



## REMARKABLE CHANGES IN THE BANKING AND REGULATORY ENVIRONMENT

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The Estonian banking environment has been undergoing remarkable changes since 1991 when Estonia regained its independence and an urgent need for an adequate regulation emerged, up to the present moment when, on January 1, 2007, the new legal framework based on the Basel II Accord entered into force. This article aims to provide a brief overview of recent developments in the Estonian legal landscape of the banking industry, as well as of current legislation in this respect.

### OVERVIEW OF HISTORICAL DEVELOPMENT OF ESTONIAN BANKING LAW

The Estonian banking regulatory framework has been constantly evolving since 1991 when Estonia regained its independence. The beginning of the independence era was marked by a rapid growth in the number of commercial banks. However, due to the transition to the market economy, Estonia lacked any significant experience in banking sector. Furthermore, a lack of an adequate regulative framework and over-enthusiastic licensing of banks led to numerous collapses, as a result of which the number of banks fell from 42 in 1992 to 24 at the end of 1993, which triggered the need for a depositor-orientated regulative environment. Thus, the Credit Institutions Act entered into force at the beginning of 1994 and was repeatedly amended afterwards to match international standards.

Similarly to other countries, Estonia was hit by an international financial crisis wave of 1997-1999 causing the Tallinn Stock Exchanges TALSE index to lose almost two thirds of its value and forcing undercapitalised banks out of the market. More stringent capital requirements enacted in 1998 also contributed to a decrease in the number of banks either due to close-downs or mergers. In 1998 the deposit guarantee scheme was introduced covering losses caused by bank close-downs. In the same year the Act on Prevention of Money Laundering and Terrorism Financing was adopted establishing the Financial Intelligence Unit. The supervision over credit institution activities, initially ineffective, reached international standards by 2002, when an independent unified Financial Supervision Authority was established.

At present, the national banking sector comprises (as of December 31, 2006) seven locally licensed credit institutions and seven branches of foreign credit institutions operating in Estonia. Two of the largest locally licensed banks, Hansapank and SEB Uhispank, share in total 78% of the entire banking sector. Both of the named banks are fully owned by Nordic banking groups. The supervision over activity of credit institutions is performed by the Estonian Financial Supervision Authority (FSA) operating at the Bank of Estonia. FSA is financed by means of regular fees payable by supervision subjects and procedural fee payable upon applying for a certain action on the part of FSA.



Banking activity in Estonia is governed by the Credit Institutions Act, last amended on January 1, 2007, and regulations of the Minister of Finance issued on the basis thereof. Investment banking regulatory framework is established by the Securities Market Act entered into force in 2002 and last amended on January 1, 2007. The basic framework for the regulation of the banking industry is as follows:

**Operating rights and licensing.** Estonian legal acts provide for several possibilities to act as a credit institution in Estonia. The first option is to establish a local company complying with all relevant requirements, and to apply for a licence from FSA. Additionally, a person who pursuant to the legislation of the home state has the right to receive money from the public as bank deposits or to receive repayable funds in any other manner may, on the basis of the activity-licence issued in the home state, conclude the same transactions and perform the same acts in Estonia by establishing branches or providing cross-border services in Estonia. Upon providing financial services in Estonia, a person established in a foreign state has to adhere to the requirements set forth for credit institutions by Estonian legal acts.

**Shareholders and management.** Qualifying holdings in a bank may be held by everyone who is able to ensure the sound and prudent management of the bank and whose structure of owners and business connections, if they exist, are transparent and do not prevent supervision from being exercised efficiently. The Financial Supervision Authority will issue a licence for the acquisition of a qualifying holding only on the condition that it can receive information regarding such persons without any hindrance arising from the legislation of the home state of the applicant. Notification obligations apply in respect of a person intending to acquire a qualifying holding in a bank or to increase a holding so that the proportion of the share capital or votes in the bank held by the person exceeds 20%, 33% or 50%, or so that the bank would become a company controlled by the person as a result of the transaction. The Financial Supervision Authority may prohibit, by a precept, the acquisition or increase of a qualifying holding or turning a bank into a controlled company if this is contrary to the principles of the sound and prudent management of the bank.

