

DEFINING THE SYSTEMICALLY IMPORTANT CREDIT INSTITUTIONS IN ESTONIA AND BUFFER RATES IN 2018

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 resilient, and to reduce the costs that accompany problems at systemically important banks.

The results of the assessment in 2018 make four banks in Estonia systemically important, and these are Swedbank AS, AS SEB Pank, Luminor Bank AS and AS LHV Pank. The addition of Luminor Bank AS to the group of systemically important credit institutions reflects the structural changes in the Estonian banking sector in the second half of 2017 that followed from the merger of AS DNB Pank and Nordea Bank AB Estonia Branch (see Table 1).

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	2,900	3,013	3,919	4,388	2,297	998	1,450
AS SEB Pank	2,042	2,208	2,388	2,411	2,044	1,326	1,989
Luminor Bank AS	1,934	1,639	1,404	1,378	1,842	3,114	1,933
AS LHV Pank	859	718	691	625	631	1,490	925
Bigbank AS	312	283	179	157	733	181	62
Versobank AS	211	216	115	73	191	465	487
Tallinna Äripanga AS	130	153	90	92	149	186	278
AS Coop Pank	161	137	145	151	119	231	135
AS Inbank	86	45	49	40	40	215	50

* 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 review of 2018, two changes have been made to the systemically important credit institutions buffer rates. Firstly, a buffer rate of 2% will apply for Luminor Bank AS from 1 July 2018. Luminor Bank AS was founded in 2017 but the lack of available data meant it could not be included in the O-SII assessment process that year, and so Eesti Pank finds it appropriate to apply an O-SII buffer requirement exceptionally to the bank from 1 July 2018. Secondly the buffer rate for AS LHV Pank will be raised from its current 0.5% to 1% from 1 January 2019. The combined points score for systemic importance for this bank was substantially higher this year than in the assessment last year. The market share of AS LHV Pank and the importance of its services for the financial system have increased over the year and the bank has been more active internationally, largely transacting with other financial institutions. The 2% buffer rate that started to apply for Swedbank AS and AS SEB Pank in August 2016 has remained unchanged after the assessment of systemic importance in 2018.

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)¹. 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 interconnectedness. The values for each credit institution are related to the total score for the indicators for all the credit institutions in the country². In this way they reflect the market share of the banks for different indicators. The final points score for each credit institution is the weighted average value of the indicators. All banks that exceed the threshold value of 350 basis points³ 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.

The particular nature of the funding structure of the Estonian financial sector means that the points scores found automatically using the EBA methodology do not adequately reflect the systemic importance of all the banks operating in Estonia, and so the methodology needs to be adapted. 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. The group of banks issuing bonds widened in 2017 and so the amount issued in bonds by the local banking sector more than doubled, but even so only 119 million euros of bonds have been issued, worth 0.5% of the total assets of the banking sector. In consequence the systemic importance of banks that have issued bonds, even to only a small extent, is overestimated in the EBA methodology.

Eesti Pank does not include the indicator for debt securities outstanding in the points score for systemic importance when it is identifying O-SIIs, and instead gives more weight to the assets and liabilities within the financial sector. The large market share of foreign banks meant that at the end of 2017 the intra-group loans and deposits gave a better picture than outstanding debt securities of the channels through which financial shocks could pass from one institution to another. Giving more weight to the assets and liabilities within the financial system also means that temporary decisions taken within a group for liquidity management can affect the points score for systemic importance found by the adjusted methodology more than is the case in the EBA methodology. This must be borne in mind in analysis of the results of the O-SII assessment. Even so, it remains reasonable to use the adjusted methodology while there are no major changes in the funding structure of the Estonian banking sector (see Table 2).

In 2018 four banks in Estonia were defined as systemically important, and these are Swedbank AS, AS SEB Pank, Luminor Bank AS and AS LHV Pank. These four banks had a points score for systemic importance using data from the end of 2017 that exceeded the thresholds for systemic importance set in both the EBA and the adjusted methodologies. The change from the assessment last year is that the new bank Luminor Bank AS, which was founded by the merger of AS DNB Pank and Nordea Bank AB Estonia Branch on 1 October 2017, is added to the list of systemically important institutions in Estonia in 2018.

¹ 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).

² The O-SII assessment process at Eesti Pank covers the whole of the banking sector. Investment firms are not affected by the assessment.

³ 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.

Table 2. The core set of indicators for the scoring of systemic importance used in the EBA and adjusted methodologies

Criterion	Indicators	Weight - EBA methodology	Weight - adjusted methodology
Size	Total assets	25.00%	25%
	Value of domestic payment transactions	8.33%	8.33%
Importance, including substitutability/ financial system infrastructure	Private sector deposits from depositors in the EU	8.33%	8.33%
	Private sector loans to recipients in the EU	8.33%	8.33%
	Value of OTC derivatives (notional)	8.33%	8.33%
Complexity/cross-border activity	Cross-jurisdictional liabilities	8.33%	8.33%
	Cross-jurisdictional claims	8.33%	8.33%
	Intra-financial system liabilities	8.33%	12.50%
Interconnectedness	Intra-financial system assets	8.33%	12.50%
	Debt securities outstanding	8.33%	0%

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 related to its importance 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 the points score for 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 sector⁴. 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.

