs. Also the financial stability overview of the ten accession countries will be included into the consolidated survey of 2004. Cooperation within the framework of the ESCB raises the quality of the financial analysis provided by Eesti Pank while offering an opportunity to tackle problems related to the development of Estonia's financial stability within a broader circle of experts.

The joint Nordic and Baltic information exchange network, which is narrower in scope and whose concept was beginning to take shape in 2003 to be implemented in the first half of 2004, is to take into consideration regional idiosyncrasies and offer necessary support to the financial sector safety net.

EESTI PANK'S FINANCIAL STABILITY SURVEY

In the autumn of 2003 Eesti Pank published its first Financial Stability Survey, which is to become the central bank's principal biannual publication covering different financial stability aspects. The main focus of the FSS is to highlight financial sector risks, describe possible developments in the near future, and evaluate non-financial sector vulnerability.

A comprehensive financial stability survey is an important tool for shaping the financial policy decisions of Eesti Pank. Meanwhile handling financial stability issues before a wider audience is important for at least two reasons. Firstly, publicising regular analyses helps to reduce financial stability risks by keeping the private sector informed of possible negative developments, thus affecting the expectations of the sector. Since the private sector lacks sufficient motivation for evaluating systemic risks, it is the central bank that has a key role to play here. Strengthening market discipline and avoiding moral risk are issues that are specifically related to the financial sector. Keeping these issues in the public eye also plays an important role in ensuring the transparency of the central bank's activities. The topics handled in the FSS are aimed at explaining the background and reasons for the central bank's monetary policy decisions affecting the financial sector.