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Abstract: Regulation of the banking industry in Estonia is theoretically significant in many respects. There is no clear straightforward model that would explain the evolution of the banking legislation, as all theoretical concepts are applicable for understanding the dynamics at certain periods in the regulatory development trajectory. This is witnessed in the interplay of domestic features and external factors. Both the need to build up the institutional framework for private finance and address re-occurring crises anchored the banking regulation and supervision to the EU and other international principles and practices. Estonia has been “accused” of meticulous punctuality in applying the EU regulations, in some cases directly copying from external legal sources, and setting even stricter requirements than the EU would dictate. This, however, has created a paradox of exemplary compliance with the EU standards in terms of its extensiveness, but meager effectiveness in addressing real-life developments. The paper shows the pragmatic approach to establishing regulatory and supervisory framework in the 1990s in the context of crises, internationalization of banking, and also EU accession aspirations, while 2000s mark gradual outsourcing of oversight and embedded formalism in terms of deepening reliance on external normative standards with insignificant economic substance, given the local circumstances.

Key words: Financial regulation, financial supervision, banking, transition economies, financial fragility, Europeanization, Estonia.

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1. Introduction

In Europe and elsewhere, the 2008 financial crisis revealed the shortcomings of the financial policies and regulations on both national and international level. Meager requirements in trading, disregard of liquidity risks, lack of transparency in complex financial instruments, freedom left to unregulated non-bank actors, and the pervasiveness of short-term incentives were few typical reasons seen behind the turmoil in the financial markets (see European Commission 2010; Montanaro and Tonveronachi 2011). Yet, deeper understanding of the implications of regulatory environments has been aggravated by the limited convergence of policies and institutions, especially within the European Union (EU) (Héritier 2001; Kohler-Koch and Eising 1999).

Inside the EU, Central and Eastern European countries (CEEC) stand out for deep integration with international markets, including for capital and financial services. For that reason they were particularly hit by the 2008 global crisis that revealed the vulnerabilities existing in these economies, such as export dependency and high-volume cross-border funding via internal capital markets inside the banking groups (see Bohle and Greskovits 2012; Lehmann et al. 2011; De Haas and Naaborg 2005, 2006). Accordingly, CEECs have found themselves in a position, where the governance of finance that has been dictated by regional or global regimes has disabled national governments to shield the economies against the crises as evidenced by their unsuccessful attempts to control the credit boom (see Pistor 2009). For CEECs, the challenges in the governance of finance arise from the multidimensionality of the financial regulation in terms of the interplay of national and supranational actors. This, in turn, refers to the pertinence of both the Europeanization and ‘regulatory state’ thesis. Majone’s (1996) notion on ‘regulatory state’ indicated to an overall shift towards the use of regulation over the other tools of stabilization and at the same time, the European Commission’s expansionist influence over policy content. In that respect, by integrating the CEECs into the internal market, the EU transferred rules to the CEECs and complemented markets with the institutions of the ‘regulatory state’ (ibid.).

So far, the scope of the Eastward Europeanization research has been rather wide with the focus at the entire acquis without any single country or issue on the agenda¹. Most of the
research attention has been also placed on policies at the level of outputs, that is, legislative decisions, with the focus on explanatory factors that affect the correct and timely transposition of EU policies, and less on outcomes in terms of implementation performance (see Falkner et al. 2005; Treib 2008). Hence, in light of the above-mentioned regulatory failures, the distinctiveness of the CEECs’ financial architecture, the role of the EU in the evolution of financial policies at the national level, and in particular, inconsistencies in the adjustment to EU policies and more specifically to the *acquis communautaire* across policy areas and countries (see Héritier 2001; Jacoby 2004), the current paper addresses the development of the banking legislation in Estonia during the period of 1991-2011 with the purpose to explain the factors affecting the formation of the regulatory practices, but also to understand the implications of the alignment with the EU banking regulation for the financial supervision and overall stability.

The focus on Estonia as a singular case, instead of a comparative perspective, accounts for the peculiarities in the local financial system, such as the currency board system operating until 2011 and substantial foreign ownership in the banking industry with the four largest foreign banks controlling over 95 per cent of the market in terms of both total assets and share capital (OECD 2011). Furthermore, the tendency of Estonia to outperform Western European counterparts, but also other CEECs, e.g. Slovenia, when it comes to compliance with the EU regulation aside from building a fully integrated financial markets (see Sedelmeier 2010; Epstein 2008; Toshkov 2008) presents the grounds for a study on the effectiveness of regulatory harmonization in terms of potential divergence between legislation and ‘real-life’ developments in the banking industry.

The following analysis will be undertaken within the conceptual framework of Europeanization and related institutionalist tradition, while acknowledging the limited scope of rather generic theoretical concepts within this tradition that have been used to explain the transposition of EU policies in specific policy fields, such as environmental and social policy, but not banking. Hence, the first chapter will present a brief of overview on the current theoretical literature and presents the analytical framework for understanding the dynamics in regulatory and supervisory practices. Second part of the paper presents
the development of the Estonian banking legislation to be followed by the chapters discussing the factors affecting it and the implications for the banking sector regulations and supervision.

2. Theoretical Overview and Considerations

Europeanization as a reflection of the convergence process has been presented in several ways: the impact of the EU on countries through the absorption of EU norms and logic, that is, the transposition and implementation of European legislation in EU member and non-member states (Grabbe 2006; Schimmelfennig and Sedelmeier 2005a; Kaeding 2006); substitution of national policy-making with supranational one that modify patterns of political and administrative behavior (Radaelli 2000; Majone 1996); or more narrowly, conceived of as the impact of individual EU policy measures on the existing policies, political and administrative processes, and structures of both member and non-member states (Héritier 2005; Pollack 2010). Even though all three interpretations are applicable in the analysis of banking regulation, focus on the mechanisms of the Europeanization and the constructs behind them enable an understanding of the dynamics in the field of study. In the context of the CEECs, these mechanisms have transformed throughout the (pre-/post-)accession period since 1989, starting with lesson-drawing, also mimetism or institutional isomorphism, and ending with coercion, that is, conditionality and eventual membership obligations (Grabbe 2006; Schimmelfennig and Sedelmeier 2005a; also Jacoby 2006). Likewise, the Europeanization has been differentiated in terms of positive integration (institutional compliance) and negative integration (changing opportunity structures) (see Knill and Lehmkuhl 2002). In that respect, several concepts have been used for the analysis on the EU’s impact on candidate countries as well as member states, such as comparative politics, European integration, international relations, and organizational behavior (see Grabbe 2006). Consequently, theoretically-informed studies on the Eastward Europeanization that reason compliance, enforcement, and policy changes have been built around: 1) a rational choice insititutionalist tradition, that is, the ‘external incentives model’, which captures the dynamics underpinning the EU’s conditionality, 2) an institution-based historical (constructivist) tradition, that is, the ‘social learning model’ that emphasizes
identification with the EU and persuasion of the legitimacy of EU rules as conditions for rule adoption, and 3) an ecological organization tradition, that is, the ‘lesson-drawing model’ with the focus on the adoption of EU rules as induced by the CEECs themselves through copying, emulation, combination, or inspiration (Radaelli 2000; Schimmelfennig and Sedelmeier 2002; Schimmelfennig and Sedelmeier 2005a; Börzel and Risse 2003; Pollack 2010; Epstein 2005; Etienne 2011).

