

## ENSURING FINANCIAL STABILITY

**Eesti Pank's key responsibility is ensuring price stability. The smooth operation of the financial system is a necessary precondition for central banks to be able to achieve their targets.**

In order to ensure the smooth operation of the financial system, Eesti Pank assesses the related risks and takes measures to minimise the potential materialisation of such risks.

To assess the risks to the financial system, the primary responsibility is to guarantee the availability of sufficient **high-quality data**. Eesti Pank cooperates with domestic and international institutions to collect, exchange and publish financial sector statistics. The **results of the analysis** of financial sector operation and related risks are published twice a year in the Financial Stability Review. The review also includes regular assessments of the operability of and risks to the payment and settlement systems; that is, the infrastructure necessary for financial intermediation.

The collection and analysis of data is a continuous process. The need to **implement measures** to improve the operability or efficiency of the financial sector may emerge very rapidly. Therefore, Eesti Pank is regularly monitoring and analysing the situation of the financial sector. In order to increase the transparency of the financial sector and provide market participants with the necessary data, Eesti Pank publishes statistics on the operation of banks and leasing companies on a monthly basis. As of 2008, the data are published with comments. In addition, the credit institutions operating in Estonia are required to publish their own consolidated quarterly financial statements.

As the Estonian financial sector and economy are globally integrated, it is essential to maintain close **domestic and cross-border cooperation** with the institutions that influence the sector's operational environment.

In order to further enhance cooperation, Eesti Pank, the Financial Supervision Authority and the Ministry of Finance revised their cooperation arrangement, which has been laid down in the Memorandum of Understanding (MoU) renewed in 2007. A committee of their representatives has been established for exchange of information and coordination of operations. In addition to providing a framework for daily operations, the MoU concluded in 2006 laid down the tasks and foundations for their joint operation in case of an emergency, i.e. a systemic financial crisis. Still, it should be borne in mind that although the operability of the financial intermediation system is a broader goal and in the interest of the society, the main responsibility for the sustainability of a bank lies with the owners and management of the bank.

In addition to domestic operations, as a member of the European System of Central Banks Eesti Pank also cooperates with the national central banks of other EU countries in order to ensure financial stability. Information exchange with the Nordic and Baltic States is especially frequent owing to close regional integration. Since 2006, Eesti Pank belongs to the cooperation network of Nordic and Baltic central banks, where information on the functioning of the financial systems and their operation environment is exchanged regularly. The areas of responsibility and operation of the Nordic and Baltic central banks regarding crisis management have been specified in the regional MoU.

### **Financial sector analysis and financial stability assessment**

The uncertainty in financial markets that started off in the US mortgage market at the end of summer 2007 evolved into a global crisis in autumn 2008, when several US and European financial institutions encountered difficulties and needed to make large-scale write-downs on trading and credit portfolios. The confidence crisis caused a

significant rise in the cost of lending, to which central banks have responded with significant cuts in key interest rates.

In Estonia, growth started to slow in the middle of 2008, when the global financial crisis had not fully unfolded yet. Investment demand has decreased, whereas banks' risk assessments and thus also risk margins have increased. As a result, growth in banks' credit portfolios has slowed considerably.

Quite expectedly, the number of bad loans has started to grow. Growth in loans overdue is alleviated by earlier provisions and available capital buffers. The latter have resulted, among other factors, from the stricter requirements to the share of own funds implemented by Eesti Pank already in previous years.

The 15% reserve requirement imposed by Eesti Pank on credit institutions serves for hedging liquidity risk. The liquidity of major banks operating in Estonia largely relies on the ability and will of their parent banks to provide funds when needed. The general cost of funds depends on fund providers' assessments of the risk level of the whole group. In the rapidly changing economic environment it cannot be ruled out that the risks, which may have been so far incorrectly assessed, will materialise, bringing along changes in the cost of funds for the whole group. Therefore it is vital that credit institutions maintain sufficient liquidity and capital buffers to cope with the difficult market conditions.

### **Measures adopted to ensure financial stability**

The operation of participants in cross-border financial groups is often integrated and the risk management of groups has become more centralised. Thus, **cross-border coordination** between the banking and monetary regulators and supervisory authorities in a group's operat-

ing region is extremely important, especially in difficult market conditions.

In order to improve cross-border cooperation between institutions responsible for safeguarding financial stability, in June 2008, pursuant to the action plan of the EU Council of Economic and Finance Ministers (ECOFIN) on ensuring financial stability in the EU, an amended version of the cooperation agreement on ensuring cross-border financial stability was concluded between bank supervision authorities, central banks and ministries of finance. Estonia also acceded to the agreement.

