ENSURING FINANCIAL STABILITY

The primary goal of Eesti Pank is to safeguard price stability in Estonia. The precondition for achieving price stability is an efficient financial system that operates smoothly.

In order to ensure the efficient and smooth operation of the financial system, the activities of financial intermediaries must be monitored and risks to the system assessed. This requires continuous attention and analysis. To increase the transparency of the financial sector performance, Eesti Pank collects and publishes the statistics of the banking sector. The results of the analysis of the financial sector and its operational environment and the evaluation of risks to the financial system are published twice a year in the *Financial Stability Review*. Published analysis results and risk assessments also form the basis for shaping financial sector policy. The objective is to reduce risks to the financial system while maintaining a system that operates efficiently and smoothly.

In addition to taking measures for ensuring the transparency of the financial system, Eesti Pank also sets regulatory requirements for the banks when conducting **banking policy**.

Eesti Pank's activities in ensuring the smooth operation of the financial intermediation system, that is financial stability, include the following:

- assessment of risks to the operation of the financial intermediation system;
- monitoring and development of the legal framework of the banking system;
- management of financial crises;
- oversight of payment and settlement systems.

In performing these activities, Eesti Pank adheres to the following principles:

- maintaining the credibility of the financial system;
- keeping the likelihood of systemic risk as minimal as possible;
- contributing to the efficiency of the financial system;
- ensuring sufficient transparency of the financial system.

Besides Eesti Pank, the Ministry of Finance and the Financial Supervision Authority (with whom a revised cooperation agreement was signed in December 2007) also play an important role in ensuring the smooth operation of the financial system.

In addition to domestic institutions, Eesti Pank as a member of the European System of Central Banks (ESCB) also cooperates with the national central banks of other EU countries as well as with the European Central Bank in order to ensure financial stability. Eesti Pank also takes part in devel-

EESTI PANK'S FINANCIAL STABILITY FRAMEWORK

In assessing the performance of the financial intermediation system, Eesti Pank proceeds from whether and to what extent the operation of the system enables the central bank to achieve its primary goal; that is, price stability. To this end, the risks related to the system's performance are classified as follows:

- Risks are low – the operation of the financial intermediation system enables the central bank to achieve its primary goal, which is maintaining price stability, but further improvement of the system is necessary.
- Risks are medium and a small share of them may have materialised – the operation of the financial intermediation system enables the central bank to achieve its primary goal, which is maintaining price stability, but corrective intervention is necessary (e.g. amending regulations).
- Risks are high and have materialised to a substantial extent – the operation of the financial intermediation system is hindered; corrective measures or crisis management activities are necessary.

oping a common European financial sector policy and improving related legislation. Since Estonia's financial system is closely integrated with those of the neighbouring countries, successful cooperation with Nordic and Baltic central banks is very important.

Eesti Pank has a direct role in the creation and functioning of the infrastructure required for the operation of the financial system. The central bank has to make sure that the payment systems that it manages and other payment and settlement systems that are important for the functioning of the financial system as a whole would operate without any major failures. For this purpose, the risks to settlement systems must be identified and minimised. Eesti Pank discloses the assessment by the overseer of payment and settlement systems in the *Financial Stability Review* published twice a year (see *Payment systems oversight*).

Financial sector analysis and financial stability assessment

In recent years, the emphases and assessment of financial stability analysis have been influenced primarily by strong credit growth and the increasing indebtedness of borrowers. In 2007, at the turning point of the economic and credit cycle, the key question was how sharply credit growth would decelerate and to which extent the loan risks taken in previous years would materialise.

The economic cycle has reached a phase characterised by slower income growth. Therefore, it is also natural that some of the credit risk accumulated during the economic boom will materialise. The share of non-performing loans is on the rise again. So far, their share in the loan portfolio of banks operating in Estonia has been very low. Thus, the rise is quite expected and this does not jeopardise the operation of the financial system in the short term. In autumn 2007, Eesti Pank conducted a stress test of banks' lending portfolios. Based on this test, it is quite unlikely that in the coming years, loan losses will grow so much that the banks operating in Estonia will be forced to raise additional capital in order to proceed with regular operations. The capital and liquidity buffers built earlier are to alleviate the consequences of the risks that might materialise.