Schimmelfennig and Sedelmeier (2005b) claim that in the early transition period CEECs were receptive to lesson-drawing and social learning approaches due to the widespread perception of policy failure and the need to replace socialist legacies or to adopt new rules in areas, where none existed before. This was evidenced by selective and limited EU-induced rule adoption (see Andonova 2003; Grabbe 2002). However, they concede that the external incentives model, associated with EU membership conditionality, generally explains the broader patterns of rule adoption in CEECs from 1995 onwards. Despite the fact that the EU’s influence worked through the conditionality for accession during the pre-2004 period, the given set of institutions once established has influenced and constrained the behavior of the actors who adopted them. Perception of the embeddedness of national policies, institutions, and regulation in line with the EU requirements, and accompanied significant “sunk costs” in the adjustment process highlight the explanatory strength of the historical institutionalist tradition. In that sense, CEECs got locked in the Europeanization process and set in path-dependencies in policy formulation and implementation (see Grabbe 2006; Fink-Hafner 2007; Young 2010; Pollack 2010).

All in all, most of the research on the implementation of EU policies, that is, the extent of Europeanization in these three traditions has mainly focused on explanatory factors like misfit (‘goodness of fit’), veto players or national bureaucracies, including administrative capacity and coordination (see Pollack 2010; Young 2010; Falkner et al. 2005; Toshkov 2007, 2008; Haverland 2000; Hille and Knill 2006; Knill and Lenschow 1998; Héritier 2001; Steunenberg 2006; Berglund et al. 2006). Other studies, mostly quantitative ones (see Lampinen and Uusikylä 1998; Kaeding 2006; Berglund et al. 2006; Mastenbroek 2005; Linos 2007; Toshkov 2008) have brought into the analysis the complexity of directives and their
By criticizing the veto player argument and misfit hypothesis, Falkner et al. (2005, 2007) and Falkner and Treib (2008) have taken another approach that theorizes on the intuitive notion of the culture. They present three (later four) worlds – obedience, domestic politics, neglect, and ‘dead letters’ - as typical patterns in implementing EU policies, where national cultures, ideology, and preferences on both the political and the administrative levels significantly affect the implementation performance. In their analysis, a world of ‘dead letters’ applies to new member states, where formal rules exist, but they do not get implemented in practice. Essentially, process pattern at the stage of transposition is of ‘obedience’, while that at the stage of practical implementation is of ‘neglect’. In a similar way, Goetz (2002) identifies “Four Worlds of Europeanization” - Nordic world, a North-West world, a Mediterranean world, and a Central and Eastern European world – by focusing on when member states accept EU requirements and combines it with a broad pattern of domestic effects. Also, Jacoby (2004) identifies four different types of impact that the EU can have on the CEECs’ attempts to emulate EU rules, ranging from ‘open struggle’ and ‘scaffolding’ to ‘continuous learning’ and ‘homesteading’ by domestic groups.

Similar to limited pertinence of the varieties of capitalism approach in understanding the divergent trajectories in post-Socialist market economies in CEECs (see Myant and Drahokoupil 2011, 299-302; Lane 2007, 13-15), existing theoretical and empirical studies on Eastward Europeanization within the institutionalist tradition have a rather narrow scope with the focus on factors affecting the implementation process in universal, homogeneous areas of study, such as social policy and environment. The Eastward Europeanization as a field of study falls short of the analysis on the effectiveness of externally-induced policies and relevance of the Europeanization process for the CEECs, in particular in the banking and finance. Hence, the following analysis tries the shed a light on these missing pieces in the discussion on Europeanization with the case of the banking regulation in Estonia.
3. Twenty Years of the Banking Regulation in Estonia

First, there was a clear link between the reform choices and a ‘regulatory state’ model in Estonia, as the institutions were geared to regulating rather than otherwise intervening in the economy (see Bohle and Greskovits 2012). As one of the key reformers at the time, Siim Kallas who was in charge of the central bank then, has argued, this choice was a conscious one, as there was low trust in government’s ability to get interventions right (Kallas 2003, 511). Further, the preference for the principle of firmly-rooted rules instead of discretionary policies was reasoned with the need to stop past practices of socialist management and reduce uncertainties in a highly risky environment of the transition process (see Steinherr and Gilbert 1994). This was manifest in the monetary institutions, that is, the currency board arrangement, which limited the function of the central bank as lender of last resort (Lepik and Törs 2002), but also evidenced by the strict approach taken to the bank and bad-debt restructuring that resulted in bankruptcies and liquidations in the early 1990s with a clear message from public authorities in terms of not bailing-out commercial banks (OECD 2000; Lainela and Sutela 1994). It can be argued that one of the underlying motives behind both limiting the role of the central bank and strict approach to crisis resolution in the early 1990s was to divide two main functions of the banking sector between domestic and external actors. Domestic actors (banks) should enable functioning and safe payment systems; external actors, through foreign direct investments, should enable financing of productive investment into restructuring of the economy.

The starting point for the Estonian banking regulation was 1989, when a bill was passed to allow the establishment of commercial banks. However, 1995 marked the beginning of the integration process into international (banking) community, when modern Credit Institutions Act, Accounting Act and Commercial Code were adopted. Development of the banking legislation in line with the EU directives with critical junctures in both Europeanization and institutional progress of the banking sector are presented in table 1 below.

In broad terms, the evolution of Estonian banking regulation and supervision can be divided into six periods after the establishment of the Bank of Estonia in 1989 (see also Zirnask
1990-1992 – period of the monetary reform and a multitude of regulations on capital account transactions³, but no measures to restore the solvency of banks in the light of the first banking crisis (Sõrg 2003). The main problems at that time were lacking supervision and lenient requirements for establishing a bank due to the objective of public authorities to enhance competition by granting an easy entry via fairly low minimum capital requirements and lax review process of applications for a license (OECD 2000).