To alleviate the consequences of the risk aversion that hit global financial markets in autumn 2008, several governments and central banks adopted extraordinary measures to support liquidity and customer confidence. As banking systems are closely integrated, the cross-border impact of the actions of governments and central banks has gained more importance. Therefore, it is very important that the adopted measures be harmonised across countries. As a response to increased risk aversion, Member States (including Estonia) agreed at the October ECOFIN to harmonise the minimum level of deposit guarantees (see below).

Among others, also Nordic and Baltic governments and central banks have taken alleviating measures. High-quality data is of key importance to ensure that appropriate measures are adopted. When the situation worsened in autumn 2008, Swedish and Estonian central banks exchanged information on a daily basis. Eesti Pank submitted relevant data, analyses and assessments also to other Estonian institutions, organisations and market participants.

In addition to cross-border cooperation, Eesti Pank participated in the development of national measures aimed at ensuring financial stability. In order to improve the ability of the Estonian

government to prevent and, if necessary, manage financial crises, the State Budget Act, the Foundation of and Participation in Legal Persons in Private Law by the State Act, as well as the Riigikogu Rules of Procedure Act and the Riigikogu Internal Rules Act were amended.

Based on the assessment of the developments, Eesti Pank decided to retain the 15% reserve requirement and 10% capital adequacy requirement to the credit institutions operating in Estonia. The central bank also continued to improve the crisis management framework.

#### **Amendments to EU legislation on banking and payment intermediation**

Although the prime responsibility for the operation of a company lies with its owners and management, the uncertainty on financial markets and the decreasing confidence in financial intermediaries call for **improving the requirements to the operation of and supervision over financial institutions.**

Supervision over different fields of activities and the globally integrated financial sector is currently decentralised. To solve the resulting problems, in autumn 2008 the European Commission established a working group which is due to present its first proposals in 2009.

Although the analysis of the lessons learnt in the current financial crisis has not ended yet, several processes were initiated in 2008 to ensure improved performance of financial systems. For instance, additional requirements are to be imposed on credit rating agencies and they are to be subjected to supervision. To this end, a working group was established to develop a draft act concerning requirements to the rating agencies and supervision over their compliance with the requirements. Work in that field continues in 2009. In addition, the framework of capital adequacy calculation and the rules of financial

accounting are to be amended in order to reduce their pro-cyclicality. In 2008, further amendments were made to the EU directive on capital requirements in the matters of supervision over international credit institutions and cross-border exchange of information between competent authorities; also some rules on capital adequacy calculation were amended. Some requirements regarding the calculation of risk weighted items were amended, the requirements for own funds were revised and additional restrictions were imposed on the concentration of credit risk.

Besides the need to improve the pre-warning and supervision systems, the need to speed up the harmonisation of **deposit insurance systems** across EU Member States came up again along with the increasing uncertainty on financial markets. In autumn 2008, the Member States agreed that the maximum amount of insured deposits would be raised to 100% of 50,000 euros (782,330 kroons) per depositor. Work in that field is to be continued in 2009.

The globalisation of financial groups has increased expectations to the central coordination of supervision and regulation at the group level or even at the EU level. Latest developments clearly indicate that successful prevention and solution of crises requires better cross-border cooperation. However, it is important that the country responsible for the functioning of the financial system and that may be expected to provide financial contribution to the improvement of the system, would receive sufficient information regarding the operation of and risks to the financial sector. Furthermore, the country should also be entitled to adopt measures that might be necessary for ensuring financial stability.

In the field of settlement systems, the directives on e-money, financial collaterals and settlement finality and the regulation on euro payments were revised in 2008.

## **Improvement of securities market infrastructures**

The global financial crisis showed the importance of financial sector infrastructures – **payment and securities settlement systems**. Therefore, greater efforts were made to improve them. In May 2008 Eesti Pank and credit institutions operating in Estonia connected to the trans-European settlement system TARGET2, which operates on a single shared platform and was launched in November 2007. As regards securities market infrastructures, the implementation of the Code of Conduct for clearing and settlement agreed upon by market participants continued. An agreement was also reached regarding the recommendations of the European System of Central Banks (ESCB) and the Committee of European Securities Regulators (CESR). The TARGET2-Securities (T2S) project, initiated by the European Central Bank, moved to the next stage.