The global liquidity environment tightened in the second half of 2007. In relation to that, the significance of the continuous monitoring and analysis of banks' liquidity position increased. For several years, Estonia's major banks, which belong to Nordic banking groups, have been managing their liquidity primarily at the group level. Therefore, the materialisation of liquidity risk in Estonia above all depends on how and to which extent the parent banks are able to raise additional resources, if necessary. Therefore, the analysis of Estonia's banks' liquidity risk requires cross-border cooperation with institutions that exercise supervision and are responsible for financial stability in the parent bank's country. At the end of 2007, the Swedish and Baltic central banks expressed their willingness to provide to each another, in addition to regular information exchange, also latest information on the liquidity positions of different banking groups or banks belonging to groups, if necessary.

EU financial sector policy

For Eesti Pank, one of the most important financial sector policy issues in EU institutions and committees in 2007 was **improving the organisation of cross-border cooperation on financial supervision in the EU**.

The problem is the current excessive decentralisation in the light of rapid cross-border financial sector integration. There are two solutions: either to head towards greater formalisation or flexible specific solutions. Estonia's financial sector mainly consists of the subsidiaries and branches of the financial intermediaries of other EU countries. Therefore, when proposing solutions and supporting initiatives, Eesti Pank has pursued the objective of achieving such an organisation of cross-border financial supervision that would best enable to protect also

the financial stability interests of the host countries. A related issue was changing the current set up of the activities of Level 3 financial sector committees (the so-called Lamfalussy framework) with regard to strengthening of the mandate and the decision-making mechanism.

Another important subject was banks' **liquidity conditions** and **organisation of liquidity monitoring and supervision**, which had emerged against the background of the uncertainty in global financial markets. So far, the legislation in this field has not been much harmonised at the EU level but closer integration calls for changes.

In addition to tackling issues related to liquidity supervision, evaluation of the need for amendments to the Capital Adequacy Directive started in 2007. From Eesti Pank's point of view, it is necessary to lay down requirements of cross-border cooperation for supervision authorities as regards systemically important branches; harmonise the definition of own funds (primarily in the case of hybrid capital instruments), and revise requirements related to risk concentration.

An important field relating to the cross-border activities of the financial sector is definitely **securities settlement, i.e. post-trading infrastructure of the securities market**. One major obstacle to creating single European capital market is the lack of interoperable securities clearing and settlement systems. The integration of securities market infrastructures in the EU fostered on the basis of a **Code of Conduct for clearing and settlement agreed upon by market participants** on the one hand, and initiatives of public institutions on the other. At the end of 2006, three bigger market participants' unions[1] that handle post-trading infrastructures signed the Code of Conduct. The Code focuses on three main topics: transparency of prices and services; interoperability of and access to systems, and unbundling of services and implementing accounting separation. The measures in the conduct were set out to be implemented gradually by the beginning of 2008.

The most important public sector initiative for Eesti Pank in 2007 was a project of the Eurosystem called **TARGET2-Securities, a single shared platform for settlement of securities**, initiated by the European Central Bank. EU finance ministers have also expressed their support to the project. In relation to the project, two public consultations covering various interest groups were commenced. The first consultation addressed the general principles of the TARGET2-Securities platform; the second dealt with user requirements. The Eurosystem will decide on further development of the platform in summer 2008.

The goal of the institutions responsible for financial stability is to prevent financial crises. However, even with the best crisis prevention activities, there is still the possibility of a financial crisis. Thus, to ensure financial stability it is also necessary to be ready for effective crisis management.

Safety net

Failures in the functioning of the financial system may occur unexpectedly and rapidly pass on to other markets and market participants. Since a financial crisis may bring great damage to the society, public sector institutions must be well-prepared for the crisis and coordinate their activities in a crisis situation.

The tasks of Eesti Pank, the Financial Supervision Authority and the Ministry of Finance and the foundation for their joint operation have been laid down in a **Memorandum of Understanding (MoU) on the management of financial crises** concluded at the end of 2006. Eesti Pank has also concluded multilateral MoUs with institutions responsible for the financial stability in EU countries and a MoU with the central banks of Sweden, Latvia and Lithuania.

[1] Federation of European Securities Exchanges (FESE), European Association of Central Counterparty Clearing Houses (EACH), European Central Securities Depositories Association (ECSDA).