1992-1994 – first attempts at regulating banking activities with prudential ratios – solvency ratio⁴, liquidity ratio⁵, risk concentration ratio⁶, net foreign exchange position ratio – in order to restrict the excess risks taken by banks (Bank of Estonia 1994). Also, new methods were adopted in the supervision of credit institutions that included a complex assessment of the quality of the bank’s assets, the strength of capital base, profitability, and the effectiveness of administration, while pre-emptive control was strengthened in the stage of issuing licenses to credit institutions by approving the members of management (Bank of Estonia 1995). Initially, the Bank of Estonia followed the recommendations of Basel Committee on Banking Supervision, but later the requirements of the EU directives in elaborating prudential ratios (Bank of Estonia 2003).

1994-1997 – qualitative changes in the regulatory framework with the enactment of the Credit Institutions Act⁷. Legislation on credit institutions established the basis for universal banking model and enabled banks to own and finance other financial institutions, which also entailed the introduction of principles for consolidated financial statements. Aside from provisions on the establishment, management, and supervision of the bank, tighter regulation of different risks (credit, foreign exchange, market, etc.) was adopted. One of the messages of 1995 law and following amendments was to restrict lending to banks’ staff and owners as well as to prevent large exposures⁸.

1997-2004 – modern banking period with the focus on requirements arising from macroeconomic and international, in particular the EU developments. In the aftermath of 1997-1998 banking crisis, Estonia introduced the institution of deposit guarantee and
adopted a European-type Credit Institutions Act⁹, based on EU banking directives and materials from Basel Committee on Banking Supervision. New Credit Institutions Act was more specific in establishing the roles and responsibilities of the Banking Supervision Department at the central bank in executing oversight by stipulating specific rights for obtaining information, executing on-site inspections, demanding revitalization plans and issuing prescriptive orders, including the removal of a member of the Executive Management or Supervisory Board of the credit institution. By 2000, Estonian legislation on banking activities, accounting practices, and organization of supervision was harmonized with Western practices with the exception of deposit guaranteeing system. Amendments made in the early 2000s were mostly related to continuous harmonization of national legislation in banking to achieve full integration with the EU directives for accessing the EU in 2004.

2004-2008 – continuous adaptation to the existing and new banking regulation of the EU. Accession to the EU in 2004 and the development of international financial regulations did not leave Estonian legislation unaffected, as amendments in the Credit Institutions Act in 2004 concerned the procedures for banking license application, clarifications of relationships between market participants and the Financial Supervision Authority, and the modifications in credit institutions’ prudential requirements (Bank of Estonia 2005). Further strengthening of capital adequacy regulation was caused by the need to adopt new Basel II framework.

2008-... – post-crisis period with reactive measures to the global financial crisis of 2008, including the improved guarantee of deposits and establishing a framework for granting emergency liquidity assistance to troubled credit institutions (OECD 2011). Also, the rights of the Financial Supervision Authority were expanded for intervention into and inspection of the activities of banks in crisis. Moreover, the state was granted the right to consider expropriating the shares of banks operating in Estonia (Bank of Estonia 2011). The most significant development was the enforcement of Debt Restructuring and Debt Protection Act¹⁰ in 2011 to enable individuals in financial difficulty to restructure their debts.
As a consequence of joining the Euro-zone, the minimum reserve requirement had to be lowered from 15 per cent to 2 per cent in 2010 (ibid.).

This periodization corresponds to three general trends in the banking sector: a rapid increase in the number of banks as result of the liberalization of the banking environment in 1991-1992; a decrease in the number of banks and stabilization period until 1997-98, as regulatory environment was made more stricter; a growth phase after 1998 with increasing share of foreign ownership through organic growth and take-overs (Myant and Drahokoupil 2011, 261). Hence, such a periodization and general trends also reveal potential factors affecting developments in the banking regulation.

4. National Idiosyncrasies and Perseverant Europeanization

In light of the institutional development of the banking sector, the challenge in the 1990s was the establishment of institutions in both private and public sector by finding compromises between international regulatory trends and ad hoc country-specific needs, while post-1997/98 period posed the regulators with a task to adjust the regulatory and supervisory environment to suit a multinational cross-border context (Ross 2013). Also, Estonian banking regulation in the early 1990s entailed the elimination of restrictions on capital movement and current account convertibility under the general liberalization agenda (see De Castello Branco et al. 1996; Kattel and Raudla 2013). Late-1990s and the following years, on the other hand, saw convergence with the EU banking directives that implied either extensive regulation of uncovered issues or re-regulating. In this regard, de- and re-regulatory cyclicality can be observed to some extent. For instance, approach taken in authorization of credit institutions was very loose in early 1990s, followed by more stringent licensing requirements in mid-1990s, but then again loosened due to adoption of the principles of the Second Banking Directive on cross-border banking activities.

