ESTONIA

REVIEW OF THE FINANCIAL SYSTEM

October 2011

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

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FOREWORD

This review of Estonia by the Committee on Financial Markets (CMF) was prepared as part of the process of Estonia's accession to OECD membership.

The OECD Council decided to open accession discussions with Estonia on 16 May 2007 and an Accession Roadmap, setting out the terms, conditions and process for accession, was adopted on 30 November 2007. In the Roadmap, the Council requested a number of OECD Committees to provide it with a formal opinion. In light of the formal opinions received from OECD Committees and other relevant information, the OECD Council decided to invite Estonia to become a Member of the Organisation on 10 May 2010. After completion of its internal procedures, Estonia became an OECD Member on 9 December 2010.

The CMF was requested to review Estonia's financial system, including its market and regulatory structure, to assess whether it is market-oriented and sufficiently open, efficient and sound, based on high standards of transparency, confidence and integrity, for Estonia to be able to accept the requirements of membership in the area of financial markets. The present report was finalised on the basis of information available in September 2009. It is released on the responsibility of the Secretary General of the OECD.

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LIST OF ABBREVIATIONS

BoE	Bank of Estonia (Eesti Pank)
CESR	The Committee of European Securities Regulators
CSD	Central Securities Depository
ECB	European Central Bank
EEK	Estonian Kroon
EFSA	Estonian Financial Supervision Authority
ESCB	European System of Central Banks
IFRS	International Financial Reporting Standards
MoU	Memorandum of Understanding
SEK	Swedish crowns
SME	Small and medium-sized enterprise

I. INTRODUCTION AND OVERVIEW

A. Macroeconomic Context

After high rates of real GDP growth during 2000-2007, which allowed Estonia to converge rapidly towards the EU average income levels, the Estonian economy is now experiencing a hard landing, largely unwinding a loan-financed over-expansion of domestic demand. Real GDP contracted 3.6 percent in 2008, due to a collapse of first domestic, and then also external demand, and a slowdown of foreign-financed credit (Table 1). The OECD Economics Department forecasts a further 14 percent decline in 2009.

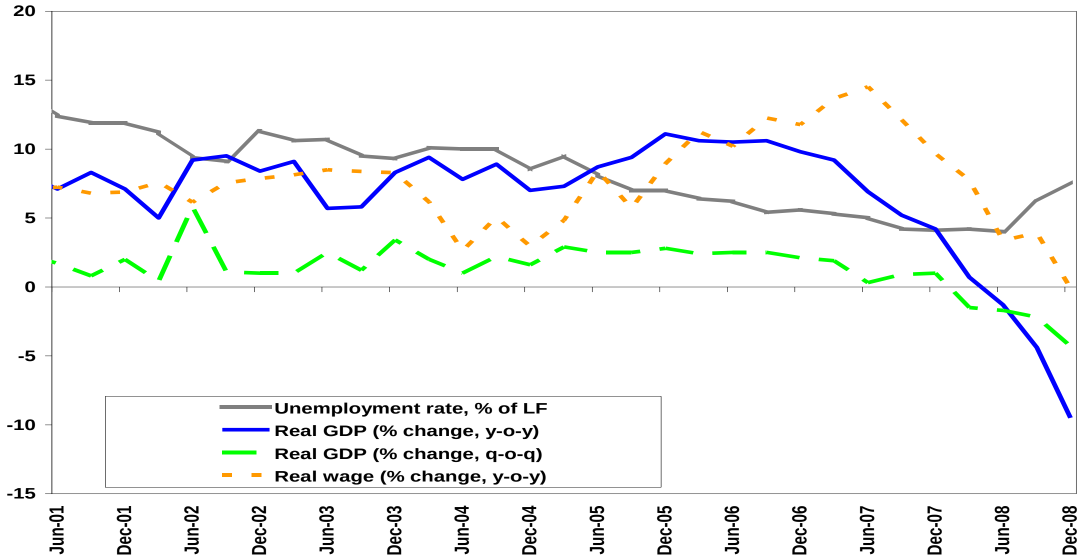
The ongoing recession was triggered by declining real estate prices and construction activity, and accompanied by credit tightening, plummeting consumer confidence, and a slowdown of export growth in the context of the global financial crisis. House prices, which had surged in recent years, have decreased substantially since mid-2007. Even though the large external imbalances of preceding years implied that a correction and slowdown were necessary, the speed and size of the output adjustment were much faster and larger than expected. The slowing of the economy has also brought about a deterioration of the fiscal balance, which is projected to show the first significant deficit since the Russian crisis in 1998. Unemployment has increased rapidly since the second half of 2008, putting an end to years of steady decline. At the same time, the current account deficit has disappeared rapidly, after reaching a peak of 18 percent of GDP in 2007.

While lower domestic demand has been the main factor for the initial reversal of output growth, the country remains exposed to external risks, namely to a further slowdown of growth in the euro area and a tightening of global credit conditions. Estonia remains vulnerable to adverse spillovers from international financial markets, as the maintenance of credit growth depends almost entirely on lending from foreign parents banks. Whereas the substantial stock of short term external debt has increased demands on fresh external financing (the share of foreign currency in total debt being high and reserve coverage of such debt being one of the lowest among the European emerging market economies), a substantial share of those claims of also those of foreign parent banks toward their Estonian operations. Negative growth and falling real estate prices are also beginning to impact credit risk.

Estonia's private investment boom was financed by massive capital inflows, in an environment of a liberalised capital account and under-pricing of lending risks by foreign banks, stemming mainly from their overly optimistic assessment of Estonia's growth prospects. The counterpart to the investment boom was thus a soaring current account deficit. Over time, the net international investment position has markedly deteriorated, and its structure has created an important source of vulnerability. Specifically, since the current account deficits were financed by foreign credit and direct investment targeting mostly non-tradables, the country's export capacity and competitiveness have not directly increased. Moreover, as a significant share of the current account deficit was continuously financed by borrowing, Estonia's stock of gross private external debt rose to more than 100 percent of GDP at end 2007. Whereas the accumulation of short term debt, which at the end of 2007 had reached almost 40 percent of GDP, is of particular concern, the Estonian authorities note that this risk is mitigated by the fact that up to 50 percent of this stock and practically all short-term liabilities are related to inter–company lending.

Largely mirroring strong capital inflows, private sector credit surged during 2000-2007, albeit from a low base. The currency board locked in low (and eventually negative) real interest rates, but other factors (high GDP growth, consumer confidence from rising real incomes and EU accession) also contributed to the credit boom during this period. To some extent, credit growth was due to the financial deepening/"catch up" process, reflecting an initially low level of bank intermediation. At the same time, credit to the private sector expanded rapidly even relative to the country's regional peers.

Figure 1: Estonia - Real GDP, wages and unemployment rate (2001-08)



Source: Statistics Estonia

Table 1: Estonia: Economic projections as of March 2009

	2006	2007	2008	2009f	2010f
	Percentage changes, volume (2000 prices)				
Economic Activity					
Gross domestic product	10.4	6.3	-3.6	-13.9	-0.7
Private consumption	12.7	7.9	-3.8	-12.0	-0.9
Government consumption	1.8	3.9	4.4	-3.2	-0.3
Gross fixed capital formation	19.5	4.9	-7.6	-29.2	-0.7
Exports of goods and services	11.6	0.0	-1.1	-21.0	-3.6
Imports of goods and services	20.4	4.2	-7.9	-22.3	-3.5
Memorandum items					
	Annual percentage changes, unless otherwise indicated				
Harmonised index of consumer prices	4.4	6.7	10.4	-0.5	-0.5
Budget balance (per cent of GDP)	2.9	2.7	-3.0	-5.6	-5.1

Source: OECD Analytical Database

In the face of intense competition, foreign banks took on increased risks, especially as their exposure in the Baltic countries was small relative to their total portfolios. Accordingly, they set nominal interest rates in Estonia at levels similar to those in Nordic markets, and real interest rates, with a rise in local inflation, turned negative for local borrowers. Prevailing, and overly optimistic, views about Estonia's growth prospects were also supported by improved scores from credit rating agencies.

B. Recent Trends in Financial Markets

Estonia's economy and financial sector have in recent years taken on a strong emphasis on real estate. The combined share of real estate and construction in value-added has reached almost 20 percent, and this is reflected in the portfolios of financial institutions, which are heavily geared toward real estate. Private investors have also largely favoured real estate over other investments. Since the onset of the crisis, however, the real estate market has stopped functioning, and, according to official statistics, transactions are down by at least 30 percent from the previous year.

The stock market declined substantially in 2008, before stabilising somewhat in the first half of 2009. By the end of 2008, the OMX Tallinn index, Estonia's main stock exchange index, had fallen back to levels last seen at the end of 2003 (see Figure 2), and has recovered only slightly since then.

Figure 2: Estonia - OMX Tallinn index (December 2003-December 2008)

1 December 2003 = 100

Source: OECD Economics Department

Since 2007, Estonia's two largest banks, both of which are subsidiaries of Swedish banks, have started to put a brake on lending in the context of a re-evaluation of the risks arising from their Baltic exposures. The flow of private sector credit as a share of GDP has fallen sharply. The large banks are now in the process of transferring real estate collateral to affiliated asset management companies. While banking liquidity was tight in 2008, reduced loan activity has helped to ease liquidity pressure, and, according to the BoE's financial accounts, more recently some of the foreign banks have at times repatriated liquidity. Looking ahead, the BoE is concerned that the current stable funding channel of Nordic banking groups might be insufficient to support the beginning of a new investment cycle.[1]

C. Summary

Estonia's financial system has developed rapidly since restoration of the country's independence at the beginning of the 1990s, and in particular since Estonia's accession to the EU in 2004. Internet banking is the norm, and the financial market is highly integrated within the EU, particularly with the Nordic and Baltic regions. Estonia has a unified financial supervisory agency, independent from, but housed within the central bank. International surveillance assessments have found Estonia's banking system to be well-regulated.

Estonia is, however, suffering the fallout from the bursting of its real estate bubble. Apartment prices in Tallinn have reportedly halved from their 2007 peak, and bad loans are rising fast, especially in real estate development. The situation in the mortgage market is also expected to deteriorate in the face of rapidly rising unemployment. Most of the banks are sitting on growing inventories of real estate collateral that are difficult to liquidate in the current environment.

While its economy is suffering a sharp recession, the impact of the crisis on the country's financial system has been cushioned by the fact that all major financial institutions in Estonia are foreign-owned. The two Swedish banks that dominate Estonia's financial sector have benefited from the support of their home country, and the Swedish and Estonian authorities appear to cooperate closely. Estonia's central bank has recently concluded a stand-by agreement with Sweden's central bank.

Estonia is one of the few countries where branches of foreign banks play an important role in the retail banking market. The Estonian branches of two foreign (Finnish and Danish) banks now account for about one third of the banking market. All the large banks operate as universal banks, covering a wide range of market segments, and thus have similar lending portfolios with a high share of real estate. Beyond the "big four", a few smaller banks operate in the market. While the Estonian authorities consider them relatively well capitalised and not systemically important, it is unclear how far they are affected by the crisis.

One of the government's key objectives is the adoption of the Euro as soon as possible, as the preferred exit strategy from the current currency board arrangement. In order to comply with the EU's budget deficit criteria, the government is trying to push through large expenditure cuts. Private sector wage agreements are also being renegotiated on a broad scale in order to restore external competitiveness. Developments in neighbouring Latvia are complicating the task of improving investor perception.

Estonia is undertaking legislative reforms to liberalise the cross-border provision of financial services, as requested by the OECD Investment Committee. The full liberalisation of the cross-border provision of financial services will likely pose challenges for supervisors, particularly when it comes to areas such as deposit insurance, and will require, as a minimum, close cooperation with the home country supervisors of cross-border service providers.

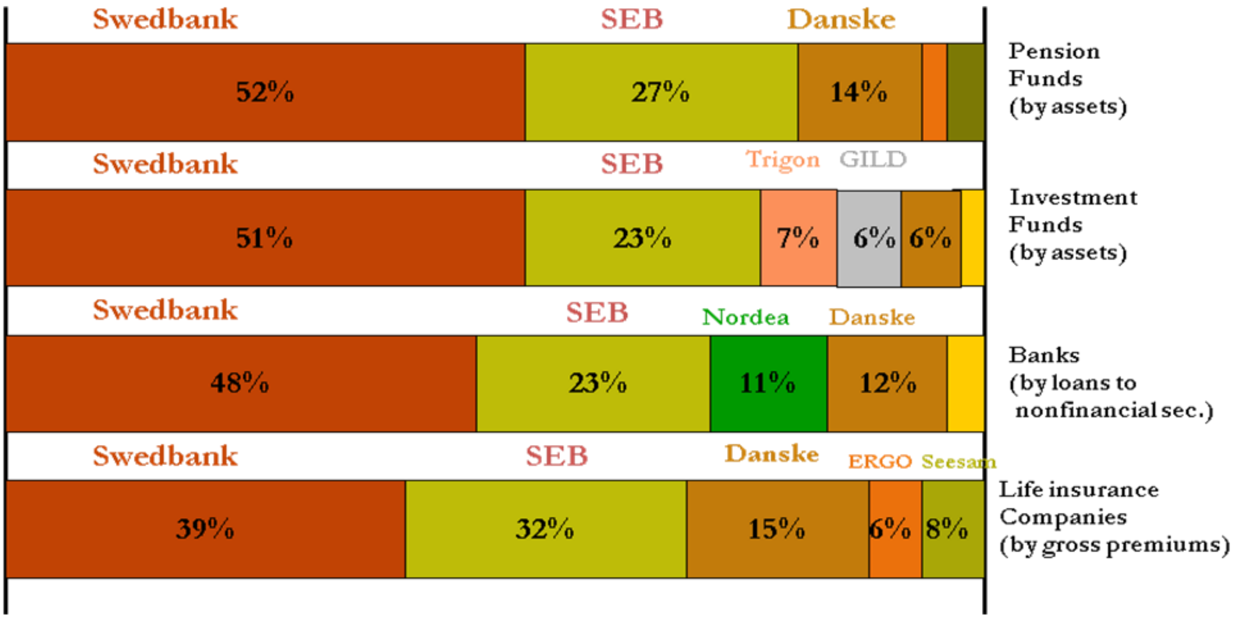
[1] Bank of Estonia, Financial Stability Review 1/2009, Tallinn, July 2009

II. ESTONIA'S FINANCIAL SYSTEM IN A LONG-TERM PERSPECTIVE

While Estonia's financial system has developed rapidly since restoration of the country's independence at the beginning of the 1990s, the financial system is still young. The privatisation of state property, including banks, in Estonia started in 1992. Important milestones for the financial sector included the establishment, in 1991, of the Estonian Financial Supervisory Authority (EFSA), which since 2002 operates as a joint supervisor of banking, insurance and securities markets, the first Securities Market Act passed in 1993, and the founding, in 1994, of the Estonian Central Securities Depository (CSD). Another important development was the reform of the pensions system in 2002.

Estonia started out, at the beginning of the 1990s, with as many as 42 banks. In the following years, the number of banks decreased mostly due to mergers and takeovers. After being hit by the Russian crisis in 1998, some of the remaining banks faced difficulties and were forced to close or merge with other banks. After further consolidation, only five or six banks remained in Estonia. Over time, these were then taken over by foreign banks, mainly from Sweden, Finland and Denmark. These banks, some of which have been converted to branches, now dominate most of Estonia's financial sector, including also asset management and insurance (see Figure 3).

