

## IDENTIFYING THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA AND SETTING THE BUFFER RATES IN 2017

European Union member states assess the importance of credit institutions for the financial system each year, and update the list of systemically important credit institutions. In Estonia the credit institutions that are systemically important for the financial system here are defined by Eesti Pank as O-SIIs, or Other Systemically Important Institutions. Eesti Pank also decides on the rate for the additional capital buffer for O-SIIs, and can set it at up to 2% of total risk exposure. The additional buffer is intended to make the operation of systemically important market participants and the system as a whole more secure, and to reduce the moral hazard that arises for large credit institutions that are seen as being too big to fail.

In 2017 Eesti Pank named AS LHV Pank as systemically important alongside Swedbank AS and AS SEB Pank, which have been on the list of systemically important credit institutions in Estonia since they were first so nominated in 2015. The market share of AS LHV Pank has grown since the last assessment a year ago, the importance for the financial system of the services it provides has increased, and it has made more transactions with other financial institutions. This meant that the aggregate point score for systemic importance of AS LHV Pank, which is found using the data for the end of 2016 and which takes account of the specific feature of the Estonian financial sector, exceeded the threshold of 350 basis points for systemically important institutions<sup>1</sup> (see Table 1). As a result AS LHV Pank was added to the list of systemically important credit institutions in Estonia alongside Swedbank AS and AS SEB Pank.

**Table 1. Scores of the banks operating in Estonia (basis points)**

Institution	Overall score		Criteria				
	Base*	Adjusted**	Size	Importance (including substitutability/ financial system infrastructure)	Complexity/cross-border activity	Interconnectedness	
						Base*	Adjusted**
Swedbank AS	3 006	3 080	3 941	4 399	2 810	873	1 168
AS SEB Pank	2 229	2 434	2 328	2 322	2 624	1 640	2 460
AS LHV Pank	949	409	377	438	201	2 780	620
AS DNB Pank	247	272	335	226	224	203	305
BIGBANK AS	202	205	159	149	480	22	33
Versobank AS	222	134	81	162	214	432	78
Tallinna Äripanga AS	103	117	87	81	136	109	164
AS Eesti Krediidipank	97	103	117	122	101	48	72
AS Inbank	145	23	34	29	19	499	10

\* The automatic score is calculated using the EBA methodology

\*\* The adjusted score takes account of the specific features of the Estonian financial system and excludes one indicator (debt securities outstanding) from the calculation of the score.

Following the results of the assessment of systemic importance of credit institutions in 2017, Eesti Pank decided to leave the O-SII buffer rate for Swedbank AS and AS SEB Pank unchanged at 2%, where it had been since August 2016, and to introduce an O-SII buffer rate for AS LHV Pank of 0.5% from 1 January 2018. The overall score for systemic importance for Swedbank AS and AS SEB Pank calculated from data from the end of 2016 was at a level where Eesti Pank finds it necessary to apply the maximum rate of 2%. The assessment of systemic importance for AS LHV Pank is lower, making it appropriate to set a buffer rate of 0.5% for that bank.

The systemic importance of credit institutions will be assessed again in 2018. Eesti Pank will analyse the developments in the banking sector and if there are major structural changes it will adjust the list of O-SIIs as quickly as possible. The same developments are taken into account when the level of the buffer

<sup>1</sup> To simplify, 350 basis points is on average equivalent to market share of 3.5% of the assets and various activities of the banking sector.

rate and the need for additional O-SII buffers are assessed. The data available at the time the O-SIIs were defined in 2017 did not allow the assessment results this year to reflect the structural changes in the Estonian banking sector caused by the merger of the Estonian branch of Nordea bank AB and AS DNB Pank to create a credit institution with the name Luminor Bank AS. This change will be taken into account in the next assessment of O-SIIs and the buffer rates that apply to them.

## IDENTIFYING THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA

**The starting point for identifying systemically important credit institutions in Estonia is the two-stage methodology in the guidelines of the European Banking Authority (EBA)<sup>2</sup>.** In the first stage, other systemically important institutions, or O-SIIs, are identified automatically using the criteria and mandatory indicators in the EBA guidelines. The overall score for systemic importance is calculated from ten mandatory indicators, which are divided into four categories for size; importance, which includes substitutability / financial system infrastructure; complexity / cross-border activity; and interconnectiveness. The values for each credit institution are related to the total score for the indicators for all the credit institutions in the country<sup>3</sup>, meaning that different types of market participant can be reflected. The final point score for each credit institution is the weighted average value of the indicators. All banks that exceed the threshold value of 350 basis points are automatically classed as O-SIIs. The second stage is a supervisory assessment in which any other credit institutions that scored below the O-SII threshold in the first stage but are still systemically important for the domestic financial system can be classed as O-SIIs. This can be done on the basis of the score in any category or the qualitative and quantitative indicators listed in the EBA guidelines.