Thus, different motives and situational circumstances in the early and late 1990s as well as 2000s account for varying explanatory strength of theoretical concepts within the institutionalist approach on the matter of Eastward Europeanization.
Although the build-up of regulatory environment in the early 1990s was aligned with the international framework, specific domestic circumstances, such as a currency board system, influenced its design, while banking crises led to stricter regulations than international minimum standards (Ross 2013). Thus, crises-wrecked banking system needed pragmatist approach in policy-making for finding solutions to single episodes of failing banks, but at the same time building institutional environment from scratch (see De Castello Branco et al. 1996). In the condition of re-occurring banking crises, policy-making was of rather reactionary nature that was manifest in rule amendments after every major crisis and mostly related to practical issues in accounting, reporting, reserve and capital requirements. Consequently, attention was turned to international practices and example was taken from other Central and Western European countries in forming banking legislation, e.g. practices of Germany, Austria, Denmark, Finland, Iceland, and Hungary were relied upon in drafting the legal acts, but also the Basel I principles and EU directives were used as source of inspiration to the extent it was appropriate and possible, given the circumstances at that time12. This indicates to the predominance of bottom-up imitative-copying approach, associated with the 'lesson-drawing model'. 'External incentives model', on the other hand, has cogency in explaining banking regulation from 1995 onwards, when the EU began to spell out the content of legislation that had to be adopted as a precondition for membership, implying political commitment in adjusting to the acquis (Schimmelfennig and Sedelmeier 2005b; Fink-Hafner 2007; Tison 2002, 44-45). Thus, the start of pre-accession negotiations can be considered as a critical juncture in the institutional adaptation. White Paper of 1995 specified the legislation in the area of financial services that needed to be implemented in order to join the EU. The adaptation of EU banking directives was one of the key aspects of the Association (Europe) Agreement reached between the EU and Estonia in 1995 that foresaw the right for EU financial institutions to operate in Estonia by the end of a transition period at the latest, although the Europe Agreement contained transitional rules and some exemptions in the liberalization process13 (see EBRD 1998; Tison 2002, 39). As can be seen from the table 1 above, the major harmonization efforts were made around the turn of the millennium in 1998-99, after the
EU included Estonia in the first group of membership negotiations in 1997 and the Association Agreement came into force in 1998. Hence, the EU’s impact on the alignment process intensified especially once the EU opened accession negotiations, which signaled the credibility of EU’s membership incentive (see Sedelmeier 2011). Moreover, the EU banking policies have become embedded in the Estonian legislation due to expectation on fulfillment of conditions without opt-outs in an asymmetrical relationship and dependence of Estonia on EU’s input that has allowed the EU an unprecedented influence on domestic institutions and policies in the private finance (see Grabbe 2006; Schimmelfennig and Sedelmeier 2005b). In the words of Bohle and Greskovits (2012) the period of 1989-1998 included the historical turning points with key decisions shaping the post-socialist legislative order, while the following period until 2008 crisis brought about consolidation and further embeddedness of created structures. Such a path-dependence in adopting EU banking directives is witnessed in the adoption of institutions and legislating financial instruments that were non-existent, before the harmonization with the EU rules was initiated. For instance, investment firms and agents, financial conglomerates, securitization transactions, hybrid capital instruments, etc. were instituted in the legislation only as a result of EU’s influence, although the necessity of provisions on these notions could be questioned (see below). In that respect, the Estonian banking legislation has been exposed to path-dependency in policy formulation from late 1990s and essentially being locked in the Europeanization process. This kind of embedded socialization in the EU integration, emphasized in the historical institutionalist tradition, has been also supported by the prevalence of ‘simple politics’ approach, whereby policy-makers seek to govern with the means for constructing communicative discourses, the purpose of which has been the persuasion of the legitimacy of policies and regulations on the grounds of EU’s accession or membership obligations (see Kattel and Raudla 2013; Bohle and Greskovits 2012). Also, Sedelmeier (2011) has argued that in the matters of macroeconomic policy, such as the liberalization of the banking sector, the influence of the EU has relied on socialization strategies emphasized in constructivist analyses, even though rather quick and formal adoption of EU rules in the context of accession conditionality confirmed rationalist
expectations (see also Schimmelfennig and Sedelmeier 2005b). Yet, as stated above, historical institutionalist tradition predicates the “stickiness” of formal rules and institutions transposed to Estonia in the long-run.

It can be concluded that despite the dichotomy of rationalist and constructivist arguments in explicating the adoption of EU rules in the 1990s and 2000s, the EU’s domestic impact through the conditionality should not be overstated. Several idiosyncratic influences that were present during these times caused ad hoc reactive actions and were guided by more pragmatic considerations due to the high political salience of the issue, namely dealing with several rounds of financial crises in the 1990s. Hence, in the 1990s the legislative development in the banking sector was driven by the interplay between Europeanization process as an exogenous factor and post-communist transition process, seen as an endogenous factor. One could argue, then, that the regulation in finance, and in banking in particular, has been consistent with the differentiation thesis whereby simultaneous Europeanization, liberalization and regulation have brought about both a horizontal and vertical differentiation of regulatory authority (see Eberlein and Grande 2005). However, none of the theoretical discourses has addressed the issue of potential impact, not to mention significance of discussed regulatory tendencies for the institutional development of the banking sector.

5. Peculiarities and Direct Implications of the Harmonization Process

Veto player and goodness of fit propositions, associated with the aforementioned theoretical concepts, are of little significance in explaining transposition of EU banking directives into national legislation. First, the rationale underlying the misfit argument never emerged in the banking regulation, as regulatory philosophies or deeply entrenched models were only taking shape and were largely missing prior to the harmonization process. This could be also reasoned with the ‘new’ regulation and re-regulation of banking sector, while the communist legacy endowed no institutional resistance to EU policies (see Schimmelfennig and Sedelmeier 2005b; Grabbe 2002). Second, as already stated, it was common to justify policies by referring to EU norms and expectation in the harmonization process with the acquis. Moreover, the nationalist logic of integration required efficient
work in order to guarantee a positive evaluation in the Commission’s Progress Reports (see Laar 2000). Consequently, transposition of directives, including in the field of banking, has been excluded from daily political struggles, implying technocratic policy-making, that is, the persistence of simple polity stance of the government and de-politization of EU matters (see Kattel and Raudla 2013; also Börzel 2010; Berglof and Bolton 2001; Kaik 2002; Kivirähk 2013; Bohle and Greskovits 2012). Estonian political leadership tended to make integration an elite project because of its complexity or importance for wider democratic politics with legitimation coming from the EU rather than from the citizens. This explains the diminished role of the Parliament that was supposed to be a mere enforcer of legislation without actual influence on the formulation of legal acts, and hence, the executive bias in the overall accession process (see Grabbe 2006). However, because of low administrative capacity and priority given to speed in improving banking regulation, legal acts were of low quality with technical inaccuracies (see Kasemets 2000; Bonin et al. 2008). This implied prolonged transposition of EU directives into national legislation, evidenced by several rounds of amendments in banking-related legal acts in consequent years in late 1990s and early 2000s.

Such an approach in dealing with the EU affairs has reduced both political and administrative capacity to address the developments in the financial sector that have not been dealt with on the EU level, such as issues related to non-bank credit providers (SMS-loan providers), new forms of financing (P2P platforms), etc. First credible measures for regulating pervasive activities of non-bank financiers, who have extended so-called ninja loans, that is, high interest rate loans to no-income and no-job borrowers via easily accessible electronic channels, including mobile phones, were drafted only at the beginning of 2014 (Valdre 2014). Bohle and Greskovits (2012) have also questioned the ability to expand beyond the core EU areas aside from the implementation of the EU banking directives, despite the continued reform efforts even after the EU accession. Again, path dependence and its negative consequences in policy formulation for addressing the issues in the field of private finance can be observed.

6. ‘Dead Letters’ Manifestations

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Grabbe (2006) has argued that the encouragement of institutional isomorphism in order to gain political legitimacy for institutional and policy changes during post-communist transition could lead to functional dualism, whereby institutions resemble to the EU ones, but are not functional. Hence, concerns have been raised about the real impact of the adopted formal rules with the possibility of a mere existence of regulations on paper, that is, ‘formal structures without substance’ (see Bugaric 2006). Dimitrova (2010) has brought the danger of the EU rules being created for a different set of preferences and economic conditions that might not fit the domestic economic conditions, when transferred to candidate states. In a similar line of argument, institutionalization is undermined, if there is a mismatch between formal and informal rules, meaning that the adopted formal rules will remain rather rules-on-the-books than rules-in-use without any real effects. In addition, Jacoby (1999) has observed a specific kind of superficial domestic change through ‘Potemkin harmonization’, where political and regulatory changes were carried out for the purpose of EU monitoring without significant institutionalisation.