Figure 3: Estonia – Market Share of the largest players in the financial system (end-2008)

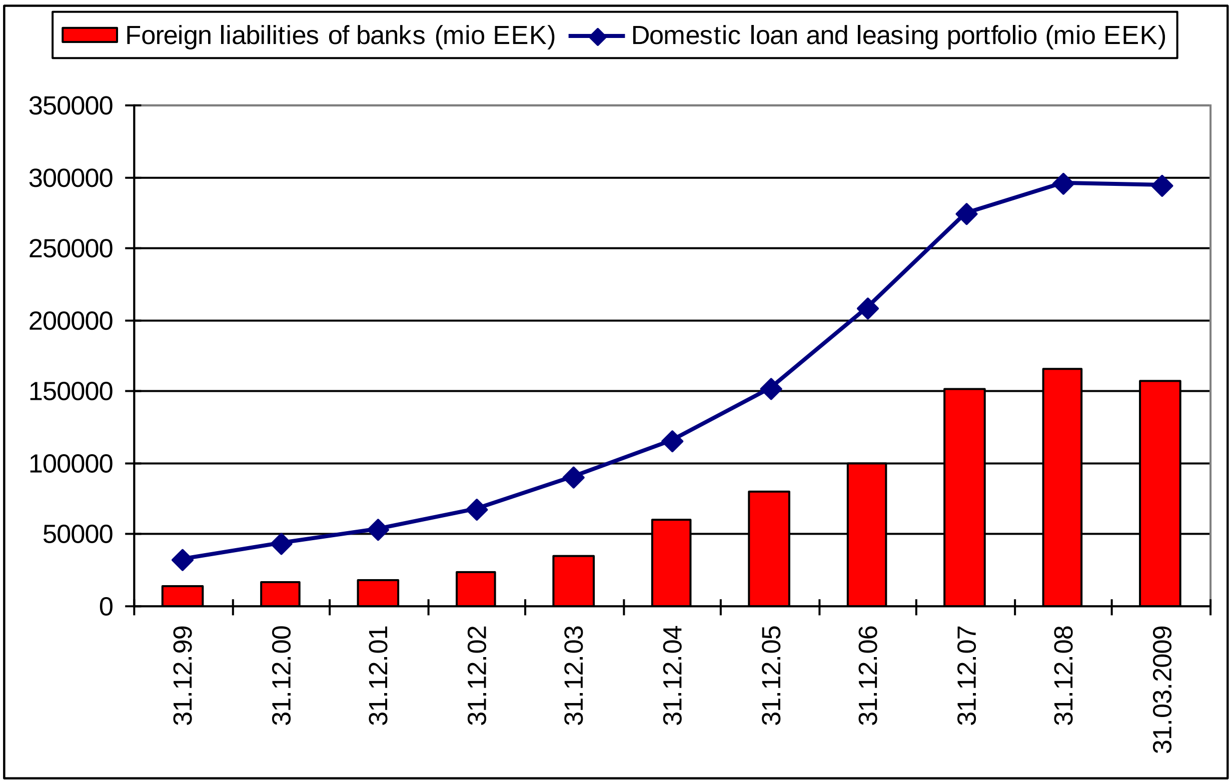


Source: Ministry of Finance

As households had practically no savings at beginning of the period of restored independence, financial deepening has largely been based upon foreign savings. As can be seen from Figure 4, growth of the domestic loan and leasing portfolio, which accelerated strongly in 2004/2005, was largely financed by parallel increases in banks' foreign liabilities. These liabilities are for the most part liabilities of banking subsidiaries to their foreign (Swedish) parents. Loan growth finally tapered off starting in 2007, and has (on aggregate) remained stagnant since late 2008.

The rapid growth of the banks' loan portfolios reflected strong interest from borrowers in real estate financing, which was not surprising considering the state of the country's housing stock during Soviet times. The banks were happy to lend amid favourable refinancing conditions in international markets. As real estate prices started to surge, more and more people jumped on the bandwagon and took out mortgage loans, mostly in Euros. Real estate development boomed, and investment became heavily skewed toward the real estate sector.

Figure 4: Estonia – Financing of domestic lending (1999-2009)



Source: Bank of Estonia

The focus on real estate, together with the universal banking system (and later the decline in stock prices), has likely contributed to the relatively low importance of non-bank financial intermediation. Whereas bank and lease financing has reached over 140 percent of GDP, the stock market currently accounts for less than 10 percent of GDP (although reaching over 30 percent at the height of the boom). Other contributing factors are the still relatively low level of accumulated savings, lack of domestic investment alternatives, and, possibly, negative experiences related to the stock market crash.

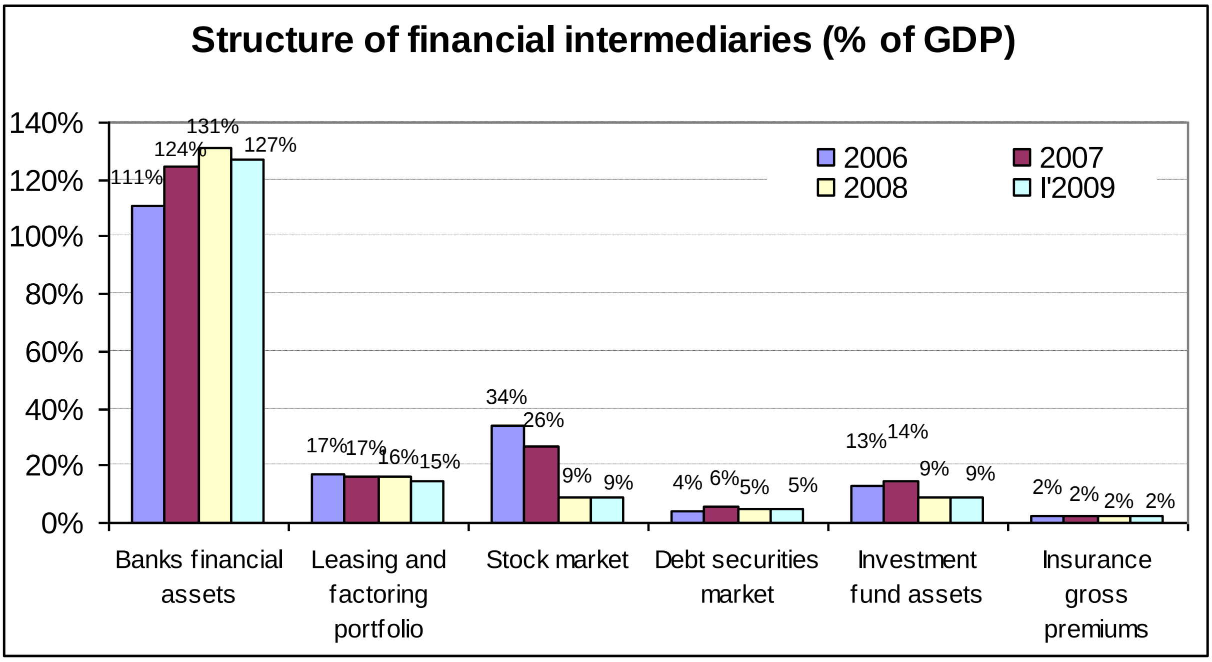
Debt securities (5 percent of GDP) and investment fund assets (9 percent of GDP) do not play a large role in the Estonian financial sector, mainly for the reasons mentioned above. Relative to the stock market, and of course real estate investments, fixed-income investments were regarded, among mostly younger-age investors, as less attractive alternatives. In the case of debt securities, domestic supply has also been rather limited. It remains to be seen whether this situation will change in the aftermath of the crisis.

Table 2: Estonia – Financial System Participants (2002-2009)

	2002	2003	2004	2005	2006	2007	2008	Jun-09
Credit institutions	7	7	9	13	15	15	17	18
incl. foreign branches	1	1	3	6	8	9	11	11
Management companies	7	7	7	7	9	11	14	16
Investment funds	17	15	15	22	22	25	45	47
Pension funds	19	21	22	20	22	22	31	31
Investment firms	6	5	5	6	7	8	8	7
incl. foreign branches	-	-	-	-	1	1	1	1
Insurance companies	13	13	13	15	19	19	19	19
incl. foreign branches	-	-	-	3	5	5	6	6
SE	-	-	-	-	1	1	1	1
Stock exchange issuers	14	18	18	25	21	24	23	23

Source: Ministry of Finance

Figure 5: Estonia – Financial System Assets (2006-2009



Source: Bank of Estonia

III. FINANCIAL INFRASTRUCTURE

A. Central Bank and Monetary Policy Framework

Estonia's central bank, the Bank of Estonia (Eesti Pank), forms part of the European System of Central Banks (ESCB). Information on the ESCB can be found at *www.ecb.europa.eu*. Since June 2004, the Estonian kroon (EEK) participates in the exchange rate mechanism ERM II.

Eesti Pank is legally, operationally and financially independent. It operates pursuant to the Constitution of the Republic of Estonia, the Constitution of the Republic of Estonia Amendment Act, the Treaty establishing the European Community, the statute of the European System of Central Banks and of the European Central Bank, legislation of the European Central Bank, Eesti Pank Act, other Acts and its statute.

Eesti Pank is prohibited from granting loans to any institutions or agencies of the European Union, the governments and local or other public authorities of Estonia and the Member States of the European Union, other legal persons in public law or companies with the participation of the state or local government.

The highest body of Eesti Pank is the Supervisory Board, which consists of a Chairman and seven members. The Chairman of the Supervisory Board of Eesti Pank, like the other members of the board, is appointed to office for a term of five years by Parliament (Riigikogu) on the proposal of the President of the Republic. The members of the Supervisory Board of Eesti Pank are appointed by the Riigikogu on the proposal of the Chairman of the Supervisory Board of Eesti Pank.

The Chairman and the Members of the Supervisory Board of Eesti Pank must be Estonian citizens and have a university degree. Members of the Government of the Republic and employees of Eesti Pank shall not be members of the Supervisory Board of Eesti Pank. They also shall not be an employee of any management institution, investment fund, investment company, credit institution, insurance company or other subject of financial supervision, nor be a member of the decision-making body of any such institution.

The Executive Board, chaired by the Governor, manages the central bank's work on monetary policy. The other members of the Executive Board of Eesti Pank are the Deputy Governors of Eesti Pank. The Governor of Eesti Pank is appointed to office for a term of seven years by the President of the Republic on the proposal of the Supervisory Board of Eesti Pank. The Governor of Eesti Pank shall not be appointed to office for more than one consecutive term.

Estonia has applied a currency board arrangement since 1992. In order to maintain the fixed rate of the Estonian kroon, the central bank's liabilities, including the monetary base in the economy, must be fully guaranteed by gold or foreign exchange reserves. According to the Law on the Security of the Estonian kroon, Eesti Pank has no right to devalue the exchange rate of the kroon.

The monetary policy framework has essentially remained unchanged since 1992. Under the currency board arrangement, the efficiency of the monetary policy instruments is rather limited. As the exchange rate is fixed, the economy cannot be balanced by exchange rate changes. Therefore, economic growth has to adjust on the side of the non-financial sector with fiscal policy being the main economic policy instrument at the disposal of the government.

The main instruments of monetary policy are the forex window and the reserve requirement for banks. The forex window, i.e. the standing facility of buying and selling foreign currency provided to credit institutions, is the main instrument. There is no exchange rate spread of EEK-EUR purchase and sale transactions between credit institutions and Eesti Pank. There is not much of a local interbank market in Estonia, as the banks refinance themselves almost exclusively through their head offices abroad. The interbank market, which accounts for only about 1% of refinancing activity, is mainly used in the context of foreign exchange transactions.

The reserve requirement obliges credit institutions to keep a part of their assets as buffers in the central bank or in high-quality foreign assets. Under the currency board framework, the reserve requirement ratio is considerably higher in Estonia (currently 15% of the required reserve calculation base) compared to countries employing other exchange rate systems.

The monetary policy transition mechanisms of euro area countries are already largely operational in Estonia, as the Estonian economy has adjusted to these mechanisms during the past years under the conditions of the currency board. The authorities stress that final harmonisation of the monetary policy framework with that of the euro area will not require a long-term gradual adjustment period. The authorities aim to adopt the euro as soon as all the necessary requirements are fulfilled. In recent years, a high inflation rate was the main obstacle to meeting the Maastricht criteria.

B. Payments System[2]

Over the past decade the Estonian payment system has evolved from the cash-oriented system it once was. Following a phase of active use of paper-based payment instruments, Estonia is now moving towards a more automated electronic payment system. Conventional paper-based payment orders are increasingly giving way to internet banking and card payments. In 2000, the major banks developed two new electronic product groups: an e-money-type payment instrument called “Mobile Account”, and internet-based WAP banking. However, these new payment instruments are not yet widely used. In order to offer companies more flexible payment services, the commercial banks have started to introduce internet-based telebanking products. The first internet-based telebanking product was adopted at the end of 2001.

In the first half of 2008, about 70 percent of all interbank payments were made by two major banks. In 2008, around 10 percent of payments by volume (and 30 percent of payments by value) were made through Eesti Pank’s interbank payment system. The current interbank payment and settlement system, which is owned and operated by Eesti Pank, consists of three systems: ESTA, EP RTGS and TARGET2-Eesti. Domestic payments are settled through the Settlement System of Ordinary Payments (ESTA) and the Real-Time Gross Settlement System (EP RTGS) for settling express transfers. Cross-border express transfers initiated in euro are settled through the Trans-European Automated Real-time Gross Settlement Express Transfer System (TARGET2-Eesti).

ESTA operates on a fixed time schedule and is used for settling ordinary credit-type payments between system participants. Payments are forwarded to the system in batches of payment orders. ESTA uses collateral deposited by each participant of the system to settle payments. EP RTGS is

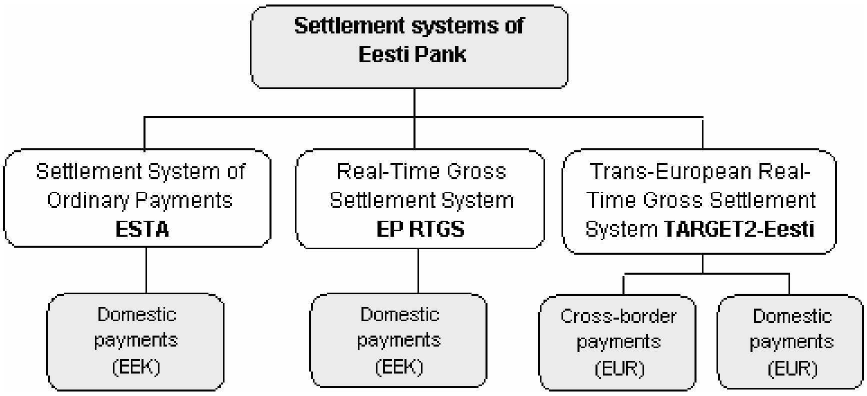
[2] More details on Estonia’s payment and securities settlement systems can be found in the Estonia Section of the European Central Bank’s “Blue Book”, available at *http://www.ecb.int/pub/pdf/other/ecbbluebooknea200708en.pdf*.

based on real-time gross settlements whereby all payments are processed one-by-one and it is intended for processing urgent credit-type payments between the system participants. EP RTGS settles domestic payments in the Estonian kroon between system participants.