The most important public sector initiative for Eesti Pank and the Estonian Central Register of Securities was the **T2S project**, the single shared platform for the settlement of securities. After the project's feasibility study, identification of user requirements and receiving feedback from market participants, the Governing Council of the European Central Bank decided to start the development of the T2S settlement platform. With the launch of the T2S the Eurosystem will be providing a single infrastructure for securities settlements to securities depositories, using the central bank's money if the transaction is conducted in euros. The T2S services will be extended to other currencies in case there is sufficient market demand, the central bank issuing the other currency requests it and the Governing Council of the ECB approves it. The platform will be operational in 2013. With the support of Eesti Pank and the market participants operating in

Estonia, at the end of 2008 the Estonian Central Register of Securities gave a conditional commitment to join the T2S platform. Since the second half of 2008, Eesti Pank and the Estonian Central Register of Securities have been participating in the T2S Advisory Group; at the beginning of 2009, the T2S Estonian National User Group (EENUG) was established. The aim of the EENUG is to represent the country's interests for the T2S project team operating at the European Central Bank and between the T2S Advisory Group and the market participants operating in Estonia.

## **Payment and settlement systems oversight**

**In 2008, regardless of the financial crisis, 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.**

The value of transactions processed in the payment and settlement systems increased as a result of the global financial crisis. However, thanks to sufficient buffers the payment and settlement systems experienced no failures that would have triggered a systemic risk in the systems or the financial sector in general.

The **implications of crisis** on interbank payment and settlement systems could be perceived from mid-September to mid-October. Namely, then the number of interbank transactions increased robustly, credit institutions used the central bank's forex window, and the demand for cash rose. **Credit institutions had no problems with meeting the reserve requirement.** Owing to a deviation in the euro area interest rates from their customary levels because of the financial crisis<sup>1</sup>, in mid-October some credit institutions fulfilled the reserve requirement only as

<sup>1</sup> Due to tensions in the international money and capital markets, it became more profitable for some banks to deposit their entire required reserve in Eesti Pank, rather than investing it in other widespread debt instruments, such as government bonds. Capital investment in other instruments is generally more profitable, but due to the crisis, depositing capital in central banks became safer and more profitable.

kroon deposits in Eesti Pank, temporarily eliminating their high-quality securities held for meeting the reserve requirement base.

By now, all major Estonian credit institutions have joined the new payment and settlement system TARGET2-Eesti launched on 19 May 2008. This means that Estonian bank customers now have an alternative to settle express payments in euro. In **overseeing TARGET2-Eesti**, Eesti Pank proceeds from the guide on the implementation of the Eurosystem's TARGET2 oversight function and Eesti Pank's framework on settlement systems oversight. The assessment of TARGET2 and its subsystems is based on the "Core principles for systemically important payment systems" by the Bank for International Settlements (BIS) and „Business continuity oversight expectations for systemically important payment systems" implemented by the Eurosystem.

The responsibility for the oversight of the entire TARGET2 lies with the European System of Central Banks, including the Eurosystem and the central banks outside the Eurosystem that are connected to TARGET2. The leading overseer of the single platform of TARGET2 is the European Central Bank. Owing to the legal and operational decentralisation of the subsystems of TARGET2, the responsibility for overseeing TARGET2-Eesti lies with Eesti Pank.

The oversight of TARGET2 supports its secure and effective operation; the primary purpose of oversight is to minimise systemic risks. To this end, national central banks assess the compliance of TARGET2 and its subsystems with internationally recognised standards, make recommendations and implement measures to achieve compliance.

**According to the overseer of Eesti Pank, the system of TARGET2-Eesti complies with the principles recognised internationally and by**

**the Eurosystem.** The probability of the occurrence of systemic risks is reduced by acknowledging and preventing other potential risks in the settlement system. The legal framework, functional and technical solutions and procedures of TARGET2-Eesti are secure and appropriate. In addition to the legislation of the Republic of Estonia, the legal relationships of TARGET2-Eesti are regulated by the rules of TARGET2-Eesti and the accession agreements concluded between the settlement system participants (between Eesti Pank and the members of the settlement system).

In accordance with the strategic goal of Eesti Pank to foster the integration of European financial markets, the **central bank evaluated one development concept for the securities market infrastructure.** In cooperation with other Baltic stock exchanges, the Tallinn Stock Exchange and the Estonian Central Register of Securities analysed the introduction of the euro as a trade and settlement currency in the entire Baltic market. In addition to Estonian kroons, the securities traded on the Tallinn Stock Exchange have been denominated also in euros since the beginning of 2002, when the trading system of the Helsinki Stock Exchange HEX was introduced by the Tallinn Stock Exchange. Given that the TARGET2 provides the necessary infrastructure for euro settlements, Eesti Pank supports the idea to allow stock exchange members settle their transactions in euros and, in the case of over-the-counter transactions, in Estonian kroons or euros as required by the transaction parties. For introducing the euro as a currency for securities settlements, Eesti Pank recommends to proceed from the same principles as applied for the listing of securities in euros. In other words, financial claims and liabilities resulting from securities transactions will be settled using the official exchange rate of the Estonian kroon and the euro throughout the transaction process from the seller to the final investor.