Stringent requirements are set forth in respect of the management of credit institutions. Only persons who have the education, experience and professional qualifications necessary to manage a credit institution and who have an impeccable business reputation may be elected or appointed as managers of credit institutions. The managers and employees of a credit institution are required to act with the prudence and competence expected of them and according to the requirements for their positions and the interests of the credit institution and the clients thereof. The managers and employees of a credit institution are required to give priority to the economic interests of the credit institution and the clients thereof over their own personal economic interests.

#### RECENT DEVELOPMENTS RELATED TO CAPITAL ADEQUACY REQUIREMENTS

The legal landscape of Estonian banking has been marked in 2007 by a significant amendment to the existing regulation. Namely, Act Amending Credit Institutions Act entered into force on January 1, 2007. The said amendment is due to the transposition of Directives 2006/48/EC and 2006/49/EC of the European Parliament and of the Council of June 14, 2006 (CAD III) relating to the taking up and pursuit of the business of credit institutions and to the capital adequacy of investment firms and credit institutions, implementing Basel II Accord.



Implementation of the adequacy directives enables credit institutions to rely more on their internal risk assessment mechanisms when determining adequacy of capital, allowing for a more flexible and dynamic approach to the changing financial environment. The new system is meant to encourage credit institutions to identify and measure risks inherent to their activities. Another revolutionary innovation is the regulation encompassing operational and market related risks.

The new regulation enables banks to choose one of three methods to determine adequacy of capital. The Foundation Approach method requires determination of credit risk pursuant to classification of the claims based on the standardised assets classes. Under the Foundation Risk Approach banks are required to use credit risk ratings awarded to the company by acknowledged rating agencies. Since very few companies in Estonia have been awarded such ratings this method is not likely to be very popular among local credit institutions.

Presumably, the banks will mostly seek to implement the Internal Ratings Based Approach, although it represents a more complex and consequently more expensive method. Application of Internal Ratings Based Approach will enable banks to use lower capital requirements resulting in more effective use of funds. In this approach, banks will be entitled to use their own internal credit assessment systems as the basis for the capital calculation, subject to meeting certain conditions. All credit institutions using the Foundation Internal Rating Based Approach will only be allowed to determine the borrowers' probabilities of default while those using the Advanced IRB Approach will also be permitted to rely on their own estimates of loss given default and exposure at default. The banks adopting this approach will be required to elaborate a credit risk assessment system subject to approval by the Financial Supervision Authority and to establish independent credit risk control units that will be responsible for the design or selection, implementation and performance of their internal rating systems.

In order to use the Internal Ratings Based Approach banks will have to apply for a relevant licence from the Financial Supervision Authority. An institution applying for such licence will be required to prove that it has used the rating system meeting the minimum requirements set forth by the law for at least three years prior to submission of the application.

Out of two major locally-licensed banks SEB Eesti Uhispank is currently planning to submit an application to the Financial Supervision Authority for use of IRB Approach as of year 2008. Hansapank is also waiting for a relevant approval for implementation of IRB method.

In addition to capital adequacy calculation rules, the new Basel II based framework sets forth extensive disclosure requirements aimed at guaranteeing transparency of the bank activities, to increase market discipline and compliance of the credit institutions with applicable legal acts, and to facilitate supervision. The Credit Institutions Act which was in force up to January 1, 2007, already stipulated the obligation of a bank to publish annual and interim reports. As of entry into force of the amendment the disclosure of risk management principles, own funds and capital adequacy indexes is also required.

The principle of responsible lending has also been introduced into the Estonian legal system. Formerly, banks used to assess credibility of the potential borrower from the aspect of bank's potential loss should an event of default occur, irrespective of borrowers interest. Currently



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the bank is required to advise the client on the optimal loan burden calculated on the individual basis.

Capital adequacy directives provided for over one hundred clauses subject to national discretion. The following principles were relied upon while transposing the CAD III into Estonian legal system:

- risk-related considerations should prevail over political values;
- unfounded discrepancies with other states regulation to be avoided; and
- application of more favourable clauses and avoidance of undue restrictions.

**Notes:**

1. Based on loans issued to the non-financial sector as of Dec 31, 2006
2. Source: 2006 Yearbook of the Estonian Financial Supervision Authority. Available at: <http://www.fi.ee/?id=1949>