TARGET2-Eesti settles trans-European payments initiated in euro in real time; i.e. the system enables the settlement of both cross-border and domestic euro payments. In TARGET2, payments are processed one-by-one and the system is intended for settling urgent payments.

Besides the settlement systems managed by Eesti Pank and the securities settlement system managed by the Estonian CSD, a card payment system managed by Pankade Kaardikeskus (card centre of banks) also operates in Estonia. The IMF, as a result of the 2000 FSAP, recommended that the private card payment organisation be subject to oversight. The Estonian authorities are considering various options for doing this, in the context of EU-wide discussions on the supervision of private card payments systems.

Figure 6: Estonia – Structure of the settlement systems managed by Eesti Pank.



Eesti Pank fully owns, manages, and operates the interbank payment systems operating in Estonia. Payment systems operated by Eesti Pank have a clear governance structure, with the Executive Board of Eesti Pank having ultimate responsibility for the management of the system. The governance arrangements of Eesti Pank, as the owner, operator, and overseer of the system, are laid down in Eesti Pank Act, the Statute of Eesti Pank, and legislation issued on the basis thereof. There is a separation of operational and oversight roles of different departments of the central bank, i.e. the Clearing and Settlement Department is responsible for the running and management of payment systems of Eesti Pank, while the oversight function is carried out by the Financial Stability Department.

The Monetary Policy Committee makes decisions regarding policy, regulation, operation and governance related to payment systems operated by Eesti Pank. Decisions of the Monetary Policy Committee are based on the overviews of the Clearing and Settlement Department (quarterly) and of the Financial Stability Department. The decisions of Eesti Pank and summaries of regular overviews and assessments on payment and settlement systems are disclosed on the website of Eesti Pank as well as in the publications.

In order to ensure adequate preparation for changes made to the system, prior to making final decisions, Eesti Pank seeks comments and/or suggestions from the participants through the Council of Payment System Experts. This high-level committee is led by a Deputy Governor of Eesti Pank and composed entirely of representatives of system participants, including credit institutions and net settlement system operators.

IV. STRUCTURE AND OPERATION OF THE FINANCIAL SYSTEM: BANKING SYSTEM

Estonia's domestic financial system is dominated by commercial banks, and the banking sector is fully privately owned. The majority of the banking sector is foreign owned. Market concentration is high, with the four largest banks (Swedbank, SEB, Sampo, and Nordea, all foreign owned) accounting for over 90 percent of the market in terms of total assets. Between 2002 and 2007, financial deepening progressed rapidly, with domestic banks relying increasingly on foreign funds to finance lending. Domestic bank credit (excluding loans to other financial institutions) has been the main source of domestic financing, and amounted to 100 percent of GDP at the end of 2007. About 80 percent of loans are denominated in foreign currency, mostly euros, which carry interest rates lower than those denominated in Estonian kroons.

Table 3: Estonia - Market share of banks (end-2008)

	Market share	Total assets (EUR mio)
Swedbank (Sweden, subsidiary)	49.0%	10 681
SEB Pank (Sweden, subsidiary)	21.1%	4 616
Sampo Pank (Danske Bank, branch)	11.9%	2 592
Nordea Pank (Finland, branch)	11.2%	2 446
Eesti Krediidipank (Latvia, subsidiary)	1.6%	348
DnB Nord (Denmark/Norway, branch)	1.2%	264
Tallinna Äripank	1.0%	210
UniCredit (Italy, branch)	0.8%	175
Parex Pank (Latvia, branch)	0.5%	117
Non members of EBA	1.7%	379
Total	*100.0%*	*21 828*

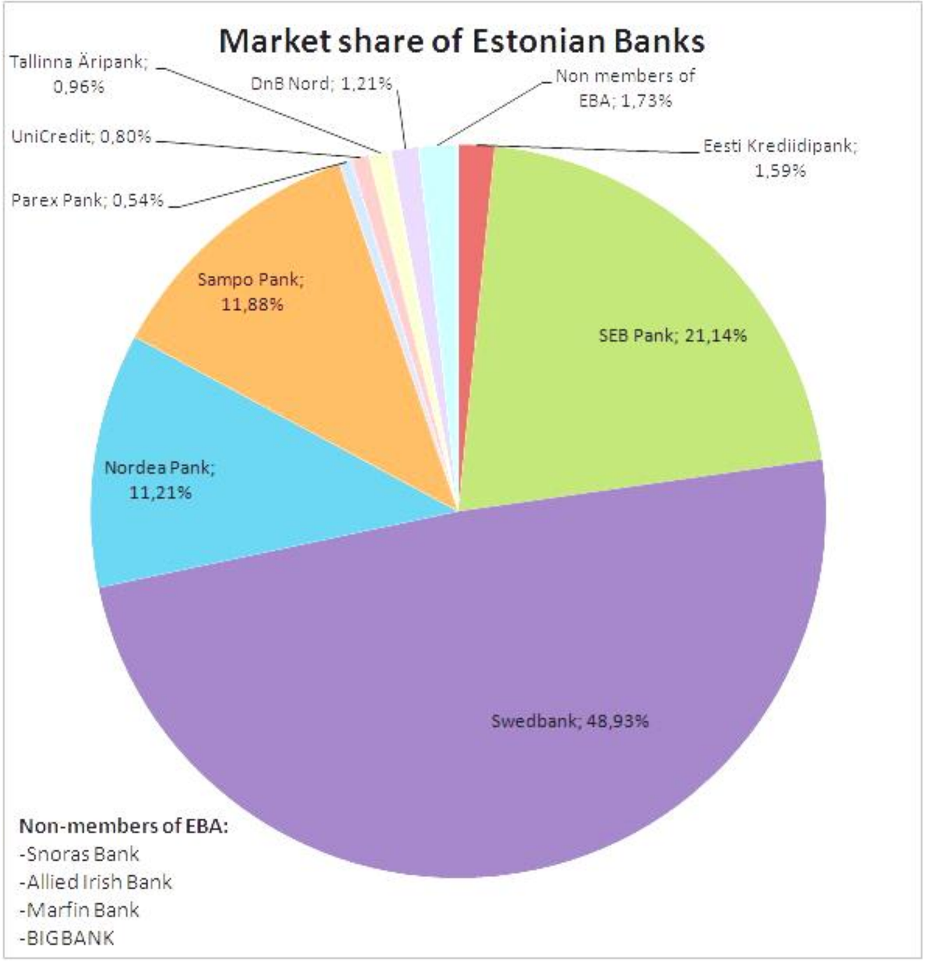
Source: Estonian Banking Association (EBA)

As of 31 December 2008, there were six locally authorised credit institutions and ten branches of foreign credit institutions operating in Estonia. In 2008, two new market participants were registered: the Estonian branches of AB Bankas Snoras and Allied Irish Bank. LHV Bank was granted a license in 2009. The two large Swedish financial groups Swedbank and SEB own the two largest banks in Estonia (previously named Hansabank and Eesti Ühispank, respectively). Danske Bank converted the Estonian operations of its Sampo Pank to a branch, and Nordea is also operating in the form of a branch. By the end of 2008, the combined market share of foreign-owned banks had increased to over 97% of total banking sector assets.

Estonia is one of the few countries where branches of foreign banks play an important role in retail banking. All the large banks operate as universal banks, covering a wide range of market segments, and thus have similar lending portfolios with an important share of real estate. The Estonian branches of Nordea and Danske banks now account for about one third of the banking market. On the deposit side, these branches have, since the start of the crisis, been able to increase their market share, because some clients have considered them safer than the Estonian subsidiaries of Swedish banks.[3] On the lending side, it appears that these branches are also gaining market share, as the Baltic exposures of these banks account for a much smaller share of their portfolios than in the case of the Swedish banks (see Figure 8).

Beyond the “big four”, fourteen smaller banks operate in the market. These include three locally-owned banks: Tallinn Business Bank (Tallina Aripank), subprime lender BIG Bank[4], and newly established LHV Bank[5]. Eesti Krediidipank and Marfin Bank operate as subsidiaries of foreign banks from Latvia and Cyprus, respectively. Finally, seven smaller branches of foreign entities are authorised in Estonia, including DNB Nord (Denmark), Unicredit (Italy), Parex (Latvia), Snoras (Lithuania), Allied Irish (Ireland), Pohjola Bank (Finland), Handelsbanken (Sweden), Scania Finans (Sweden), and Siemens (Sweden/Germany).

Figure 7: Estonia - Market share of banks (end-2008)



Source: Estonian Banking Association (EBA)

[3] Prior to Estonia’s increase in the deposit insurance cap, the branches benefited from higher deposit insurance coverage in Denmark and Finland.

[4] BIG also offers services in the other Baltic countries, as well as, on a cross-border basis, in Finland.

[5] Local investment firm LHV, which was implicated in an insider trading scandal in the U.S. several years ago, received a bank license at the beginning of 2009.

A. Financial groups and conglomerates

The two large banks, Swedbank and SEB, form part of larger financial groups headquartered in Sweden. Both have fully-owned subsidiaries dealing with leasing, life insurance, asset management, and real estate. These subsidiaries dominate the Estonian life insurance and fund management (including pension fund) markets, although Danske group is also a significant player in these sectors. Branches of foreign banks, including the smaller ones, also mostly form part of larger banking groups. The larger banks have further established, or are considering establishing, asset management subsidiaries in order to hold bad real estate assets.[6]

B. Concentration of the banking system

Estonia's banking system is highly concentrated, with Swedbank and SEB accounting for 70 percent of banking sector assets. Swedbank alone accounts for almost half of banking sector assets. With Nordea and Danske (Sampo) together accounting for another quarter, the four largest banks control over 90 percent of banking sector assets. Through their ownership of insurance, brokerage, and pension management companies, the same institutions also dominate the rest of the financial sector. Most of these products are in fact marketed through bank branches.

The authorities have not signalled any wider problems relating to competition in the banking sector. It appears that recently, among tighter financing conditions in world markets, competition for deposits has been vigorous, as reflected in high deposit interest rates offered to clients, especially by some of the smaller banks. Whereas the ease of opening internet accounts would be expected to facilitate switching of accounts among banks, the domination of the wider financial sector by these same universal banks may discourage clients from shopping around, as customers find it easier to buy all their financial services from the same bank.[7]

C. Soundness of the banking system

Due to the dominance of foreign-owned banks, the soundness of Estonia's banking system is inextricably linked to the soundness of several Nordic banking groups. Estonia's banks are highly dependent upon foreign borrowing, mainly from their parent entities.[8] There are no signs, however, that these parent entities are hesitating to support their Estonian operations, and their home country authorities have also taken a supportive stance. The Swedish banks benefit, until at least the end of October 2009, from guarantees by the Swedish state, and both Swedbank and SEB participate in the program.[9]

In September 2008, a situation emerged where depositors, worried about the extent of parent support, caused a run on Swedbank, which suffered an outflow of about 15 percent of its Estonian deposits. Most of the funds withdrawn by depositors were reportedly deposited in the branch of one of the other foreign banks (Nordea). Liquidity problems were, however, averted through an expansion of

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[6] In practice, these subsidiaries participate in auctions in order to acquire the real estate from their "mother" bank.

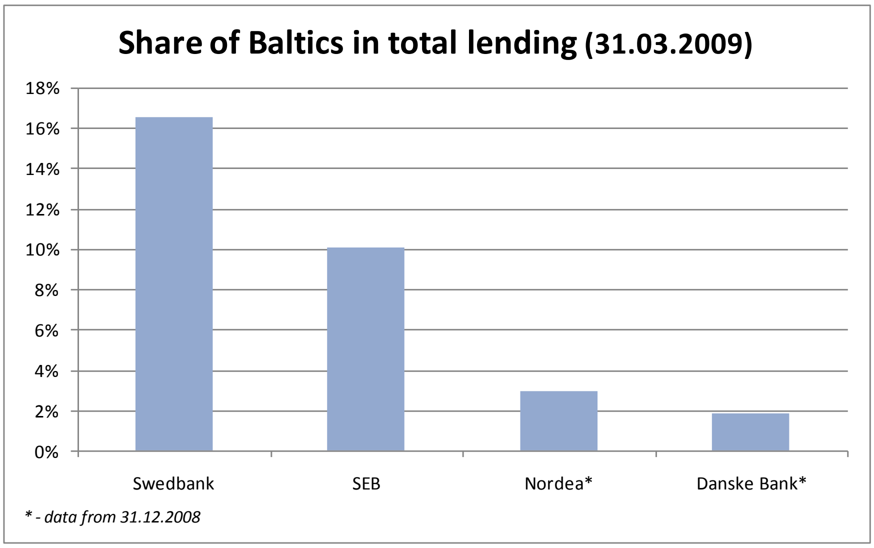
[7] Banks also typically have an incentive for "tying" different products under such systems.

[8] Estonia also requests banks to hold high liquidity reserves – 15 percent of the required reserve calculation base. Since nearly 50% of the liabilities are loans from parent banks, the immediately available liquidity reserve covers, according to the authorities, approximately 30% of bank customers' deposit volume.

[9] A complete overview of Sweden's bank support measures can be found on the website of the Swedish Debt Management Office at *https://www.riksgalden.se/templates/RGK_Templates/TwoColumnPage____17103.aspx*

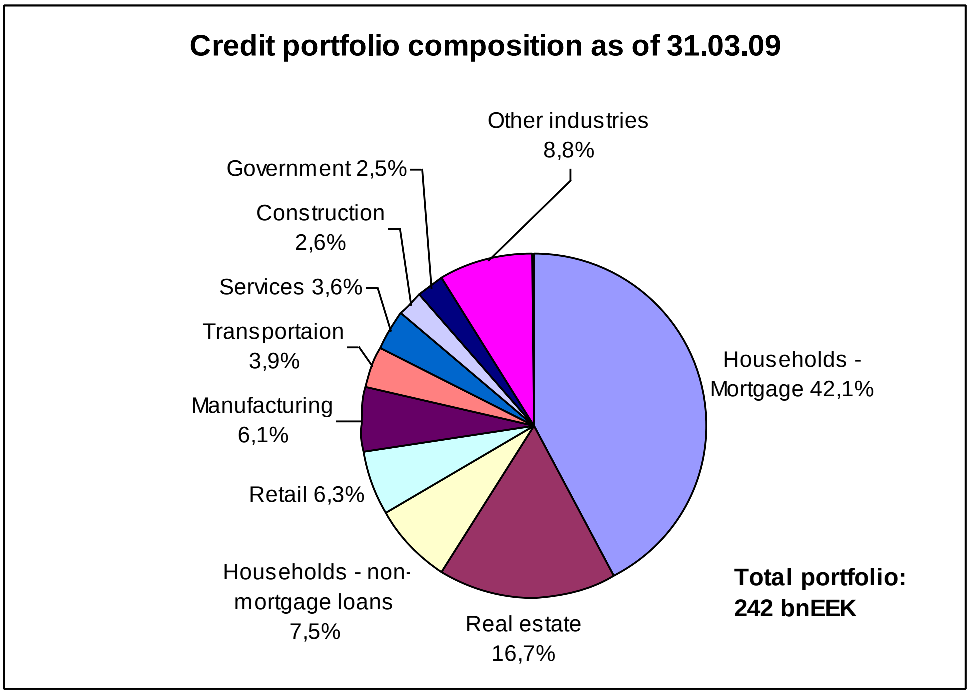
the list of eligible collateral by the Swedish central bank, which allowed Swedbank to continue to fund, inter alia, its Estonian subsidiary.[10]

Figure 8: Estonia – Baltic exposure of the four largest banks (end-March 2009)



Source: Bank of Estonia

Figure 9: Estonia – Banking System Credit Portfolio by Sector (end-March 2009)



Source: EFSA

[10] The Riksbank removed the 75 percent cap on the share of collateral that can be comprised of covered bonds, and lowered the minimum credit rating requirement for longer-term securities pledged as collateral.