Similar developments are present in the field of banking regulation in Estonia. For instance, financial conglomerates, ‘significant branches’, e-money institutions and their practices have been regulated in detail, but without real use in practice due to the lack of such institutions operating in the Estonian financial market. Similarly, provisions on hybrid capital instruments, credit risk mitigation techniques, securitization transaction and instruments were legislated, although being not practiced in the banking sector19. Neither banks nor investment firms in Estonia conclude any complicated financial transactions. The types of financial instruments and transaction negotiable on the Estonian market have been restricted and trading activity has been very low, implying non-existent speculative transactions in Estonia (see Auväärt 2013; Oja 2012, 2013). For instance, foreign debt securities have been the dominant assets in the portfolio of banks, while the shares held for trading staying at low level (3 per cent of securities portfolio in 2001) (Lepik and Tõrs 2002). Essentially, mortgages denominated in foreign currency, and not complex financial structured instruments, such as CDOs, CDSs etc., were considered as innovative financial products that proved to be risky practices in CEECs, including Estonia (EBRD 2012).
Insignificance of some of the capitalization regulation regarding the trading book and counterparty risks is due to the fact that the banking sector operates in mostly commercial banking field. In addition, banking policies do not allow it to claim that managers of the Estonian financial institutions have been paid unreasonable salaries or bonuses in light of the recent EU’s attempts at reining excessive remuneration episodes. In principle, one can witness nominal (legislative) convergence with the EU legislation, but to some extent divergence between adopted rules and real life practices. This, in turn, raises the question on the effectiveness of financial policies and regulations in addressing real-life banking practices.

Furthermore, when analyzing the cases of the worlds of ‘dead letters’, Falkner and Treib (2008) found that literal translation of EU Directives at the expense of careful adaptation to domestic conditions implied frequent shortcomings in enforcement (see also Schimmelfennig and Sedelmeier 2007; Sissenich 2002). In this regard, the basic elements of the EU banking regulation, including risk weighted capital adequacy requirement, large exposure limits, initial minimum capital requirement etc., were copied into Estonian legislation in the 1990s (see Ross 2013). This explains the lack of analysis and assessment of banking legal acts in the 1990s, evidenced by the limited consultation with outside organizations as well as civil society (see Kasemets 2000) and low-quality Explanatory Notes that accompanied legislation (European Commission 1999).

It could be argued that the regulatory evolution of the banking sector was driven by pragmatic considerations in the 1990s, only to be permeated by the embedded formalist approach afterwards, that is, mechanical adoption of EU legislation, implying the nature of ‘dead letters’ in this policy field. In principle, one can observe both path-dependency in terms of a continuous alignment with the EU policies and ‘dead letters’ in the evolution of the EU-led banking regulation in Estonia. Hence, one of the problems in the Estonian banking regulation is related to its isolation from the underlying economic substance, as rules have not been adapted to the market structure. Consequently, operational functionality of regulation has been reduced with repercussions for financial supervision.
7. Supervisory Obstacles and Challenges

In contrast to transposition of prudential regulation, the EU directives have left an ample room for national discretion in the supervisory intrusiveness without any clear quality standards to be followed (see Tonveronachi 2010). This is evident in a high success rate for the new member states in transposing EU legislation into national legislation, but the failures in the policy enforcement stage, mostly due to constrained administrative and judicial capacities, e.g. weak enforcement of contracts, legal restrictions on disposal of assets backed by real estate, difficult access to collateral and low collateral recovery, and so forth (see EBRD 1998; De Castello Branco et al. 1996; Schimmelfennig and Sedelmeier 2005a; Falkner and Treib 2008; Sedelmeier 2008, 2010; Pollack et al. 2010; Steinherr 1997; Scholtens 2000). In the words of Wagner and Iakova (2001; see also EBRD 1998), the effectiveness of financial regulations was lagging behind the extensiveness of regulatory coverage.

By the mid-1990s banking regulation in Estonia was considered to be on par with international standards, but adequate implementation was lacking by public authorities, but also bank owners and auditors (Korhonen 1996). Although the central bank established basic rules for commercial banks, such as minimum capital requirements, capital ratios, exposure requirements, etc., the scope of adherence to the rules was undetermined due to ineffective supervision (Lainela and Sutela 1994). This was evident in several cases of mismanagement, like incorrect reporting of the value of the securities and non-performing loans. For instance, at the Hoiupank, equity was pledged by senior managers to back a loan to finance purchases of the bank’s shares by the very same managers, while at Eesti Maapank, mismanagement of the bank’s equity portfolio, including fraudulent behavior, brought about losses that resulted in the bank’s bankruptcy (see EBRD 1998). Eesti Maapank reported the higher face value of the securities instead of marking them to market – as required by the Bank of Estonia – thus inflating both its assets and profits. Essentially, the bank abused the option given by the central bank to undertake sophisticated transactions with forward contracts and the managers could make deals with themselves (Khoury and Wihlborg 2006). Aside from cases of engagement in extensive
insider and connected lending, banks also violated standard prudential banking norms by using illegal mechanisms, such as shell companies in order to disregard or actively circumvented legislative restrictions (Lainela and Sutela 1994; Hansson 1995, 156; De Castello Branco et al. 1996; Myant and Drahokoupil 2011, 266). Thus, fraud was present mostly due to lax enforcement of laws in the 1990s (see Steinherr 1997), which in turn, was caused by institutional and human capital constraints. For instance, in 1992 only ten officials at the Bank Inspection department in the central bank, who were mostly inexperienced newcomers, supervised over forty banks (see Hansson 1995, 159). Problems were further aggravated by limited reporting requirements and the lack of specificity in rules for transparency, disclosure of information, and insider trading (Bank of Estonia 1997). Thus, the banking problems in the 1990s were to great extent attributable to lacking supervision as well as inexperience of supervisors.

In 2000s, the rights of the Financial Supervision Authority were expanded for intervention into and inspection of the activities of banks. Particularly in 2010 and 2011, power of the Financial Supervision Authority was expanded, e.g. authority to require a reduction of the performance pay, amendments in internal rules, an increase in own funds in the reorganization plan, including increase in share capital, and make a proposal to amend or supplement the organizational structure of a credit institution among others. Yet, most of the actions have been taken against investment firms as well as insurance companies and have been related to withdrawal of licenses (mostly on the request of investment firms themselves), issuing recommendations on credit policies of banks, notifications on misleading advertising and violations of information requirement, and dealing with complaints filed against financial institutions (Financial Supervision Authority 2014). Essentially, precepts have mostly addressed the issues in relation to customer protection. This indicates to the emphasis on market conduct supervision by the FSA, whereas prudential supervision has been challenged by the broader internationalization of the banking activities.