**The particular nature of the Estonian financial sector means that the point scores found automatically using the EBA methodology do not adequately reflect the systemic importance of all the banks operating in Estonia.** In measuring the interconnectedness of credit institutions, the EBA methodology considers not only the assets and liabilities within the financial sector, but also the volume of bonds issued. This indicator is of very minor importance for the Estonian banking sector though, because a large share of the banking groups operating in Estonia are foreign-owned, and the local units generally do not issue bonds themselves but mainly access market-based funding through their parent banks. Even though only 44 million euros of bonds had been issued at the end of 2016, worth 0.2% of the total assets of the banking sector, the EBA methodology requires 10,000 basis points to be divided among the banks for this, accounting for 8.33% of the final total number of points. In consequence the systemic importance of banks that have issued bonds, even to only a small extent, is overestimated in the EBA methodology.

**To avoid distortions, Eesti Pank does not include the indicator for debt securities outstanding in the points score for systemic importance when it is identifying O-SIIs.** Having taken account of the particular nature of the Estonian financial system, the assessment of systemic importance follows the principles of the EBA methodology in all other ways, as each category has equal weighting, and each indicator within each category also has equal weighting (see Table 2). So in the adapted methodology, like in the EBA methodology, the category of interconnectiveness between credit institutions is as important in identifying systemic importance as the size of the credit institution, its importance for the banking system through substitutability and financial system infrastructure, and its complexity and cross-border activity. As the Estonian banking sector is largely foreign-owned, and as a consequence is connected to other credit institutions through intra-group loans and deposits, the liquidity management of the banking groups and the features of their funding structure are channels through which financial shocks can pass from one credit institution to another. This implies that the particular nature of the Estonian finan-

<sup>2</sup> Guidelines issued on 16 December 2014 by the EBA on the criteria to determine the conditions of application of Article 131(3) of Directive 2013/36/EU (CRD) in relation to the assessment of other systemically important institutions (O-SIIs).

<sup>3</sup> The Eesti Pank assessment process for O-SIIs covers the whole of the banking sector. This means that credit institutions operating with an Estonian activity licence and branches of foreign credit institutions are all covered. Investment firms are not covered by the assessment.

**Table 2. The core set of indicators for the scoring of systemic importance based on EBA and adjusted methodology**

Criterion	Indicators	Weight - EBA methodology	Weight - adjusted methodology
Size	Total assets	25.00%	25%
Importance (including substitutability/ financial system infrastructure)	Value of domestic payment transactions	8.33%	8.33%
	Private sector deposits from depositors in the EU	8.33%	8.33%
	Private sector loans to borrowers in the EU	8.33%	8.33%
Complexity/cross-border activity	Value of OTC derivatives (notional)	8.33%	8.33%
	Cross-jurisdictional liabilities	8.33%	8.33%
	Cross-jurisdictional claims	8.33%	8.33%
Interconnectedness	Intra-financial system liabilities	8.33%	12.5%
	Intra-financial system assets	8.33%	12.5%
	Debt securities outstanding	8.33%	0%

cial system makes it appropriate in assessing systemic importance to give more weight to the assets and liabilities within the financial system than is the case in the EBA methodology.

**In 2017 Eesti Pank identified three systemically important credit institutions in Estonia, these being Swedbank AS, AS SEB Pank and AS LHV Pank.** Swedbank AS and AS SEB Pank have been listed as systemically important banks in Estonia since the O-SIIs were identified for the first time in 2015, but AS LHV Pank has never previously been named as systemically important by Eesti Pank. If the first stage of the EBA methodology were applied strictly, as LHV Pank would have passed the threshold for systemic importance in 2015 and 2016, but this was because of the particular nature of the funding of the Estonian banking sector, which the EBA methodology is not able to take full account of. In 2017 the aggregate score for systemic importance reached automatically was again inflated for AS LHV Pank because it is one of the few banks that has obtained funds by issuing bonds (see Table 3). Even though the share of bonds in the assets of the bank itself remained quite small, the mandatory EBA indicator added a point score of 591 basis points for this. Unlike in earlier years though, the point score for AS LHV Pank was above the threshold even without the indicator for the volume of debt securities issued. The