Potential vulnerabilities of Estonia's banking system derive to a large degree from a real estate lending boom over the past few years. Over 60 percent of banks' credit portfolios (or about EUR 9.5 bio) in Estonia consist of real estate, construction, and mortgage loans (see Figure 9). So far, losses have arisen mainly from lending to real estate companies, and predominantly relating to residential real estate developments. Loss rates on individual mortgages have not yet increased to the same degree.[11] The mortgage situation is, however, expected to deteriorate toward the end of 2009 in the face of rapidly rising unemployment.[12] Overall, the BoE expects loan losses to grow further over the next few years.

As most mortgages are denominated in euros at variable rates, the repayment capacity of borrowers depends not only on their employment situation, and of course the evolution of real estate prices, but to a significant extent also on continued low interest rates and on the maintenance of the currency board.

The liquidation of real estate collateral is proving difficult, as reflected in the failure of several real estate auctions in which the large banks tried to offload collateral. EFSA estimates that if all current 60-day overdue loans end up in foreclosure, it could take four to five years to execute all foreclosure sales without causing a further market crash.[13] The large banks have established, or are in process of establishing, asset management companies, effectively "bad banks", to hold the real estate in question until it can be sold.

On a system-wide basis, non-performing loans, defined as loans overdue by more than 60 days, have risen to above 5 percent in April 2009. While the Estonian authorities consider such levels manageable, the BoE expects the non-performing loan ratio to reach 9 percent by the end of 2009. In the construction sector, the non-performing loan ratio is rapidly approaching 20 percent (Figures 10 and 11).

Estonia's banks have been operating on a relatively low cost base, as an estimated 95 percent of bank transactions are done electronically. Past profitability allowed them to keep high levels of retained earnings. While regulatory capital requirements are higher than the Basel minimum (10 percent rather than the 8 percent minimum), high ratios are partly supported by reduced risk weights (since 2008) for mortgage exposures[14], and by Swedbank's recent switchover to the internal ratings based approach under Basel II. Banks are also required, in the context of the currency board, to maintain high reserve levels.

The spread of banking problems from neighbouring Latvia has been limited, as Latvia-based Parex Bank only holds a very small share (0.5 percent) in the Estonian banking system, and, after getting into difficulties, was supported by the Latvian government and the EBRD. In the perception of investors, however, problems in one of the Baltic countries are often seen as a reason to reduce exposures to the whole Baltic region, due to geographical proximity, similar exchange arrangements (currency boards) and engagements of the same market participants.

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[11] One reason may be that Estonia's legal regime does not give buyers the option to "walk away" from their debts, if the mortgage exceeds the value of the house or apartment.

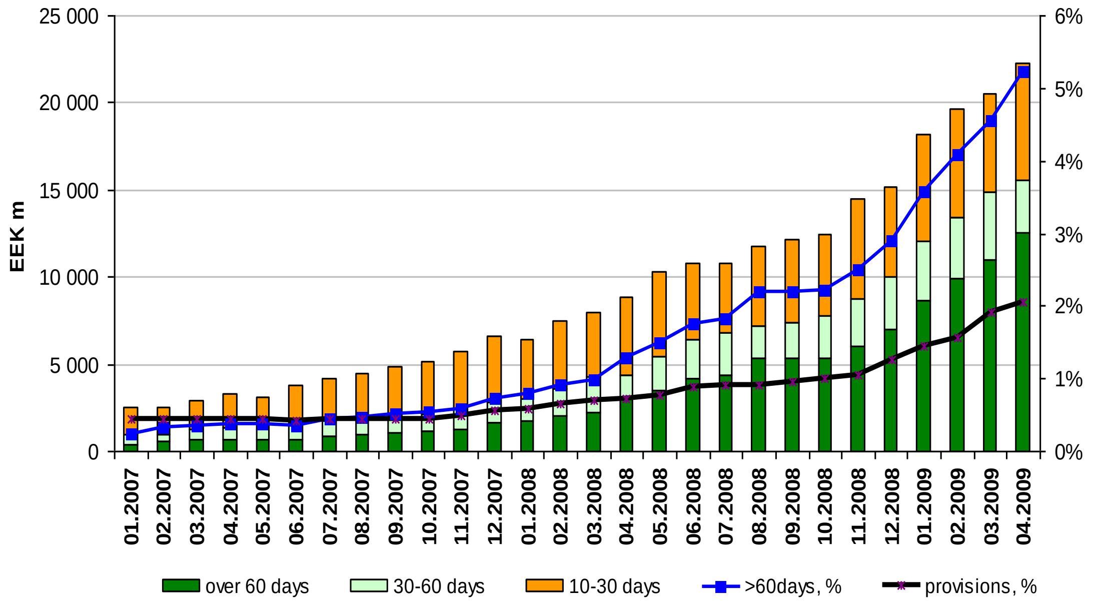
[12] According to Eurostat, the seasonally adjusted unemployment rate in Estonia rose to 15.6 percent in May 2009, up from 3.9 percent a year earlier.

[13] Some of the banks are more optimistic, estimating the liquidation period to be around two years.

[14] At 60 percent they remain, however, higher than the 35 percent currently required by EU Directives.

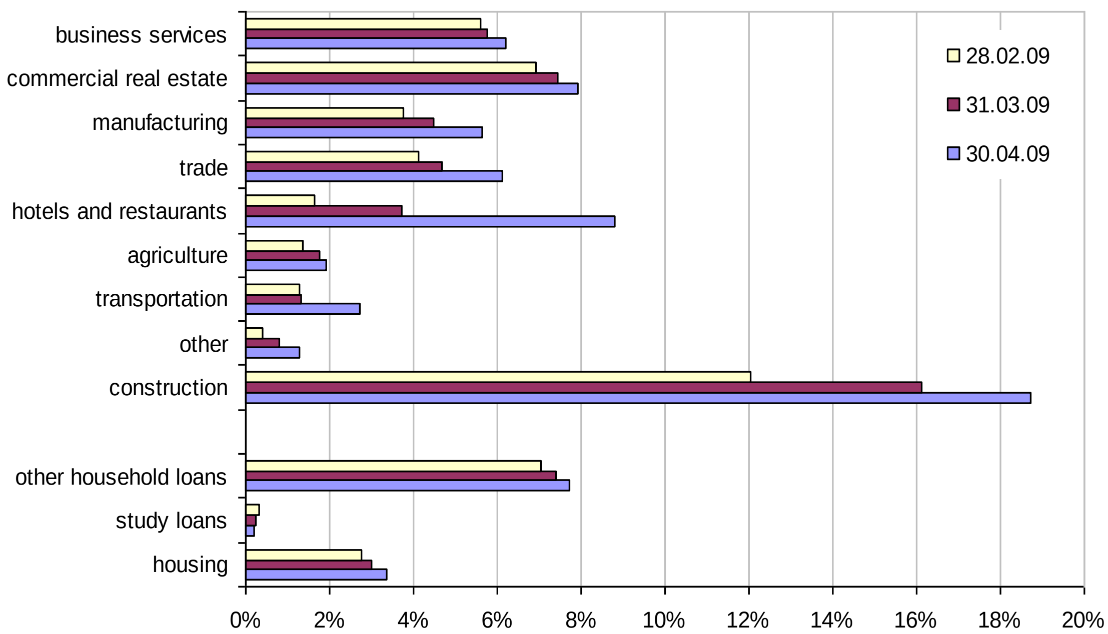
While the authorities do not consider the smaller banks systemically important, the extent to which they are affected by the crisis remains unclear, particularly in light of their involvement in the real estate market. BIG Bank, a bank specialised in sub-prime loans, reportedly had an overdue loan ratio of 43 percent in the first quarter of 2009. Other small banks also report being affected by the crisis.

Figure 10: Estonia – Non-performing loans (01/2007-04/2009)



Source: Bank of Estonia

Figure 11: Estonia – Loans due more than 60 days by sector (2009)



Source: Bank of Estonia

V. STRUCTURE AND OPERATION OF THE FINANCIAL SYSTEM: CAPITAL MARKETS

A. Capital Market Intermediaries

At the end of March 2009, the Tallinn Stock Exchange had 32 members. Swedbank was the most active member on the TSE in 2008, accounting for almost half of stock exchange turnover, and well over a third of transactions, followed by SEB with over one third of turnover. A number of smaller firms are also active in the investment advisory, portfolio management and securities brokerage markets, including local firms such as Gild, Trigon, and LHV, and several subsidiaries of foreign firms, including KIT Finance Europe, a subsidiary of a Russian investment bank, and Finnish-owned Evli Securities.

In 2008, eight investment firms were authorised and operating in Estonia, including one branch of a foreign investment firm[15]. The investment firms, most of which are active in the wider region as well, are suffering from strong declines in demand for their services, and some of them are engaged in major restructurings. Even the sector as a whole still appeared adequately capitalised in 2008, EFSA has expressed concerns about potential inadequacies of own funds in some firms, especially in light of expectations of a further downturn in demand for their services during 2009, notably related to investments in the Baltics, Russia, and Ukraine.

B. Fixed-Income Market

The development of the capital market and its infrastructure in the years following Estonia's restoration of independence has been affected by factors such as the government's conservative fiscal policy and borrowing, which has resulted in modest issuance of government bonds, the currency board system, where Eesti Pank does not conduct an active monetary policy and banks' liquidity management is carried out through international financial structures, and the relatively high cost of local resources compared to foreign funds, all of which have supported the bank-based financing of Estonia's economy.

Integration of financial markets and their infrastructures in the Nordic and Baltic countries, have favoured consolidation rather than the emergence of national markets. Debt instruments accounted for less than 5 percent of GDP by the end of March 2009. The secondary market is also shallow, as buy and hold investors snap up the few issues available. Average daily turnover of bonds has recently been EEK 14 million, and bond market capitalisation declined by about 20 percent since the autumn of 2008.

Government debt

The State Treasury Department in the Ministry of Finance is responsible for the issuance, management and surveillance of the Central Government Debt. Debt issuance procedures and choice of instruments is also the responsibility of the State Treasury Department.

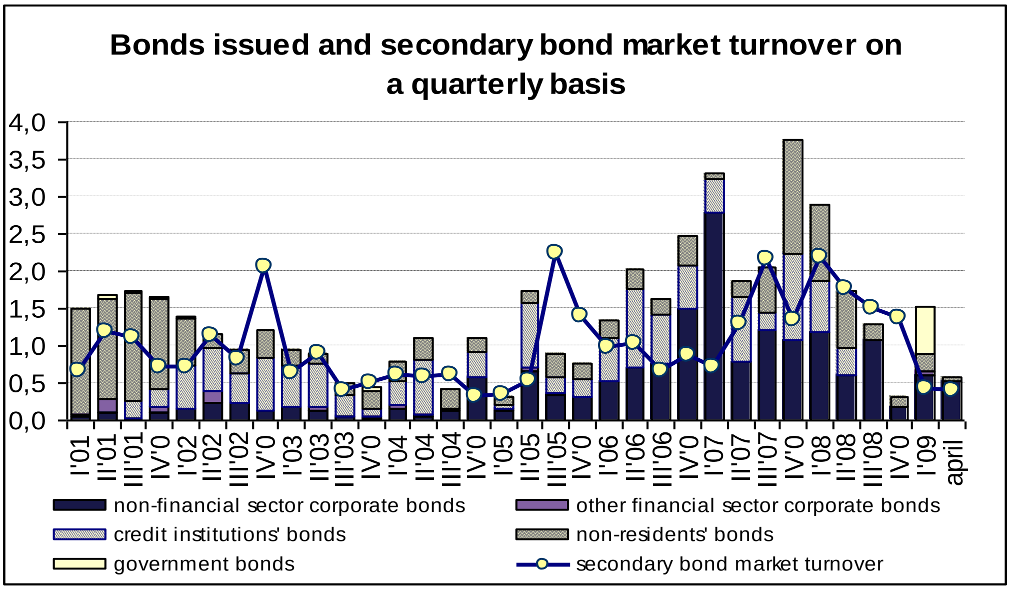
[15] The branch is the Estonian Branch on the Finnish investment firm Privanet Pankkiiriliike Privanet.

At the end of the 1990s and at the beginning of 2000 there had been a few local government issues, but after an issue at the end of 2003, the public sector in Estonia did not issue any bonds for five years. By 2008, the public sector did not have any domestic bonds outstanding. More recently, however, local government have issued several bonds, including an EEK 491 million issue by the City of Tallinn (priced at 3 month Euribor plus 3 percent) at the beginning of 2009.

Corporate bonds

There is not much of a corporate bond market in Estonia, which is not surprising considering (1) the small number of large corporations, (2) easy availability of bank credit over the last few years, and (3) the absence of a government bond market that could serve as a benchmark. Four corporate bonds are listed on the stock exchange, but the market is not active. Reportedly, these bonds were bought by local pension funds. Some real estate projects were financed through (privately-placed) bonds.

Figure 12: Estonia – Bond Market (2001-2009)



Source: Bank of Estonia

Rating agencies

In Estonia credit rating agencies are not yet subject to special regulations, but this will change in the future when the EU Directive in this field is implemented.

C. Equity Market

Tallinn Stock Exchange (TSE)

The Tallinn Stock Exchange is the only regulated securities market in Estonia. The TSE was founded as a private company in April 1995 by Eesti Pank, the Ministry of Finance and 21 other financial organisations, and became operational in June 1996. Since its launch the TSE has been an electronic market in which a combination of the electronic dealer market and the order book market is used. Since a restructuring of ownership in the second half of 2000, the TSE has been the parent company of the ECSD. In April 2001 the Finnish HEX Group acquired a majority ownership of the TSE and the TSE was incorporated into the HEX Group under the name HEX Tallinn.