8. Challenges in Addressing Cross-border Banking Activities
As suggested by Pollack et al. (2010) as well as Bohle and Greskovits (2007), the substantial presence of foreign ownership in the banking sector has implied that policy priorities in CEECs have been influenced by the players form EU member states. Similarly, Lenschow (2006) has attributed domestic changes to forces other than the impact of the Europeanization process, such as the increasing internationalization of finances and markets. Further, Andonova (2003) has shown the absence of opposition by potential veto players to the EU’s demands, if a policy area lacks institutional legacies or the regulated sector is highly internationalized, as is the case with the banking industry in Estonia with over 95 per cent of the banking assets controlled by the foreign-owned credit institutions.

In the case of Estonia, Sweden and other Nordic countries as home countries of banks operating in Estonia have been proactive in guiding subsidiaries and thus endowing Estonian authorities with coordination and supervision challenges (see Lehmann et al. 2011). The dominance of foreign capital in the Estonian banking sector renders all banks subject to consolidated supervision by the home country authorities. In that respect, the division between consolidated and delegated supervision is less distinct than it appears from legislation26. Further, the local supervision of subsidiaries is rendered ineffective, given that banks tend to treat subsidiaries increasingly as branch offices. Within vertically integrated financial groups, centralized strategies are being implemented in a manner that is oblivious of national legislation and where subsidiaries remain relevant only for tax and accounting purposes (see ECB 2005; Pistor 2009). Consequently, cross-border dimension of banking activities and supervision has allowed for political risks, associated with regulatory and taxation policies (see Kudrna, Gabor 2013). Moreover, political risks are present due to two unaddressed issues in the current regulatory regime: the misallocation of regulatory responsibility and related lack of accountability for failures in markets beyond the home regulator’s jurisdiction (see Pistor 2010).

Potential legal loopholes in Estonia exist in the area of the reallocation of capital and liquidity through internal capital markets, which enable banks to evade taxes and undermine any counter-cyclical financial (monetary) policies at the disposal of the Bank of Estonia due to a non-transparent transfer pricing mechanism (see also Kudrna, Gabor
Duty of corporate income tax that has been levied in Estonia only in case of profit distribution, that is, exemption on re-invested profits, has been circumvented by substituting repatriation of retained earnings with lending to parent companies (Sulg 2014; also Vadler 2010). As of 2009, the accumulated retained earnings of the banking sector amounted to 1461.5 million Euros or 10.6 per cent of GDP, compared to 0.4 million Euros and 0.006 per cent of GDP in 2000 (Bank of Estonia 2012), and none of the foreign subsidiaries has paid out dividends as of end-2013. Out of 1.4 billion Euros as net profit of four largest banks for the period of 2010-2013 (III quarter), only 21 million Euros was paid in income tax (Arumäe 2014).

Similarly, the effectiveness of entity based regulation in Estonia, such as higher capital and reserve requirements, in curbing the credit growth has been impaired by the possibility of parent banks to circumvent Estonian legislation and prudential policies by providing cross-border financial services to local businesses or lending to leasing, asset management and other non-bank financial institutions within the same group that are not included in the banking statistics (see Pistor 2010; Atanas and Sanne 2013; Ross 2013; Lehmann et al. 2011). This, in turn, has been made possible by the universal banking model, stipulated in both the Estonian legislation and the EU banking directives. Financial intermediation was envisaged to be built around the universal banks and eventually resulted in credit institutions growing into banking groups (Lepik and Törs 2002; EBRD 1998).

Therefore, the effect-based regulations have been curtailed within the established regulatory framework; particularly in relation to the cross-border provision of financial services and the activity of branches (see Pistor 2010). The banking supervisory has focused on the solvency of individual institutions, but not on macro-prudential issues, such as dynamic systemic risks in the whole system (see also Kregel 2014 for a general discussion of this issue). In the established legislative framework, the potential danger for Estonia lies in insufficient interest of a home country regulator in a subsidiary that might have an insignificant part on the banking group level but entails systemic risks for the financial sector in Estonia (see Bonin et al. 2008; EBRD 2012). In that respect, the liquidity and credit squeeze could emerge in case of repatriation of liquid assets from Estonia, when parent banks
banks face funding difficulties. Furthermore, as foreign owned banks serve as the main channel for productive investments, weak domestic regulator and supervisor also poses a threat of diminished investments. Such an international dimension of banking activities has put Estonia in a complicated position in guaranteeing financial stability (see Begg 2009). All in all, the overall outcome of financial liberalization, the dominance of financial groups from Nordic countries, and the systematic ‘outsourcing’ of regulatory supervision to home country authorities has been a form of financial governance that emphasizes positive integration, but is void of feasibility to control the risks associated with exposure to capital flows (see Pistor 2009; Khoury and Wihlborg 2006). The outsourced nature of supervision was exemplified during the crisis by the emergence loan taken by the Swedish central bank to cover the potential losses of Swedish banks in Estonia and elsewhere in the Baltics. Hence, Estonia has been lacking an effective governance regime for finance that has addressed only the credibility aspect of finance (and this security of the payment systems), but not money supply — two sides of the same coin that are conventionally interlinked. As argued above, this division of labor within the banking sector follows in Estonia the dividing line between domestic and foreign actors.

It can be argued, further, that domestic efforts for financial stability through the build-up of banking regulations have been undermined by the need for Europeanization processes. For instance, in relation to higher capital requirements for mortgage lending and to counter overheating, new EU level regulations meant for Estonia pro-cyclical loosening of requirements as domestic regulations had to be scaled down. Similarly, stricter rules could not be introduced in Estonia alone that would have made the equal treatment of branches and subsidiaries problematic, while the initiatives to introduce stricter risk weights on mortgage loans at the regional level failed due to contradiction with broader process of harmonization of regulations as well as differences in authority and motives (see Sutt et al. 2011; Ross 2013). For instance, Estonian supervisors’ petition for stricter capital requirements during the boom years was rejected by the Swedish peers on the grounds of sufficient capitalization on the group level (see EBRD 2012).