Under the framework of the Eesti Pank O-SII buffers and following the results of the assessment of systemic importance for credit institutions, an O-SII buffer rate requirement of 2% was set for Luminor Bank AS, the same rate as for Swedbank AS and AS SEB Pank, and the rate for AS LHV Pank was raised to 1% to reflect its increased systemic importance. The basis for deciding the recommended O-SII buffer rates 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 3013 basis points under the adjusted methodology for assessing systemic importance, AS SEB Pank scored 2208 basis points, and Luminor Bank AS scored 1639 (see Table 3), so the O-SII buffer continues to apply to Swedbank AS and AS SEB Pank at the rate of 2% and an O-SII buffer rate of 2% was introduced for Luminor Bank AS. As Swedbank AS and AS SEB Pank are subject to an O-SII buffer rate of 2% at the parent bank level, there is no restriction on the rate of 2% being applied to them⁵. The aggregate points score for AS LHV Pank in

⁴ 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

⁵ The European Union's Capital Requirements Directive 2013/36/EU must be considered when decisions are taken on O-SII buffers, as the rate that can be applied to a credit institution that is part of a banking group where the parent bank is subject at the consolidated level to a buffer requirement as a globally systemically important institution (G-SII) or an O-SII may be up to 1%, or not more than the rate that applies at the consolidated level to the global or other systemically important institution. The O-SII buffer rate for Swedbank AB and Skandinaviska Enskilda Banken AB is 2%.

Table 3. Scores for indicators (basis points)

Criterion	Indicators	Swedbank AS	AS SEB Pank	Luminor Bank AS	AS LHV Pank	Bigbank AS	Versobank AS	Tallinna Äripanga AS	Coop Pank AS	Inbank AS	Branches
Size	Total assets	3,919	2,388	1,404	691	179	115	90	145	49	1,020
Importance, including substitutability/ financial system infrastructure	Value of domestic payment transactions	4,062	2,428	1,582	908	5	103	164	150	0	599
	Private sector deposits from depositors in the EU	5,123	2,254	855	597	239	94	90	173	68	506
	Private sector loans to recipients in the EU	3,981	2,550	1,698	369	227	22	23	130	53	948
Complexity/cross-border activity	Value of OTC derivatives (notional)	4,319	2,581	2,328	0	0	78	0	0	0	693
	Cross-jurisdictional liabilities	688	2,159	2,481	1,150	492	370	155	178	14	2,313
	Cross-jurisdictional claims	1,884	1,393	716	744	1,707	125	294	180	106	2,851
Interconnectedness	Intra-financial system liabilities	1,097	2,604	2,689	1,140	7	135	4	52	2	2,270
	Intra-financial system assets	1,802	1,373	1,178	710	116	838	553	217	98	3,115
	Debt securities outstanding	95	0	5,475	2,620	419	421	0	423	546	0
Total score (EBA methodology)		2,900	2,042	1,934	859	312	211	130	161	86	1,363
Total score (adjusted methodology)*		3,013	2,208	1,639	718	283	216	153	137	45	1,587

*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.

2018 found using the adjusted methodology gives a buffer requirement of 1% in the framework for calibration of buffer rates used by Eesti Pank. In other words, the increased systemic importance of the bank has led to the O-SII buffer rate for it being raised by 0.5 percentage point from its previous level.

The points score for systemic importance for LHV was affected by new business lines and by the rapid growth in lending to local companies and households and in deposits taken from them. As the banks in the Estonian banking market mainly concentrate on serving the local private sector, the systemic importance of banks with different business lines could be relatively large. The points scores of AS LHV Pank for interconnectedness and cross-border activity rose primarily because the bank is involved more actively in areas related to international payment intermediary services, which are not among the core activities of banks operating in the local market in Estonia. The importance of AS LHV Pank has still increased through serving the local private sector, which made it necessary to raise the buffer rate.

The calibrated buffer rates for Swedbank AS, AS SEB Pank, Luminor Bank AS and AS LHV Pank are higher than the minimum O-SII buffer requirements found using the methodology of the European Central Bank. Single supervision of banking means that Eesti Pank shares responsibility with the European Central Bank in macroprudential supervision. For the instruments set out in the Capital Requirements Regulation and Directive (CRR / CRD IV), including the buffer for systemic importance, the European Central Bank may set even stricter requirements than those that Eesti Pank has passed if necessary. The starting point for the O-SII buffer rate decisions of the European Central Bank is the framework that is used to set the minimum level for the O-SII buffer for a bank from its points score for systemic importance⁶. Regardless of whether the points score found with the EBA methodology or the adjusted methodology is used, the additional buffer requirements for Swedbank AS, AS SEB Pank, Luminor Bank AS and AS LHV Pank are higher than the minimum O-SII buffer requirements found using the methodology of the European Central Bank.

⁶ For more details see the ECB Macroprudential Bulletin, June 2017.