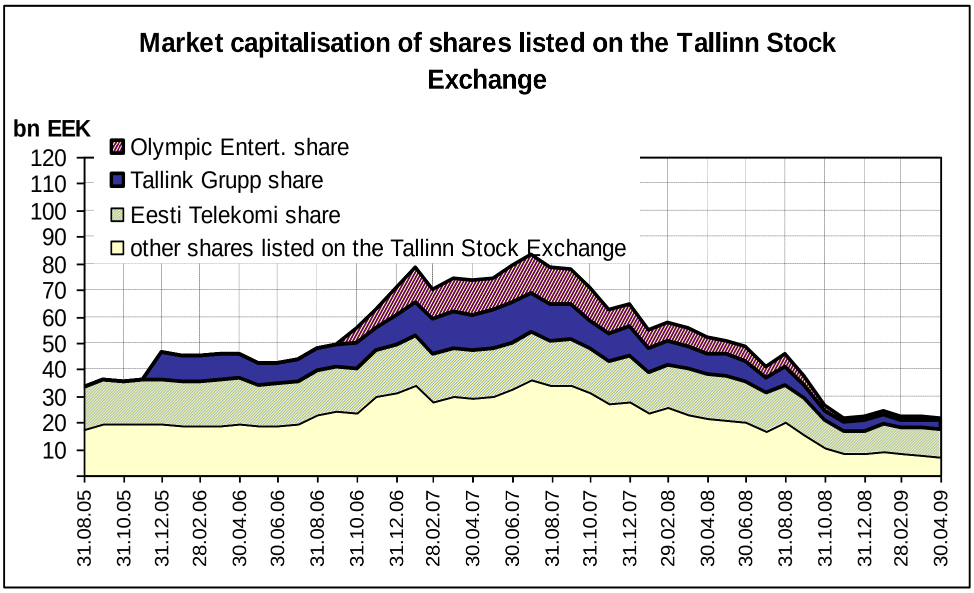
As a consequence of the merger of the Swedish OM and the Finnish HEX in 2003, the TSE is a part of the owner and the operator of the Nordic-Baltic market-place, OMX Exchanges. In 2004 the TSE became a member of the alliance between the Nordic and Baltic stock exchanges, NOREX, and adopted a common trading environment, SAXESS, which is also used by the other NOREX members. Securities can be traded via the SAXESS trading system as TSE trades or directly between buyer and seller as OTC trades.

In February 2008, the Baltic and Nordic stock exchange group OMX AB, the majority shareholder of the Tallinn Stock Exchange, merged with NASDAQ Stock Market, Inc. Hence, the strategic owner of the TSE and the ECSD is NASDAQ OMX Group, which has a 61.58% ownership share in the TSE. The rest of the TSE is owned by Swedbank (13.16%), SEB Bank (12.11%), Gild Bankers (6.97%), Cresco Väärtpaberid (3.16%), Evli Securities (1.32%), Bank of Estonia (1.05%), and Eesti Krediidipank (0.65%).

While the authorities see long-term benefits in providing local operators improved access to world markets, they also consider it important to maintain a regional capital market infrastructure and stock exchange that may play an important role in financing Estonia's small and medium sized companies and in providing an alternative to bank-based financing.

The OMX Tallinn index declined 63 percent in 2008, and has recovered only slightly since then. The market value of the shares listed on the TSE was EUR 1.4 billion at the end of 2008, down from 4.1 billion at the end of 2007. TSE turnover was EUR 618 million during the year 2008, and liquidity on the TSE has recently reached a historic low. At the end of March 2009, the shares of 18 companies were listed on the TSE, all of which also form part of the main Baltic stock index, the Baltic Main List. By far the largest stock on the TSE is Eesti Telekom, and much of the rest in terms of market capitalisation is accounted for by Tallink Group and Olympic Entert. (see Figure 13 below).

Figure 13 Estonia -- Stock market developments (2005-2009)



Source: Bank of Estonia

Clearing and settlement of trades executed at the TSE

In Estonia there is one securities settlement system, the Estonian Central Securities Depository (ECSD), which settles stock exchange and OTC trades. The ECSD was founded as a private company in March 1994 on the initiative of certain commercial banks, along with the Ministry of Finance and Eesti Pank. The main tasks of the ECSD are: to operate the securities depository and settlement system for publicly and privately issued securities that are registered in the Estonian Central Register of Securities (the ECR), and to maintain the government mandated register of securities.

Whereas trading on the TSE, has already been conducted in EUR for several years now (since before Estonia's accession to the EU), settlement still takes place in EEK. The TSE is, however, planning to move to settlement in EUR as soon as possible, and once it receives the necessary regulatory clearance. The TSE further plans to join TARGET2 during 2009, and to sign a Memorandum of Understanding with Target 2 Securities.

Plans are to further harmonise the Baltic clearing and settlement systems. A bilateral clearing and settlement link solution between the Estonian, Latvian, and Lithuanian CSD exists since May 2005, covering Baltic stock exchanges transactions and over-the-counter (OTC) delivery versus payment transactions. It is thus possible to open a securities account in one of the Baltic CSDs (via a local account operator/account manager) and to settle all Baltic securities transactions to that account. The cut-off and affirmation times for Baltic stock exchange transactions are the same. Trades are settled according to the "Issuer Model", i.e. settlement takes place in the securities' domicile CSD and in original currency (EEK, LVL or LTL).

The TSE also operates, since July 2007, a unilateral link (only Estonian securities) with the Polish CSD (KDPW), for currently two link-eligible securities. Another unilateral link, covering all TSE listed Estonian securities, exists, since April 2003, with the Finnish CSD (APK).

Central securities depository (CSD)

According to the Estonian Central Register of Securities Act, all government and private sector bonds, shares, units of investment funds traded on a regulated securities market, units of pension funds, and subscription rights for shares and for securities subject to entry in the register that are publicly issued or publicly tendered must be registered in the register of the ECSD. In addition, the ECSD executes clearing and settlement for securities transactions concluded on the Tallinn Stock Exchange (TSE) and OTC market, as well as providing market information services.

The registering requirement helped to introduce transparency into enterprise structures, and legally secured ownership of joint stock companies. The introduction of a central and neutral body of shareholder lists was designed to improve the business environment, and it appears that in addition to the public companies, more and more private limited companies have also found it useful to register with the CSD in order to maintain a list of their owners.

Equity Ownership and Corporate Governance

Corporate governance and state-owned enterprise issues in Estonia, including in the financial sector, are covered more comprehensively in the report of the OECD Steering Group on Corporate Governance.[16]

[16] DAF/CA/CG/ACS(2009)3

Venture Capital

The venture capital market in Estonia is small, although some investments have taken place in the information technology sector.

Exchange-Traded Derivatives

Whereas the large banks trade in derivatives among themselves in the OTC market, derivatives are not traded on exchanges in Estonia. Some of the mutual funds marketed by the large banks come with embedded derivatives, mainly in the context of capital-guaranteed structures. While listed on the stock exchange, they are not actively traded, but sold directly by the banks to customers.

Recent reform measures

Recent reform measures related to the implementation of major EU Directives such as the Market for Financial Instruments Directive (MiFID). Further revisions to many of the Directives are forthcoming as a result of the crisis, and will require transposition into Estonian law. The Estonian authorities are also planning legal changes to facilitate the cross-border provision of financial services, as requested by the OECD Investment Committee.[17]

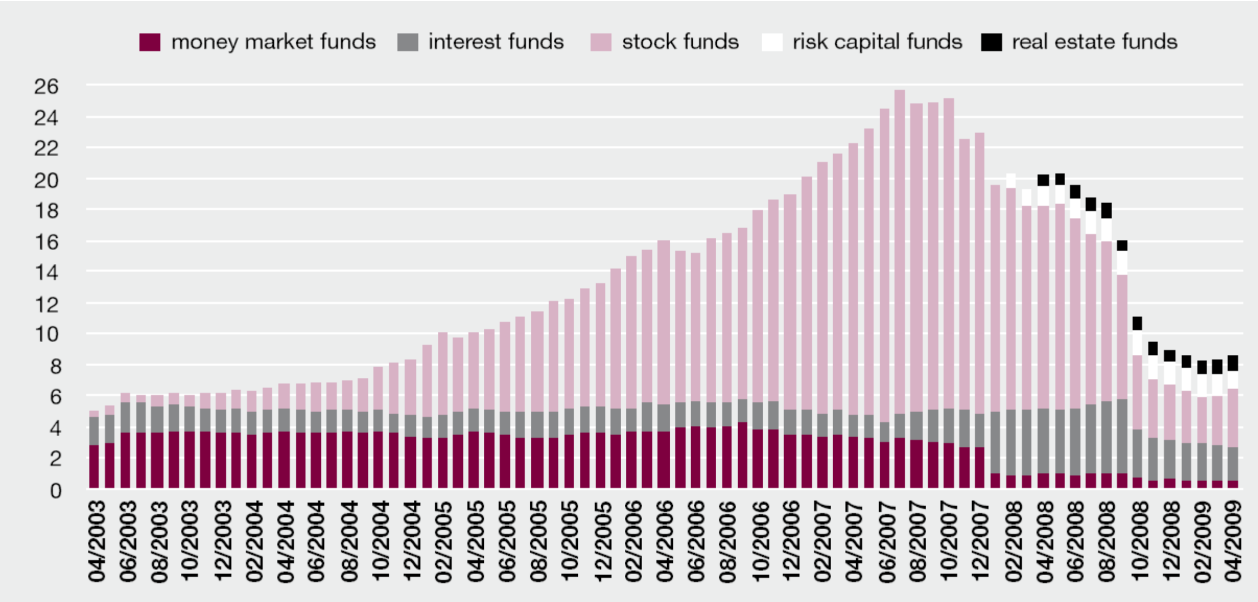
Collective investment schemes

As of 31 December 2008, 14 locally authorised fund management companies were operating in Estonia. The Estonian retail market for investment funds is mainly served by the large banks, who are selling their international in-house funds to their banking clients. These funds are centrally managed and registered in the bank's home country or in Luxembourg. Swedbank accounted for over 50 percent of the market in 2008, and SEB held over 20 percent. Concentration is high, with the three largest fund managers holding a combined market share of well over 80 percent.

The funds marketed by local management companies are largely targeted toward private banking clients, institutional investors such as pension funds, and foreign investors seeking exposure to emerging markets in Eastern Europe and Russia. It is not required that these funds be UCITS, although some of them are registered as UCITS to improve their marketability.

[17] See Chapter VII.B. below.

Figure 14 Estonia – Investment Fund Assets (2003-2009)



Source: Bank of Estonia

Not surprisingly, during the time of the real estate boom, several real estate funds were launched. These funds were reportedly bought by institutional investors, including pension funds. A highly leveraged private equity fund has been closed after finding it difficult to value its investment.[18] It is unclear whether the losses incurred by investors in real estate or private equity funds have in all cases been recognised in their accounts.

The money market fund sector has also suffered, as according to the BoE money market and interest funds lost about half their assets since the fourth quarter of 2008. One bank (SEB) was fined by EFSA for disclosing incorrect and incomplete information, and has had to compensate clients for Lehman-related losses incurred by its money market fund.

[18] The AS Guild Arbitrage Fund, which has not disclosed a net asset value since September 2008, suspended redemptions until November 2009.

VI. FINANCIAL SUPERVISION AND REGULATION

A. Supervision of Markets and Intermediaries

The framework for safeguarding financial stability mainly involves three institutions – the Ministry of Finance, Eesti Pank (the central bank) and the Financial Supervision Authority (EFSA).

The obligations of the **Ministry of Finance** with respect to safeguarding financial stability mainly concern financial policy making and providing legal background for the financial market. This includes the preparation of the positions and the legal acts for the government and coordination of state institutions activities and arrangements in conjunction with financial supervision, institutional development of the financial markets, accounting standards, auditing, pension reform, grants and supervision of state aid. In the context of a restructuring in 2008, the Ministry of Finance streamlined its hierarchy, by rolling divisions into departments, and let go about 60 (mainly administrative) staff.

Eesti Pank operates pursuant to the Constitution of the Republic of Estonia[19], the Constitution of the Republic of Estonia Amendment Act, the Treaty establishing the European Community, the statute of the European System of Central Banks and of the European Central Bank, legislation of the European Central Bank, and the Eesti Pank Act[20], its statute. The primary goal of Eesti Pank is to safeguard price stability. This task can be fulfilled only if the financial intermediation system operates smoothly. The BoE thus oversees the operation of the financial intermediation system; i.e., financial stability. This encompasses: assessing threats to the operation of the financial intermediation system; and monitoring and developing the legal framework of the banking sector, which mainly consist of Decrees of the President of Eesti Pank.

The **Financial Supervision Authority (EFSA)** is an agency that operates at the Central Bank of Estonia, but with autonomous competence and a separate budget. The management of EFSA acts and submits reports pursuant to the procedure provided for in the Financial Supervision Authority Act. The Financial Supervision Authority conducts financial supervision in the name of the state and is independent in the conduct of financial supervision; it functions under the rules stated in the Financial Supervision Authority Act[21]. The objective of the Financial Supervision Authority is to protect the interests of clients and investors by safeguarding their financial resources and thereby supporting the stability of the Estonian financial and monetary system. Besides ensuring the stability of the Estonian financial sector, the objective of the Financial Supervision Authority is to increase the credibility and transparency of the financial sector. The Financial Supervision Authority also aims at contributing to the effectiveness of the financial sector, and its task is to ensure the functioning of an efficient, fair and competitive financial market. Work aimed at reducing systemic risks and preventing the abuse of the financial sector for criminal purposes is also considered of major importance.

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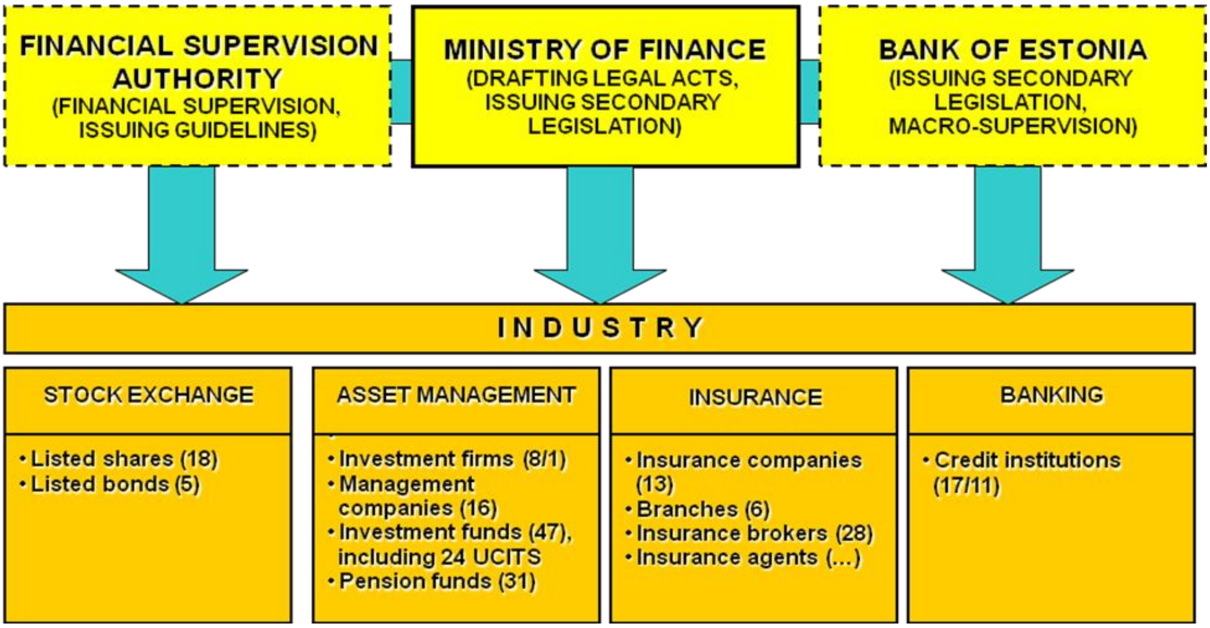
[19] *http://www.legaltext.ee/et/andmebaas/tekst.asp?loc=text&dok=X0000K1&keel=en&pg=1&ptyyp=RT&tyyp=X&query=p%F5hiseadus*

[20] *http://www.eestipank.info/pub/en/dokumendid/dokumendid/oigusaktid/seadused/epact_706.html*

[21] *http://www.legaltext.ee/et/andmebaas/tekst.asp?loc=text&dok=X50008K5&keel=en&pg=1&ptyyp=RT&tyyp=X&query=finantsinspektsiooni*

Figure 15: Estonia – Financial Supervision and Regulation



The fourth party that plays a role in safeguarding financial stability is the **Guarantee Fund**, which acts under the rules stated in the Guarantee Fund Act[22]. The objective of the Fund is to guarantee the protection of funds deposited by clients of credit institutions, investment institutions and unit-holders of mandatory pension funds. At present, the Guarantee Fund only plays a pay box role in Estonia, i.e. it only serves as the source of funds for reimbursing depositors/investors and has no supervisory role.