As a response, the regulatory voids left by the EU legislation in addressing cross-border
financial stability and the allocation of responsibility have been filled with new types of informal institutions, that is, the transnational regulatory network in the form of memorandum of understanding (MoU). As a co-ordination mechanism this informally harmonizes regulatory activities of regional members (see e.g. Eberlein and Grande 2005). The Baltic-Nordic MoU, signed in August 2010 has been considered as one of the most specific burden-sharing model, which was based on asset share of the financial group in a given country and introduced exacerbating and mitigating factors that adapt the share of the country (Kudrna 2012). Compared to other similar agreements, it was special for engaging ministries of finance (along with central bankers and financial supervisors), for introducing a permanent body – the Nordic-Baltic Cross-Border Stability Group (NBSG) – to oversee financial stability issues, and for including ex ante burden-sharing procedures (EBRD 2012). Yet, Märten Ross, the former deputy governor of Bank of Estonia has acknowledged the difficulties in such a coordination of regulations in the region, although stressing the importance of cross-border coordination of banking supervision (Ross 2013).

It has been established that within the emerged architecture of the financial regulation on cross-border banking activities, the presence of two supervisory authorities challenges the supervision as well as the application of macro-prudential measures. This was seen during the credit boom in the mid-2000s, encouraged by limited control by the Estonian authorities over the crediting of the economy and insufficient cross-border coordination that impaired prudential regulation to halt the over-heating of the economy (EBRD 2012). This raises the question on the compatibility of two characteristics of the integration process, namely the simultaneous liberalization of external accounts and national responsibility for financial stability without EU-wide lender of last resort facility.

9. Conclusions
Regulation of the banking industry in Estonia is theoretically significant in many respects. There is no clear straightforward model that would explain the evolution of the banking legislation, as all theoretical concepts – lesson-drawing model, rationalist institutionalism, and historical institutionalism – are applicable for understanding the dynamics at certain periods in the regulatory development trajectory. This is witnessed in the interplay of
domestic features, such as banking crises in the 1990s that required steadfast responses by the public authorities\textsuperscript{30}, and external factors, such as increasing presence of foreign financial intermediaries in Estonia from late 1990s. Both the need to build up the institutional framework for private finance and address re-occurring crises anchored the banking regulation and supervision (nominally) to EU and other international principles and practices. As seen from the table 1 above, many facets of the Estonian banking regulation and wider liberalization agenda outperformed international practices, not to mention those of other CEECs. From time to time, Estonia has been “accused” of meticulous punctuality in applying the EU regulations, in some cases directly copying from external legal sources, and setting even stricter requirements than the EU would dictate. For instance, Estonia has implemented a reserve requirement on liabilities of 11-15 per cent or a 10 per cent capital requirement throughout the accession and post-2004 period, compared to the ECB’s minimum requirement of 2 per cent on liabilities with maturity up to 2 years and a 8 per cent capital requirement in most Western European countries (ECB 1998). This, however, has created a paradox of exemplary compliance with EU standards in terms of its extensiveness, but meager effectiveness in addressing real-life developments in the banking industry. The paper has shown the pragmatic approach to establishing regulatory and supervisory framework in the 1990s in the context of crises, internationalization of banking, and also EU accession aspirations, while 2000s mark gradual outsourcing of oversight and embedded formalism or regulatory ‘auto piloting’ in terms of deepening reliance on external [EU, Basel] normative standards with insignificant economic substance, given the local circumstances. As indicated above, several institutions and prudential norms were introduced in Estonia only due to the harmonization process with the EU legislation with little or no intersection with practices in the banking sector. Furthermore, given the ideological (neo-liberal) position of government coalitions on the one hand and the necessity to establish new institutions from scratch on the other hand, the evolution of the regulatory framework in Estonia has been a mix of de-regulation and re-regulation at the same time. Particularly, this was the case in the early 1990s, when
several institutions were established and corresponding regulations implemented but with gradual easing of overall supervisory grip.

One of the peculiarities of the Estonia banking industry has been a high degree of internationalization, which has entailed important ramifications for the local financial system. Foreign acquisitions in Estonia have changed the institutional landscape and deepened financial sector’s cross-border integration, but also posed the economy to new challenges. As a result of the institutional transformation and internationalization of the Estonian banking sector throughout the last 20 years, several challenges to the regulatory and supervisory framework have emerged in addressing the problems in cross-border banking crisis management, such as insufficient information, limited power, and conflict of interest (see Kal Wajid et al. 2007). Moreover, the general tendencies toward supervisory consolidation based on home-country principle and the centralization of key business functions, such as liquidity and risk management, have made separate assessments of subsidiaries more difficult, when the obligation for general financial stability runs along the national borders. Thus, deep Europeanization in terms of both normative but also industry-wide convergence has locked Estonia into dependency in terms of decreasing political and economic autonomy, essentially trapping the economy into paths that tend to reproduce, but as seen above also contribute to fragility.
Studies have been mostly undertaken in the fields of environmental policy (e.g. Héritier 2001) and social policy (e.g. Linos 2007; Falkner et al. 2005), while only few studies exist on the impact of the EU banking legislation on the banking and finance in CEE, focusing on the region as a whole or Visegrad countries in particular (see Green and Petrick 2002; Mörner 1997).

Due to the legacy of communism and a landscape of institutional relics, and hence, lack of embeddedness of political institutions, the goodness of fit argument between an EU and the CEE institutional context has not been relevant with institutional inertia playing a lesser role in reducing the impact of EU rules in the CEECs (Grabbe 2006; Schimmelfennig and Sedelmeier 2005b).

For instance, until 1992, foreign ownership of banks by either legal or natural persons was not allowed (Lainela and Sutela 1994).

The ratio of a bank’s own means to the total of risk weighted assets and liabilities.

The ratio of a bank’s liquid assets to current liabilities.

The ratio of total liabilities of high risk-concentration clients to the bank’s own means.

Credit Institutions Act (RT I 1995, 4, 36).

The loans to one customer or connected parties were not allowed to exceed 25% of the bank’s own funds, while the total sum of large exposures 800% of the bank’s own funds (Bank of Estonia 1997; Bank of Estonia 1995).

Credit Institutions Act (RT I 1999, 23, 349).

Debt Restructuring and Debt Protection Act (RT I, 06.12.2010, 1)

In contrast to the Second Banking Directive, the underlying principles of the First Banking Directive embraced by the European Agreements provided the option of limited liberalization in terms of allowing host state to impose an authorization regime similar to the regime applicable to domestic institutions and exercise its supervisory powers on the activities of foreign bank branches (see also Matoušek and Taci 2002, 91-92; De Castello Branco et al. 1996).
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13 Estonia with all other the new members of the EU had transitional arrangements in the acquis, governing the part of financial services sector, in particular concerning the arrangements in the coverage and sufficiency of deposit guarantees and investor compensation mechanisms (Singh 2004).