The effectiveness of financial crisis management can be tested and weaknesses identified in crisis trainings. In autumn 2007, the **Nordic-Baltic regional financial crisis simulation exercise** was conducted. Participants included representatives of Nordic and Baltic central banks, supervision authorities and finance ministries. The crisis exercise gave the participants a valuable experience, pointing out different aspects that institutions should consider and for which they should be prepared when coordinating crisis management.

The development of a relevant crisis management framework to solve a banking crisis affecting several Member States is one of the most important tasks of the EU financial sector policy in the near future. In 2007, the principles of the EU cross-border Memorandum of Understanding were developed into practical recommendations, and these activities will continue in 2008.

A crucial component of the Estonian financial safety net is the **deposit guarantee schemes**. Deposit insurance is mandatory for banks operating in Estonia since 1998, and from July 2002 this issue is the responsibility of the Guarantee Fund. In addition to the Deposit Guarantee Sectoral Fund, also the Investor Protection Sectoral Fund and the Pension Protection Sectoral Fund operate at the Guarantee Fund.

At the end of 2007, the transition period agreed upon in the course of the EU accession negotiations with regard to the upper limit of coverage for deposits came to an end. Since 2008, the new upper limit of coverage for deposits in Estonia is the minimum level provided for in the EU directive, which is 20,000 euros (313,000 kroons).

Banking legislation

At the end of 2007, the new regulation for the implementation and calculation of the prudential ratios of credit institutions and the consolidated groups of credit institutions (Basel II) that had entered into force on January 1, 2007 was revised. Credit institutions operating in Estonia used the opportunity to start implementing the new regulation for capital adequacy calculation from 2008. For credit institutions operating in Estonia, the receipt of permits for the introduction of more sophisticated methods for calculating capital requirements will still take some time. Therefore, the section on the risk weighting on housing loans had to be revised to establish capital requirements that would make the changeover to lower capital requirements more in line with the market situation. Instead of the 35% risk weighting on housing loans laid down by Basel II, in 2008 the credit institutions operating in Estonia have to implement a 60% risk weighting.

Payment and settlement systems oversight

There were no such incidents in the operation of the Estonian payment and settlement systems that would have jeopardised the stability of the financial sector or the smooth functioning of payment systems. In addition to the oversight of systemically important settlement systems – the Real-Time Gross Settlement System (EP RTGS) and the Settlement System of Ordinary Payments (ESTA) managed by Eesti Pank – two new settlement services on the Estonian market were analysed. The overseer gave a positive assessment to both of them.

The first major development was made in the field of **securities settlement**. So far, financial claims and liabilities resulting from domestic securities transactions intermediated by the Estonian Central Register of Securities (ECRS) had been met only in terms of settling net positions. Since April 30, 2007 however, **the cash leg of claims and liabilities resulting from securities transactions can be settled on the basis of the Real-Time Delivery Versus Payment (RT DVP) service**. In case of a delivery versus payment settlement, the securities custodians intermediate the transfer of both the securities and the money. The purchased securities are transferred to the purchaser's securities account and the funds on the seller's settlement account

as soon as the sum has been transferred from the custodian's account of the credit institution representing the purchaser in the EP RTGS to the custodian's account of the credit institution representing the seller. As the RT DVP service reduces risks in the payment and settlement systems, the overseer considers the implementation of this service reasonable and positive.

Developing a functionality similar to the RT DVP was discussed already at the time the RTGS was introduced, but as market participants had no interest in the service at that time, it was disregarded during the launch of the RTGS at the beginning of 2002. For the smooth operation of the financial system, the functionality of the RT DVP service must guarantee that credit institutions are able to manage their liquidity themselves, which is especially crucial in the event of a crisis.

The second bigger development was the **implementation of the interbank direct debit scheme**. The absence of an interbank scheme and the resulting ineffectiveness on the retail payment market have been pointed out in the assessments of the overseer of Eesti Pank and the European System of Central Banks. Since June 14, 2007, most banks operating in Estonia have been offering the interbank use of direct debits. Above all, this has increased the effectiveness of domestic interbank retail payments. The new service enables customers to use domestic direct debits also if the accounts of the payer and the payee are not held with the same bank. The service also helps to strengthen competition in the retail payments market by improving the opportunities of smaller banks and increases effectiveness by expanding the services provided to bank customers.