The responsibility for managing financial crises lies with the Financial Supervision Authority, Eesti Pank, and the Ministry of Finance. The duties of the BoE, EFSA and the MoF, as well as the grounds for joint action in case of a financial crisis, are provided for in the cooperation agreement on the management of financial crises, which was signed in 2006. The exchange of information between the Parties shall include quantitative indicators of problematic credit institutions as well as a qualitative assessment of the suitability and effects of potential measures.

In December 2007, the parties also signed a cooperation agreement[23] covering general issues of cooperation on a day-to-day basis, such as cooperation in the European Union decision-making process and international communication, development of financial sector legislation and instructions, developing a safety net for the financial sector, exchange of information about the situation and risks in the financial sector and communication with the public, and other issues of cooperation. To provide for more effective cooperation and exchange of information, a memorandum of understanding was also concluded between the Financial Supervision Authority and Tallinn Stock Exchange[24].

Entities supervised by the Financial Supervision Authority include:

22 *http://www.legaltext.ee/text/en/X60018K3.htm*

23 *http://www.eestipank.info/pub/en/yldine/pank/finantskeskkond/stabiilsus/lepe_1207.html*

24 *http://www.fi.ee/failid/Koostoolepingud/Koostooleping.pdf*

- Credit institutions and foreign branches
- Consolidated groups of banks
- Investment firms
- Fund management companies
- Life and non-life insurance companies
- Insurance brokers
- The Traffic Insurance Fund, Tallinn Stock Exchange, CSD

In addition, the tasks of the Financial Supervision Authority include the registration of public securities offerings, and the registration of cross-border services providers, foreign bank representative offices and insurance agencies.

Capital markets are thus supervised by EFSA. Whereas the TSE draws up its own rules, these are subject to EFSA approval. EFSA has on-line access to the TSE systems, and can thus conduct monitoring of trading activity directly without having to rely on the TSE to conduct monitoring. According to the TSE, so far only minor cases of misconduct have been reported in connection with trading on the TSE.

Savings and Loans (S&L) institutions do not need a license and are not supervised in Estonia.[25] They are only allowed to take deposits from their own members, and, with a reported market share of less than 1 percent, they are not considered systemically important. The BoE does, apparently, receive some statistics on their activities. S&Ls do not benefit from state guarantees, and have their own guarantee fund.

The management board manages and organises the activities of the EFSA. The Financial Supervision Authority Act stipulates that the management board is competent to adopt all resolutions relating to the performance of the obligations of the EFSA and to perform all obligations and exercise all rights. The management board shall consist of three to five members. The members of the management board shall be appointed and removed by the supervisory board. The members of the management board must be Estonian citizens with active legal capacity and an academic degree recognised by the state or education corresponding to such level, the expertise necessary to manage the EFSA, professional suitability, an impeccable professional and business reputation and a total of at least five years' work experience in the fields of finance, law, auditing or information technology, or in public service in a position relating to such fields.

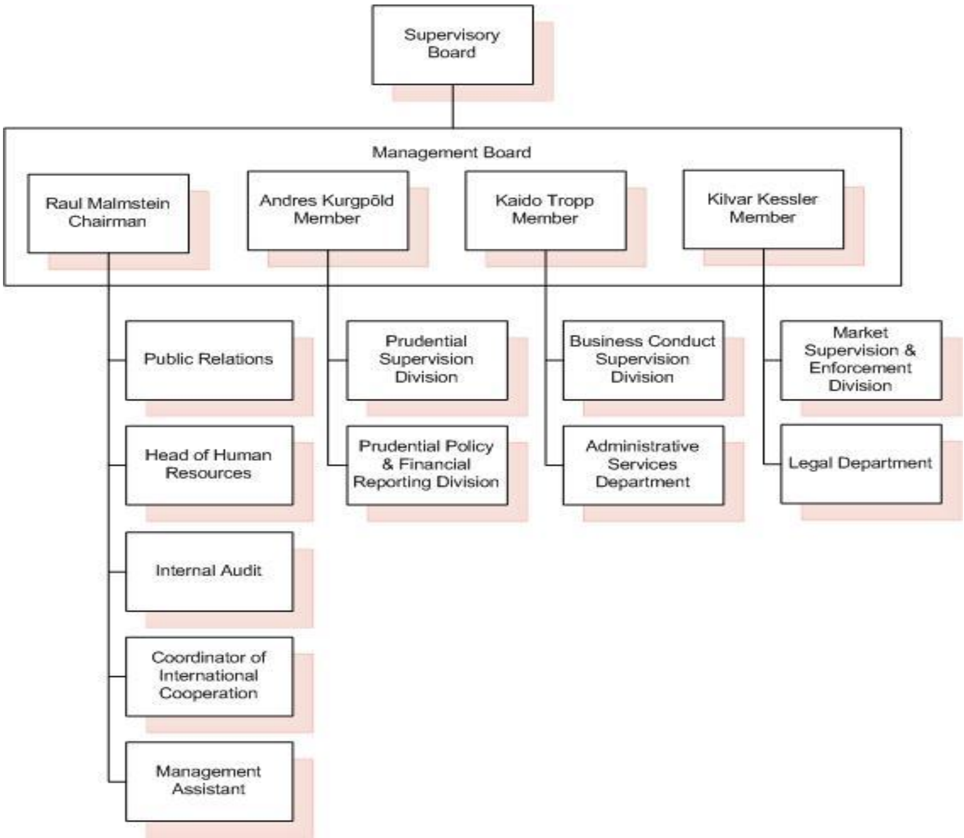
The term of office of members of the EFSA management board is three years. The term of office of the chairman of the management board of EFSA is four years. A member of the management board may be removed before the expiry of his or her term of authority if he or she suffers from an illness lasting for more than four months or if there is any other good reason on account of which he or she is unable to perform his or her duties. Upon expiry of the term of office or the removal or death of a member of the management board, the supervisory board shall appoint a new member of the management board within a reasonable period of time.

The management of the Financial Supervision Authority (EFSA) is monitored by the Supervisory Board of the Financial Supervision Authority. The Board consists of six members, two of whom are members by virtue of office – the Minister of Finance and the President of the Bank of Estonia – and

[25] It is not clear whether this arrangement is sustainable in light of EU regulatory requirements, and especially if S&Ls manage to increase their market share.

four of whom are appointed members. Two of the appointed members are appointed and removed by the Government on the proposal of the Minister of Finance and the other two by the Board of the Bank of Estonia on the proposal of the President of the Bank of Estonia. The Minister of Finance is the Chairman of the Supervisory Board by virtue of office.

Figure 16: Estonia - Structure of the Financial Supervisory Authority



In response to the IMF's 2008 FSAP mission's recommendations regarding the level of staff on-duty at EFSA, the Supervisory Board of EFSA authorised a staff increase of five positions, and EFSA expected to be fully staffed by the second quarter of 2009. In addition, Estonia is working on strengthening the ethics rules for EFSA employees, as had also been recommended by the Fund.

Every year, EFSA must publish a yearbook, which contains the annual report of EFSA as approved by the supervisory board, a list of the advisory guidelines issued by the FSA and the relevant explanations, and a summary report of the activities of the subjects of financial supervision during the previous calendar year. The annual report of the Supervision Authority approved by the supervisory board must be submitted to Parliament together with the annual report of the Eesti Pank. Parliament shall hear the report of the chairman of the management board concerning the annual report of the Supervision Authority.

The expenses of the Supervision Authority are covered through compulsory payments made by supervised institutions, administrative fees and other sources. The supervision fee consists of a share calculated on the basis of capital, and a share calculated on the basis of assets. The calculation and payment procedures concerning supervisory fees are stated in Articles 35–45 of the Financial Supervision Authority Act. As the larger share of the fees is based on assets, the EFSA budget tends to grow along with the growth of the financial market and entities' assets. From surplus funds derived from growth during previous years, EFSA has been able to form a reserve fund for recession periods.

Financial Conglomerates Oversight

Estonia does not have any Estonia-based financial conglomerates at the moment. As all financial sector entities are supervised by the Financial Supervision Authority (FSA), consolidated supervision is performed by the same authority and the exchange of information takes place internally within the organisation. The legislation and supervision framework are largely the same for the individual supervised entities. The FSA has also signed a cooperation agreement with the Ministry of Finance and Eesti Pank.

For the performance of its functions and exchange of information, the Supervision Authority has the task to cooperate with financial supervision authorities of foreign states and other competent agencies and persons of foreign states, including persons who carry out liquidation, bankruptcy or other such proceedings in a foreign state, operate schemes for guaranteeing deposits or investor protection schemes, supervise the accuracy of the accounting and reporting of foreign issuers and financial institutions, or supervise the auditors auditing financial institutions of foreign countries.

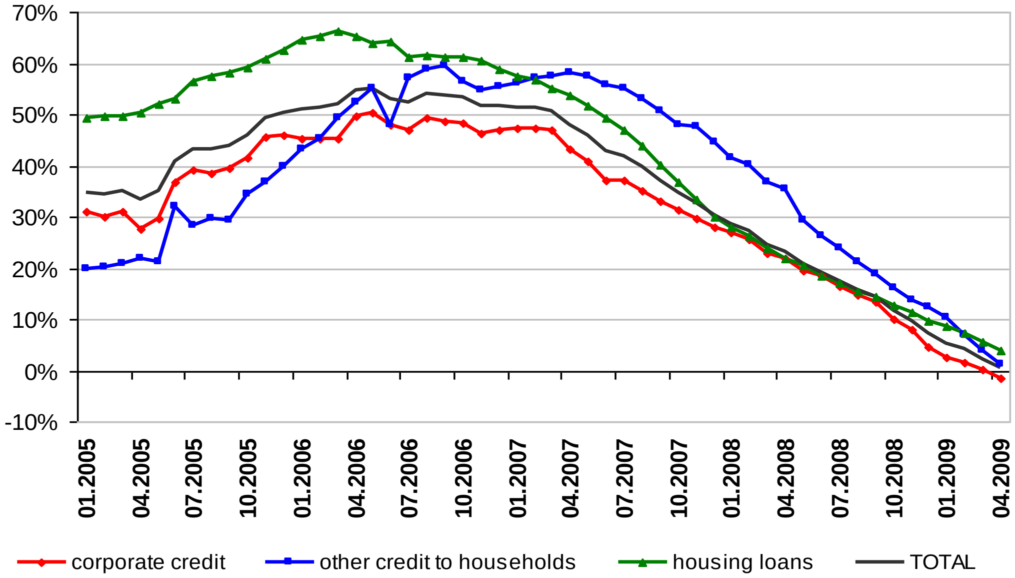
B. Financial Stability Oversight and Macro-Prudential Surveillance

Rapid credit growth reaching well over 50 percent per year (see Figure 17) accompanied by rapidly rising housing prices (Figure 16) was one of the main concerns during the economic upswing in Estonia. Due to the fixed exchange rate regime and free movement of capital, macroeconomic tools to influence credit growth are very limited. Risks to macroeconomic and financial stability were mitigated, however, by conservative fiscal policy. The Government ran significant budget surpluses for seven consecutive years.[26]

In order to limit risks related to rapid credit growth, Eesti Pank took some precautionary financial sector policy measures. Starting in 2002, the Bank of Estonia in co-operation with the Financial Supervision Authority on various occasions reminded credit institutions of potential risks related to rapid credit growth. In 2005, the risk weighting of housing loans was increased from 50 percent to 100 percent effective from 1 March 2006. In July 2006, the reserve requirement was increased from 13 percent to 15 percent effective from 1 September 2006. These measures were, however, mostly of a signalling nature and had little impact in practice. On account of the currency board, which has served the country well over the years, the Bank of Estonia was constrained in taking more forceful measures to curb rapid credit growth. The Bank of Estonia advised the government, however, to run a budget surplus, and to withdraw the tax deductibility of mortgage interest payments.

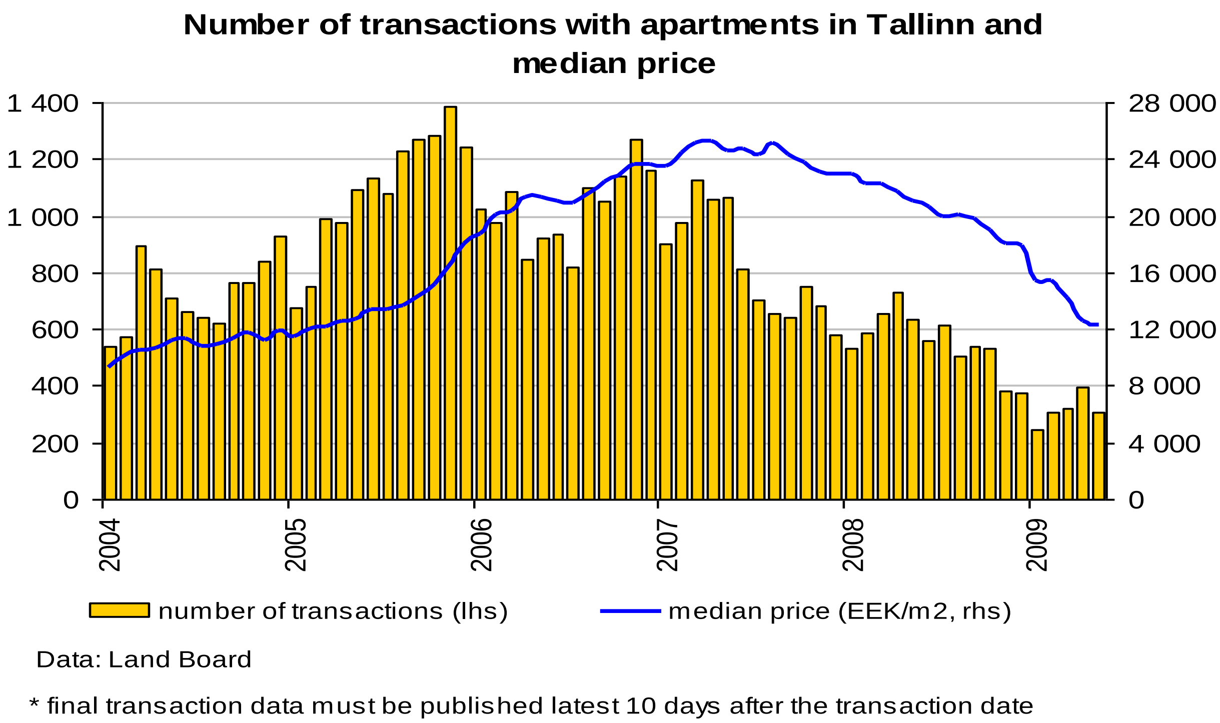
[26] In 2007-2008, large expenditure increases resulted, however, in structural fiscal policy loosening. IMF (2009).