**Table 3. Scores for indicators (basis points)**

Criterion	Indicators	Swedbank AS	AS SEB Pank	AS LHV Pank	AS DNB Pank	BIGBANK AS	Versobank AS	Tallinna Äripanga AS	AS Eesti Kredidipank	Inbank AS	Branches
Size	Total assets	3 941	2 328	377	335	159	81	87	117	34	2 541
Importance (including substitutability/ financial system infrastructure)	Value of domestic payment transactions	4 078	2 250	550	234	3	390	144	123	0	2 228
	Private sector deposits from depositors in the EU	5 141	2 200	484	126	219	74	79	149	47	1 482
	Private sector loans to borrowers in the EU	3 978	2 517	282	316	225	21	19	92	40	2 510
Complexity/cross-border activity	Value of OTC derivatives (notional)	6 172	2 409	0	0	0	161	0	0	0	1 257
	Cross-jurisdictional liabilities	1 136	1 929	163	535	366	191	164	178	1	5 338
	Cross-jurisdictional claims	1 123	3 535	441	138	1 073	291	245	125	57	2 974
Interconnectedness	Intra-financial system liabilities	1 183	2 143	166	568	8	23	12	30	8	5 859
	Intra-financial system assets	1 153	2 777	1 075	42	58	133	315	115	12	4 321
	Debt securities outstanding	284	0	7 098	0	0	1 141	0	0	1 477	0
Total score (EBA methodology)		3 006	2 229	949	247	202	222	103	97	145	2 799
Total score (adjusted methodology)*		3 080	2 434	409	272	205	134	117	103	23	3 223

\*The adjusted score takes account of the specific features of the Estonian financial system and excludes one indicator (debt securities outstanding) from the calculation of the score.

relatively rapid growth in the size of its business meant that AS LHV Pank passed the thresholds for size, importance including substitutability and financial system infrastructure, and interconnectedness. As a consequence, AS LHV Pank was added to the list of systemically important credit institutions in Estonia.

## CAPITAL BUFFER RATES FOR THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA

**When setting the buffer rate, Eesti Pank starts from the principle that the capital buffer rate should be higher the more systemically important a credit institution is.** As it may be assumed that the costs arising from financial problems at a bank are larger the more important it is in the financial system, the additional capital requirements set for systemically important banks help to reduce the likelihood and the impact of those banks becoming insolvent. In developing its methodology for calibrating the additional buffer, Eesti Pank considered various points, including the score given in the assessment of the systemic importance of credit institutions, the buffer rates applied to other banks in the Nordic and Baltic region, and analysis of data collected on the Estonian banking sector<sup>4</sup>. Eesti Pank generally applies a buffer rate of at least 0.5% to the credit institutions that pass the minimum threshold of 350 basis points in the assessment of systemic importance, which is adapted from the methodology of the European Banking Authority. The maximum rate of 2% is applied to those credit institutions that get a points score of at least 1200 basis points. If the points score for systemic importance is between 350 and 1200 basis points, the benchmark rate is found linearly, and the result rounded to the nearest 0.5 percentage point.

**Following the results of the assessment of the systemic importance of credit institutions in 2017, Eesti Pank decided to leave the O-SII buffer rate for Swedbank AS and AS SEB Pank unchanged at 2% and to introduce an Other Systemically Important Institution buffer rate of 0.5% for AS LHV Pank.** The basis for the decisions about the O-SII buffer rates in 2017 was the assessment of systemic importance using the EBA methodology adapted for the particular nature of the Estonian financial system. In this way the indicator for debt securities outstanding, which is less important for the Estonian banking system, does not distort the decision about additional buffers. Swedbank AS scored 3080 basis points under the adapted methodology for assessing systemic importance, and AS SEB Pank scored 2434 basis points, so the O-SII buffer continues to apply to them at the rate of 2%. The aggregate point score for AS LHV Pank taking account of the features of the local financial system is substantially smaller at 409 basis points. Under the Eesti Pank framework for calibrating the O-SII buffer rate, this gives a required buffer rate of 0.5%. The buffer requirement applies to the total risk exposure of systemically important credit institutions, and must be met individually and at a consolidated level. Table 4 shows the total capital requirements for the banks defined as systemically important for the Estonian financial system, compared with the requirements for other banks.

Table 4. Capital and buffer requirements in Estonia				
		Systemically important credit institutions		Other banks
		Swedbank AS, AS SEB Pank	AS LHV Pank*	
Macprudential buffers	countercyclical capital buffer (Estonian exposures)	0%	0%	0%
	systemic risk buffer (Estonian exposures)	1%	1%	1%
	other systemically important institutions buffer	2%	0.5%	-
Capital conservation buffer		2.5%	2.5%	2.5%
Minimum own funds requirement		8%	8%	8%
<b>Total capital and buffer requirements</b>		<b>13.5%</b>	<b>12.0%</b>	<b>11.5%</b>

\* The O-SII buffer for AS LHV Pank will be applicable from 1 January 2018.

<sup>4</sup> For more details, see *Systemic risk buffer and other systemically important institutions buffer. Analysis of the setting of the buffer requirements in Estonia*, April 2016.