SM/09/50
Correction 1

March 6, 2009

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Republic of Estonia—Financial System Stability Assessment**

The attached correction to SM/09/50 (2/17/09) has been provided by the staff:

Factual Error Not Affecting the Presentation of Staff's Analysis or Views

Page 6, para. 1, line 4: for "Given that most of these banks' liquid liabilities are in euros, and the central bank's reserves are insufficient to cover them, the system would be severely compromised in the event of a liquidity crisis was such an arrangement not put in place." read "This will be essential for the system not to be severely compromised in the event of a liquidity crisis."

Questions may be referred to Mr. Seelig, MCM (ext. 34927).

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

Att: (1)

Other Distribution:
Department Heads

EXECUTIVE SUMMARY

The Estonian authorities have made significant progress since the 2000 FSAP in improving financial sector supervision (see Appendix I). The creation of the Estonian Financial System Authority (EFSA) has improved supervision in Estonia. Its organizational structure has been designed in a manner to effectively address the unique features of the Estonian financial sector.

The Estonian financial sector is highly concentrated and foreign owned. Two Swedish-owned banks control 68 percent of banking assets and two other Nordic-owned banks control an additional 26 percent. These same institutions also dominate the insurance, brokerage, and investment and pension funds management sectors.

Financial indicators suggest a sound banking sector, and show particular strength in asset quality and earnings. Exceptional economic growth, in recent years, has been fueled by bank lending and has brought strong profitability and asset growth to Estonian banks. Moreover, Estonian banks have proven resilient in the face of recent problems in Latvia. Although banks have increased provisions as nonperforming loans (NPLs) have risen, an increase in lending rates and spreads have offset the impact on earnings.

However, while the current economic slowdown has not yet led to weaker banking sector performance, there are signs that credit quality is deteriorating. Banks are heavily concentrated in real estate loans, and the market has weakened and prices are falling. Housing loans 60 days past-due have almost doubled during the past six months, albeit from low levels.

The rapid expansion of bank mortgage lending has been funded by shorter-term foreign borrowing, leaving Estonia vulnerable to a shock to the real estate sector or a disruption in international financial markets. Loan growth to this sector was funded in euros, at floating rates, from parent banks and used to fund long-term euro-denominated floating rate mortgages. Estonian banks have a maturity mismatch that makes them vulnerable to a liquidity shock. Moreover, given that banks' short-term liquidity exposure in foreign currencies significantly exceeds Estonia's international reserves, this constitutes foreign exchange vulnerability as well. The vulnerability of the banking sector to a liquidity shock was confirmed by a run on one of the large banks in late September. Liquidity problems were avoided by policy actions of the home-country central bank that allowed the parent to provide sufficient liquidity to its Baltic subsidiaries.

Estonia operates under a currency board that presently limits its ability to provide liquidity support to banks. However, its relatively high reserve requirements provide a partial buffer. Recently, moreover, the BoE has developed procedures for meeting the funding needs of banks, but these would apply only to small banks and the conditions and policies surrounding their use will only be decided on a case-by-case basis should there be a need. Recognizing the need to be able to provide liquidity to the large banks, the authorities have developed a plan to provide ELA to the large foreign-owned banks with the support of a neighboring central bank. ~~Given that most of these banks' liquid liabilities are in euros, and the central bank's reserves are insufficient to cover them,~~ This will be essential for the system ~~would~~ not to be severely compromised in the event of a liquidity crisis ~~was such an arrangement not put in place~~.

There remains a need for Estonia to more fully develop its safety net, including an expanded bank resolution framework. The authorities have begun to explore options to address these vulnerabilities, while at the same time preserving the integrity of their currency board arrangement. With a more robust resolution framework, the deposit guarantee fund would be able to provide effective limited coverage of the entire system if the target amount of the fund were doubled to 4 percent of guaranteed deposits.

The bank supervisory framework in Estonia is in line with international standards and practices and EFSA provides Estonia with a strong prudential supervisory body. Most of the weaknesses identified in the 2000 Basel Core Principles Assessment have been addressed and the capital adequacy regime in Estonia is in line with international standards and consistent with the European Union (EU) Capital Requirements Directive. In response to a recommendation of the FSAP-Update mission the supervisory board of the EFSA increased staffing to meet the increasing demands of Basel II and Solvency 2. Other recommendations of the mission have also been implemented by the EFSA.

The regulatory framework for pension fund oversight should be strengthened. The supervisory framework should move from a compliance-based approach to one focused on risks, including the adequacy of reserves during the payout period. The EFSA should prohibit the practice of requiring a saver to purchase other products from the same firm and consider other measures that would result in cost reductions. In response to the mission's recommendation, the authorities liberalized the investment limit on the maximum equity exposure allowed for pension funds.