Figure 17: Estonia - Annual Credit Growth (2005-2009)



Source: Bank of Estonia

Figure 18: Estonia – Housing Market Developments (2004-2009)



Source: Bank of Estonia

In order to estimate possible risks to the financial system, EFSA and Eesti Pank both conduct stress tests. Stress testing methods and topics vary depending on the risk portfolio of the whole market and of individual entities. The Financial Supervision Authority stress tests are more focused on the individual entities, while tests conducted by Eesti Pank concentrate on the overall banking system and economic environment. The results of the tests are shared between institutions.

Eesti Pank conducts stress-tests regularly twice a year. To ensure the macroeconomic consistency in different stress-scenarios, the results of Eesti Pank's macroeconomic forecasts and its different risk scenarios are used as input variables. The base for the Bank of Estonia's stress-test is a loan loss model, accompanied by Loss Given Default (LGD) analysis. The capital adequacy ratio is the main indicator of the impact of loan losses and decreases in profitability in the model. In addition to the macro forecast baseline and risk scenario figures, the impact of more severe macroeconomic developments for banks is also tested. The results of the stress-tests are used semi-annually in the financial stability assessment process and are published in the Financial Stability Report of Eesti Pank.[27] Past stress tests were reportedly based upon the experience of the Russian crisis as a reference scenario, which, with hindsight, turned out to be insufficient.

In light of the internationalisation of its banking system, isolated stress tests of only the Estonian subsidiaries would provide a rather limited view of potential risks. EFSA therefore exchanges the results of its stress tests with those of the Swedish FSA, in the context of quarterly meetings between the authorities. Sweden's FSA recently conducted stress tests on its largest banks, and found that they would be able to cope with a further significant deterioration in market conditions. At the same time, it insisted that banks have concrete plans for improving their capital adequacy within a reasonable period of time, in order to be prepared for even more extreme scenarios.[28]

C. Financial system support measures

Financial crisis management

The responsibility for managing financial crises lies with the Financial Supervision Authority, Eesti Pank, and the Ministry of Finance, which have also signed a mutual cooperation agreement for managing a systemic financial crisis[29]. The objective of the Memorandum is to support the process of managing a possible systemic financial crisis in such a way as to minimise the damage that might be caused to the society and to the creditors of the credit institution experiencing solvency problems. Eesti Pank, the Financial Supervision Authority and the Ministry of Finance have developed their own internal contingency plans covering the field specified in cooperation agreements among the parties.

According to the Memorandum, a systemic financial crisis is defined as a situation in which the functioning of the financial system is seriously impaired; e.g. due to liquidity and/or solvency problems of one or several credit institutions, disturbances in the payment and settlement systems, or the failure of financial markets. The trigger point for activation of one of those plans can vary depending on the particular institution's field of responsibility specified in the cooperation agreement. In general, the main triggers are situations where a *systemically* important *bank is involved* either having difficulties in payment (probably first noticed by Eesti Pank) or other insolvency issues (first noticed by EFSA).

[27] The IMF also conducted stress tests of the Estonian banking system as part of the FSAP update. IMF (2009).

[28] Finansinspektionen, *Finansinspektionen stress tests major banks*, Memorandum of 10 June 2009 *http://www.fi.se/upload/90_English/20_Publications/20_Miscellanous/2009/stresstester_20090610_eng.pdf*

[29] *http://www.fi.ee/failid/Finantskriiside_haldamise_kokkulepe_EN_2006.pdf*

The memorandum foresees that financial crises shall be managed by the Financial Supervision Authority, Eesti Pank, and the Ministry of Finance. In cases where it is deemed necessary, the Parties shall involve a third party as an independent mediator. The task of an independent mediator shall be to assist the Parties in finding new strong reliable owners for a problematic credit institution.

In a situation when the Minister of Finance, the Government of the Republic, or Parliament, have decided to rescue or re-structure a credit institution amid signs of a systemic crisis, the task of the Ministry of Finance shall be to arrange the legislative proceedings for allocating the financial funds pursuant to the procedure and scope of application designated in legislation. Contributions in the form of equity capital can be made to rescue or re-structure a credit institution, or to grant loans and guarantees for loans, or to invest the funds in a financially troubled institution in a different form pursuant to legislative provisions.

In order to rescue or re-structure a credit institution, if government involvement is considered necessary, government funds shall be applied first along with the funds of the private sector and the relevant funds of Eesti Pank. If these measures turn out to be inefficient, they shall be applied separately.

The Estonian Parliament approved, on March 11, 2009, a Law related to the financial crisis management by the State. This law clarifies that the state reserve (stabilisation reserve) can be used to address a financial crisis. The law also speeds up decision-making procedures by Parliament during the financial crisis, by permitting single decisions to be made in one reading instead of the customary two. Finally, the law includes a number of other minor technical amendments which may ease crisis management by the state.[30]

The IMF, as part of Estonia's 2008 FSAP, recommended that Estonia hold a joint crisis simulation exercise with other Baltic authorities and the Swedish authorities, and including Swedbank's Baltic subgroup. Such an exercise has not yet been conducted.

Emergency liquidity assistance

As a result of the currency board arrangement, Estonia's central bank possesses only a limited ability to act as a lender of last resort. Any activity of Eesti Pank needs to be in accordance with the Law on the Security of Estonian Kroon; i.e. the activity of Eesti Pank may not endanger its currency board commitment. The requirement that the liabilities of the central bank have to be fully covered by the foreign currency reserve captures reflects the principle that the central bank should have a liability-free reserve to cover its risks. The size of this reserve is about 2-3 percent of GDP.

Eesti Pank has, however, recently worked out a framework for emergency liquidity assistance.[31] According to this framework, Eesti Pank is in now in a position, in the context of crisis management, to grant emergency liquidity assistance to troubled credit institutions. Eesti Pank may grant emergency liquidity assistance against sufficient collateral to a credit institution that is deemed solvent according to the estimation of Eesti Pank. Eesti Pank may also grant supplementary liquidity support in the form of emergency liquidity assistance to ensure a smooth process of restoring solvency. Eesti Pank is

[30] Parliament also considered, but postponed, the granting of more budgetary discretion to the Government for purpose of financial crisis management.

[31] The IMF had recommended that in order to improve transparency and allow for more rapid action, Estonia establish basic policies on liquidity assistance in advance rather than leaving it for case-by-case decisions.

required to notify the Parties immediately of any disturbances to the payment and settlement systems that are likely to have a significant impact on the functioning of the financial system.

Regarding the large banks, any liquidity assistance would have to be coordinated with the central banks of the home countries of the parent banks. A stand-by agreement for this purpose is now in place with Sweden, financed by the Swedish Riksbank. Regarding the small banks, Eesti Pank has developed procedures for the extension of liquidity from its reserves.

Deposit insurance arrangements

The Guarantee Fund (hereinafter referred to as "Fund") is responsible for guaranteeing the protection of funds deposited by customers of credit institutions, customers of investment institutions, unit-holders of mandatory pension funds, and support of the transfer of pension contract (second pillar annuities) portfolios from a life insurance undertaking to another. The Fund is a legal person in public law founded by the Guarantee Fund Act on 1 July 2002, replacing the Deposit Guarantee Fund, which had operated since 1998. The Guarantee Fund Act [32] that entered into force on 1 July 2002 provides for the objective, the legal status and the basis and procedure for the activities of the Fund. As from 9 October 2008, deposits up to the amount of 782,330 kroons or 50,000 euros are fully covered. The guarantee limit and the amount of compensation payable are calculated per depositor in a credit institution. Thus, not all deposits are guaranteed separately, but the total deposits of a depositor in every credit institution. All deposits are guaranteed, regardless of their type (i.e. demand, savings, time and other deposits), irrespective of whether the deposit is in kroons, euros or in some other currency.[33]

According to the Credit Institutions Act and Guarantee Fund Act, membership of the scheme is compulsory for all licensed credit institutions. Branches of credit institutions of EEA States are obliged to join the scheme for guaranteeing deposits only to the extent they are not guaranteed under the respective home scheme (topping up). Branches of non-EEA credit institutions have to join the scheme in case the home scheme does not provide same or higher level protection as the Estonian scheme.

The Fund is composed of several sectoral funds: 1) the Deposit Guarantee Sectoral Fund (hereinafter referred to as "DGSF"); 2) the Investor Protection Sectoral Fund; 3) the Pension Protection Sectoral Fund; and 4) the Pension Contracts Sectoral Fund (Annuity Protection Sectoral Fund). The assets of the Fund are divided into the rights to be exercised and obligations to be performed out of each sectoral fund and other assets of the Fund. The Fund must keep separate accounts for the assets of each sectoral funds. Rights or obligations of one sectoral fund may not be acquired or transferred to another sectoral fund. In addition, there is a guarantee fund for savings and loan associations.

The highest directing body of the Fund is the Supervisory Board of the Fund. The Supervisory Board of the Fund consists of eight members appointed by Parliament, the Government - on the proposal of the Ministry of Finance-, Governor of the Bank of Estonia, Financial Supervision Authority and organisations representing credit institutions, investment institutions, pension fund management companies, and insurance undertakings. The Fund is managed and represented by the Director, who is subordinate and reports to the Supervisory Board.

[32]*http://www.legaltext.ee/et/andmebaas/tekst.asp?loc=text&dok=X60018K3&keel=en&pg=1&ptyyp=RT&tyyp=X&query=Tagatisfondi+seadus*

[33] The EU's amended Directive on deposit guarantee schemes (2009/14/EC) foresees a higher level of insurance of 100,000 euros by end of 2010 (subject to the outcome of a study), and a payout within twenty working days.

The Fund operates on a pre-funded basis, by collecting single and quarterly contributions from participants that are not refundable. Credit institutions make a single contribution in the amount of 50,000 EEK. In addition, the Guarantee Fund Act grants the Supervisory Board the right to establish rates for quarterly contributions and provides the maximum rate of 0.125 per cent of the guaranteed deposits. The rates of the contributions are reviewed annually by the Supervisory Board. The current rate of quarterly contribution (effective since the 3rd quarter of 2008) is 0.0032 per cent of the guaranteed deposits. The same rate of quarterly contribution is applied to all credit institutions and branches except for EEA branches where a separate contribution rate is established for each branch, calculated pursuant to the necessity to guarantee compensation for deposits to the extent not guaranteed under the guarantee scheme of the home country of the branch.

As at the target level of accumulated premiums of 2 percent of all guaranteed deposits, the fund's existing resources (while relatively high by international comparison) would not be sufficient to cover the guaranteed deposits of the two largest banks, the IMF has recommended a doubling of the target ratio to 4 percent of guaranteed deposits. At the end of May 2009, the Supervisory Board of the Guarantee Fund increased the target of the Deposit Guarantee Fund from 2 percent to 3 percent of guaranteed deposits, to be reached by end-2011. Whereas the target ratio is not a maximum, the Council of the Deposit Guarantee Fund may stop further payments into the Fund, once the target ratio is reached. This may be problematic, if the minimum guarantee is indeed raised to EUR 100,000, as the 3 percent would then not be sufficient.

Future contribution rates may need to rise, but depend upon the development of the size of deposits (98 percent of which still amount to less than EUR 20,000), and their distribution between locally incorporated banks and branches of foreign banks.[34] If funds prove to be insufficient in case of need, the Fund does have further possibilities: It can (1) take out loans, if necessary with a state guarantee, (2) dip into the other sectoral funds, and/or (3) receive funds from the reserves of the state.

The Financial Supervision Authority appoints a member to the Supervisory Board of the Fund and verifies the compliance of the members of the Supervisory Board with the requirements provided in the Guarantee Fund Act. In addition, the Supervision Authority decides whether the guarantee deposits under the scheme of the home country of a foreign credit institution are guaranteed to the same or a higher level than prescribed by the Guarantee Fund Act. The Fund has the right to obtain information from the Supervision Authority necessary for performance of the duties of the Fund and vice versa. The fund participants and the trustees are obliged to submit reports to the Fund through the Supervision Authority. If a fund participant fails to pay a contribution by the due date or to perform any other obligation arising from this Act, the Fund is obliged immediately to notify the Supervision Authority of such failure.

In the resolution/insolvency framework, the Fund does not have any role other than guaranteeing the protection of funds deposited by customers of credit institutions. The IMF has called for Estonia to develop a more far-reaching framework for resolving insolvent banks, including statutory measures that would allow the selling of assets and liabilities, negotiation of mergers or acquisitions, and the creation of a "bridge bank". The IMF specifically suggested that the law be amended to permit the authority operating the resolution framework to assume ownership of an insolvent bank without prior compensation of shareholders. The Estonian authorities considered changing the legislation in this field, but the explicit amendments and possible timetable are not yet decided (see below).

[34] The size of the Fund increased last year in connection with the conversion of Danske's local subsidiary into a branch, which thus dropped out of the scheme, while past contributions remained in the Fund.

Further interventions

The BoE has intensified its cooperation and contacts with Sweden's Riksbank. In order to secure financial stability and to promote confidence in financial markets, Eesti Pank entered, at the end of February 2009, into a precautionary arrangement with the Swedish central bank. The arrangement allows Eesti Pank to borrow up to SEK 10 billion against EEK.

The authorities have for the time being stepped up their monitoring of interbank settlement systems, net deposit outflows from larger banks, developments in global financial markets, and of press reports, especially in the Baltic Swedish press. The BoE is placing particular emphasis on ensuring a sufficient supply of cash, both in EEK and EUR, including, if necessary, outside of working hours. Communication among the relevant domestic authorities has intensified as well, and the authorities are considering the possibility to arrange a domestic crisis simulation exercise during 2009/2010.

A draft act related to financial supervision and the specification of the use of the Deposit Guarantee Fund during the crisis is under preparation by a joint (unofficial) working group composed of staff from the Ministry of Finance, EFSA and the BoE. This act is still at a preliminary draft stage. It is expected that it will be submitted for public consultation during the second half of 2009.

The draft Act foresees the following changes: (1) possible amendments to the bank moratorium, liquidation and bankruptcy regime to increase flexibility; (2) acceleration of the procedure for the initiation of on-site inspections during crises; (3) introduction of more effective tools to replace bank management; (4) possibility to ease prudential requirements during a crisis; (5) a bank splitting (good bank/bad bank) regime; and (6) in connection with the increase of the guaranteed deposit ceiling, specification of the possible triggers for activating the Deposit Guarantee Fund, and clearer definition of certain terms. This draft act may also include the possibility of expropriation (compulsory acquisition) of a majority share in banks where the owners are not willing to co-operate, and for other reasons of financial stability. Those amendments are, however, still under consideration, and at this time have not been integrated into the draft act.

D. International Surveillance Assessment of Estonian Financial Supervision

As part of the IMF-World Bank Financial Sector Assessment Programme (FSAP), a joint IMF-World Bank mission first visited Estonia (Tallinn) in the year 2000. A smaller FSAP follow-up mission took place in 2008, and an FSSA report was issued in February 2009. While in that report the IMF noted significant vulnerabilities from real estate lending, it found no serious weaknesses in bank supervision and regulation. The IMF recommended, however, that Estonia more fully develop its financial safety net, including by implementing a lender-of-last-resort capability and an expanded bank resolution framework. The Fund also saw a need to give consideration to increasing the target size of the deposit guarantee fund.

It appears that most of the recommendations of the Fund have been, or are being implemented by the Estonian authorities. Minor delays can largely be attributed to the need to coordinate with a number of foreign supervisory authorities. One issue that has been pending for a longer period has been Estonia's signature of the IOSCO MoU (see below).

VII. INTERNATIONAL FINANCIAL INTEGRATION AND MARKET ACCESS

A. Recent Developments in Cross Border Investment

As discussed in other chapters of this report, Estonia's banking system is almost 100 percent foreign-owned, and the figures are similar for the other parts of the financial sector.[35] The Tallinn Stock Exchange is owned by Nasdaq OMX. The most notable recent development has been the conversion of Danske's Sampo Bank subsidiary into a branch. Investments in Estonia's financial sector originate mainly in the Nordic countries, and to a lesser degree in the other Baltic countries and Russia.

B. Internationalisation and Capital Market Regulation

Since 2006, the share of foreign investors in the stock market has been around 50 percent, with approximately half of this belonging to Swedish investors. The share of local and foreign investors has remained largely unchanged in recent years, although most recently it appears that the share of foreign investors in Estonian equities has fallen to about a third, as foreign investors have pulled funds out of Baltic stock markets (see Figure 19).

Foreign currency deposits have hovered at around 40 percent of total bank deposits since the beginning of 2008, with a continuous increase in the importance of EUR deposits, which in the first quarter of 2009 accounted for almost 30 percent of all deposits. It appears that the financial crisis has not led to a massive shift to foreign currency deposits (see Figure 20).

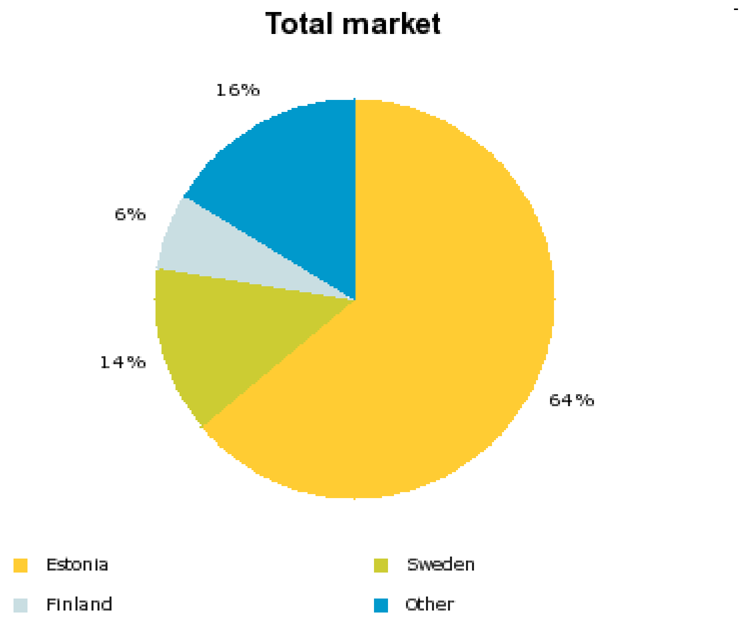
Exchange of information

The Supervision Authority has the task to co-operate with foreign financial supervision authorities and other competent foreign bodies or persons for the performance of its duties and to ensure a proper exchange of information. The Supervision Authority has the right to obtain confidential information necessary for the performance of its functions and to send such information to the authorities with which it co-operates. Information sent, received or exchanged in this manner is deemed to be confidential.

The EFSA has signed sixteen home-host agreements with the supervisory authorities of ten different countries (i.e., Sweden, Finland, Latvia, Lithuania, Denmark, Germany, Switzerland, the Netherlands Cyprus and Russia). The majority of the agreements relate to cooperation in the field of banking supervision (i.e., Sweden, Finland, Latvia, Lithuania, Denmark, Germany, the Netherlands Cyprus and Russia), but the EFSA has also signed several agreements concerning insurance supervision (i.e., Finland, Latvia, Lithuania, Denmark, Germany and Switzerland) and securities market supervision (i.e., Finland, Latvia, Lithuania and Denmark).

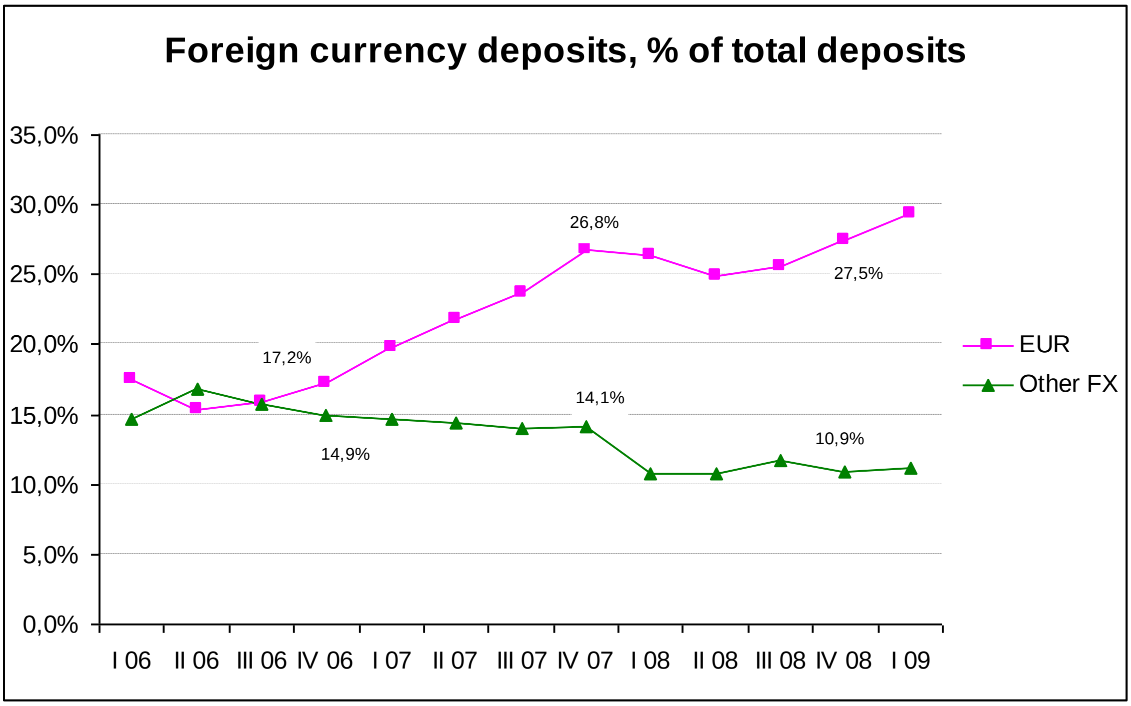
[35] See particularly Chapter IV on the structure of the banking system.

Figure 19: Estonia – Largest Investors in Estonian Equities (1 June 2009)



Source: OMX Nasdaq

Figure 20: Estonia – Share of Foreign Currency Deposits (2006-2009)



Source: EFSA

Estonia is currently in talks with the other Baltic and the Nordic countries with the aim of agreeing on a regional-based MoU in respect of financial crises. Estonia considers that this MoU should also cover the difficult subject of burden-sharing agreements. The establishment of a Cross-Border Stability Group is also under consideration. It is hoped that agreement on this MoU, which is prepared under the leadership of the Finnish Ministry of Finance, can be reached before the end of 2009.

Following the growing trend of endorsement of group-based home-host agreements to support generic MoUs, EFSA has signed group-based agreements with the Finnish FSA regarding the banking groups of Nordea and Sampo (acquired by the Danish Danske Bank in 2007). EFSA also signed (in July 2009) group-based home-host agreements with the Swedish FSA regarding the Banking Group of Swedbank (other participants are the Capital Market Commission of Latvia and the Bank of Lithuania). EFSA has also signed group-based agreements regarding SEB Group (with the supervisory authorities of Sweden, Germany, Latvia, Lithuania and Denmark); regarding Snoras Group (with Latvia and Lithuania) and regarding to Latvijas Biznesa Banka Group (with Latvia). All memoranda of understanding and cooperation agreements that have been signed are published on EFSA's webpage.

Estonia is a member of IOSCO, but has not yet signed the relevant MoU. Estonia's accession to the multilateral MoU has been held back by legal problems related to the automatic sharing of data. The signing of the IOSCO multilateral MoU has been a long-standing recommendation of the IMF.

Market Access for Foreign Institutions and Investors

Estonia compares favourably to many OECD Members, as there appear to be no major or unusual market access restrictions for foreign institutions and investors in its financial system. Through the envisaged across-the-board opening to cross-border financial services, Estonia would become significantly more liberalised than existing OECD Members.

The OECD Investment Committee discussed Estonia's accession to the OECD on 24 March 2009 and on 5 October 2009.[36] Pursuant to its March 2009 meeting, the Investment Committee considered that Estonia's proposed position under the instruments should be improved in order to be considered satisfactory. In the area of financial services, Estonia was asked to take legal steps, before accession, to liberalise the operations by non-EEA OECD based residents which, under the General Agreement on Trade in Services (GATS), Estonia has committed to liberalise for all GATS members. The operations concerned include, inter alia, the cross-border provision of financial services (including items E/2-E/4 and E/7 of the Code of Liberalisation of Current Invisible Operations (CLCIO)).

In its reply to the Investment Committee, Estonia responded that it would take steps to amend the necessary laws to permit the cross-border provision of financial services from non-EEA countries, subject to (1) proportional prudential requirements being met, (2) compliance with primary consumer protection (conduct of business) rules, and (3) existence of the necessary grounds for effective supervisory co-operation. Granting of a license to non-EEA applicants would not be automatic, but require prior supervisory assessment.

The Investment Committee also asked Estonia to confirm that for the establishment of bank and insurance subsidiaries and branches and the acquisition of qualified holdings in such entities in

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[36] The background note on the accession examination of Estonia under the OECD investment instruments is available on OLIS under the reference [DAF/INV/ACS(2009)2/FINAL].

Estonia, the presumption of the Estonian supervisory authorities is that OECD country supervisory authorities are willing and able to co-operate with the Estonian Financial Supervisory Authority (EFSA), and EFSA's readiness to give these authorities adequate opportunity to enter into information exchange and other co-operative arrangements for the purpose of prudential policy. Estonia has replied that is does not have any information indicating that there could be any problems with OECD countries regarding their supervisory authorities' willingness or ability to cooperate with EFSA.

Under EC Directive 85/611, a depository of an undertaking for collective investment in transferable securities (UCITS) must either have its registered office in the same EC country as that of the undertaking or be established in the EC country if its registered office is in another EC country; Estonia thus maintains corresponding reservations regarding List A, I/A of the CLCM and item E/7 of the CLCIO. Upon adoption of the measures outlined above, this will be the only reservation that Estonia will maintain in the area of banking and other financial services.

VIII. COMPLIANCE WITH THE OECD LEGAL INSTRUMENTS ON FINANCIAL MARKETS[37]

C(2009)62 and C(2009)62/CORR1: Recommendation of the Council on Good Practices on Financial Education and Awareness Relating to Credit

Estonia accepts this Recommendation.

Estonia considers that, in general, it has implemented the main principles of this Recommendation. The official financial education program based on European Commission's Communication regarding financial education is, however, still under elaboration.

As an example of financial education activities, Estonia refers to the activities of the Estonian Consumer Protection Board (CPB), which encompass the publication of financial information which is for instance available from its website under the sections "Useful for consumers" and "Protecting consumers' economic interests. CPB has also launched a new consumer protection related website (www.nupukas.ee) for the younger generation aiming to raise awareness on consumer related issues among pupils. This website also serves as a source for teachers who need additional information in their daily work in teaching consumer protection related subjects (like financial services, acquiring loans, credit cards, bank accounts, mobile payments, etc).

In addition, the website www.minuraha.ee, which is established and managed by the Estonian Financial Supervision Authority (EFSA), offers different financial services and products related comparative analysis and has proven to be very useful for financial clients. Other activities include the basic investor education program of the Tallinn Stock Exchange, and the Tallinn University of Technology scheme targeting school children and focused mainly on issues related to budget management. A debt counselling service is provided by the Tallinn's Social Work Centre – http://www.swcenter.ee/volanoustamine. The service is free of charge for inhabitancies of the Tallinn.

C(2005)55/REV1: Recommendation of the Council on Principles and Good Practices for Financial Education and Awareness

Estonia accepts this Recommendation.

C(75)198: Recommendation of the Council concerning the Minimum Disclosure and Procedure Rules to be Complied with before Securities may be Offered to the Public

Estonia accepts this Recommendation.

[37] Estonia's complete submission on all the legal instruments except C(2009)62 can be found in Estonia's Initial Memorandum, the relevant excerpt of which is made available to the Committee in document DAF/CMF/ACS(2009)13. Estonia's submission on C(2009)62, which was adopted after the submission of the Initial Memorandum, is set out below.

C(74)157: Recommendation of the Council concerning Regulations for the Public Offer and for Stock Exchange Listing or Quotation of Foreign Securities

Estonia accepts this Recommendation.

C(74)156: Recommendation of the Council concerning Disclosure Requirements and Procedures to be Applicable to all Publicly Offered Securities

Estonia accepts this Recommendation.

C(74)61: Recommendation of the Council concerning the Review of any Restrictions which Member Countries Impose on Portfolio Investment in Unlisted or Unquoted Securities

Estonia accepts this Recommendation.

C(71)234: Recommendation of the Council concerning Standard Rules for the Operations of Institutions for Collective Investment in Securities

Estonia accepts this Recommendation.

C(71)176: Recommendation of the Council on International Security Issues

Estonia accepts this Recommendation.

Estonia states that it has implemented this recommendation and that in principle, there are no legal obstacles which can limit the buying of the securities in question by Estonian residents or impede participation by Estonian banks and other financial institutions in issuing syndicates and selling groups. Estonia observes, however, that Section I of the recommendation basically does not apply to Estonia, as there is currently no market in Estonia for the kind of international issues referred to in the recommendation.

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ANNEX I

LIST OF BANKS AUTHORISED IN ESTONIA AS OF 15 MARCH 2009*

AB Bankas Snoras, Estonian Branch

Allied Irish Banks PLC, Estonian

AS Eesti Krediidipank

AS Parex banka, Estonian Branch

AS SEB Pank

AS UniCredit Bank, Estonian Branch

Bank DnB NORD A/S, Estonian Branch

BIGBANK AS

Danske Bank A/S, Estonian Branch

Marfin Pank Eesti AS

Nordea Bank Finland PLC, Estonian Branch

Pohjola Bank plc, Estonian Branch

Scania Finans AB, Estonian Branch

Siemens Financial Services AB, Estonian Branch

Svenska Handelsbanken AB, Estonian Branch

Swedbank AS

Tallinna Äripanga AS

* Source: Bank of Estonia.