14 Aside from the EU’ provision of external anchors in institutional development, the influence of other IFIs has been somewhat ambiguous. For instance, the propositions of the IMF to reject currency board arrangement at the dawn of the currency reform, abandon flat tax regime, and implement property tax after 2008 crisis were not been considered by the Estonian policy-makers (Bohle and Greskovits 2012).

15 The nationalist argumentation worked in the opposite direction in other CEECs, where legislation was more antagonistic towards foreign capital because of the fear of potential capital flight and inappropriateness of credit provision for economic development, whereas in Estonia, nationalist sentiments on the premise of safety nets against the ‘eastern’ influence implied openness to foreign ownership in the banking (see Bonin et al. 2008; Bohle and Greskovits 2012).

16 De-politization took place also in the public finance, as Estonia has opted for the independent central bank and currency board regime that in essence de-politicized monetary policy (see Bohle and Greskovits 2007; Khoury and Wihlborg 2006).

17 Resembling to the notion of ‘quasi-Europe’ marking the desire of CEECs’ elites to impress foreigners by focusing on the degree of Westernization (Love 1996).

18 In particular, the political position of governments on the alignment with EU policies was less important once accession negotiations started and clear conditionality for membership was in place (see Hille and Knill 2006).

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21 In a study on Hungarian banking in transition, Petrick (2002) found that neither *acquis communautaire* nor the Basle rules were designed to deal with the situation that Hungary was faced with, that is, the pervasive state-ownership, a newly formed, but financially weak and inexperienced banking sector, and a reliance on inter-enterprise debt relations.

22 Interestingly, more and more banks perceive capital regulation in Estonia to be too strict and consider the local legal system as adequate, although legal enforcement has still been seen as the weakest area (EBRD 2011).

23 General weaknesses in supervision were also related to a lack of adequate training arrangements for upgrading of skills and knowledge in new financial products (Khoury, Wihlborg 2006).


25 Investeerimisfondide seaduse ja sellega seonduvate seaduste muutmise seadus (RT I, 24.03.2011, 1).

26 The Capital Requirements Directive form 2007 has assigned the home country authorities the task for coordinating the exchange of information and cooperation between national authorities involved in the supervision of multinational banks that has to take into account the importance of a foreign subsidiary for both the parent group and from the host country perspective (EBRD 2006). Moreover, national legislation provides the opportunity to transfer the supervisory duty to the home country authorities.

27 In 2004, credit provided by bank-owned leasing companies accounted for 15.4 per cent of GDP in Estonia (Mihaljek 2006).

28 One of the problems of the EU banking directives to be adopted during the accession process was the centrality of the universal banking that allowed banks to hold shares of non-bank and non-financial entities in excess of risk exposure ratios, that is, 15 per cent of their own funds with the total of all holdings not exceeding 60 per cent of an institution’s own funds, during a financial reconstruction or rescue operations. However, in the CEECs
this situation was a rule, not the exception, as the whole economy needed restructuring and the directive enabled a 10-year period for the banks of new member countries to dispose excess holdings. Furthermore, the Second Banking Directive also offered the possibility to exclude from its scope credit institutions that specialized in public debt markets, which pre-dominated the CEECs markets – in the light of rehabilitation programs of state-owned banks, banks would not have loans to enterprises but to the government or to entities with government guarantees in exchange for government rehabilitation bonds, all of which would dramatically improve their solvency ratios. Thus, the EU directives foresaw a situation that did not exist in CEECs by assuming functioning market economies (see Borak 2000). In Estonia these issues were irrelevant, as Estonia did not have institutions specializing in inter-bank and public-debt markets fulfilling the institutional function of banking-system liquidity regulator. Moreover, the banking activities undertaken in the CEECs countries correspond to the concept of a narrow not universal banking of an Eastern banking model according to the circumstances of the transition (ibid.). In some cases, universal banking model was undermined, e.g. in Czech Republic and Hungary commercial and investment banking operations had to be separated in 1998 amidst the accession process (see EBRD 1998; Petrick 2002, 137-138).

29 For instance, the Hungarian regulation on the banking did not allow the banks to engage in investment banking activities in the early 1990s (Buch 1993; Scholtens 2000). Also, as the Hungarian authorities would have been exposed to asymmetric information and development abroad, foreign bank branches were not allowed to Hungarian market until 1998, but after that the principles of the EU legislation were not adhered to by requiring foreign branches to join Hungarian deposit guarantee schemes, meet all prudential requirements, and provide initial endowment capital (Wagner, Iakova 2002; Horvath, Zsamboki 2000). In Poland too, there were restrictions on the operation of foreign banks through the conditional licensing to foreign banks, which implied that a foreign bank acquired license only if agreeing to rehabilitate a distressed Polish bank until 1998 (Havrylchyk 2006). Even stricter banking regulation and capital controls were adopted in Slovenia that restricted non-residents’ participation in the local capital market and banking
services provision until the end of 1990s and early 2000s. Moreover, foreign banks could not establish branches in Slovenia without the Bank of Slovenia’s license and were not allowed to provide banking and other financial services directly until Slovenia had become a full member of the EU (Cufer et al. 2002; EBRD 1998; Borak and Lavrac 2002, 119; Bohle and Greskovits 2012).

Estonia was leader in the number of banking sector bankruptcies in the whole Eastern Europe in the early 1990s and responsiveness by the central bank to the growing problems of the banking sector (Lainela and Sutela 1994). In 1992, the authorities closed one bank without rescuing its depositors and merged two banks with a partial bail-out. Further, after the prudential measures were introduced in 1993-94, the Bank of Estonia did not renew the licenses of eight banks, while ten banks were forced to merge into one bigger bank, two smaller banks were forced into bankruptcy with dire consequences for depositors, and three banks declared a moratorium as a result of not meeting new requirements. Similarly, in 1998 and 1999 the central bank initiated bankruptcy proceedings and some banks were merged in order to prevent possible instability in the Estonian banking sector (Hansson 1995, 143; Khoury and Wihlborg 2006).
Table 1. Transposition of the EU banking directives and the Europeanization of the Estonian banking sector, 1992-2011

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<tr>
<td>Event</td>
<td>3rd building crisis: establishment of the Bank Supervision Authority</td>
<td>2nd building crisis</td>
<td>Stock market crash, 3rd building crisis, and takeover of banks by foreign investors</td>
<td>Creation of joint banking, insurance, and securities supervision: Financial Supervision Authority</td>
<td>Division of FSA’s supervision of capital and services</td>
<td>Collapse of real estate and consumption bubble</td>
<td>The Baltic Nordic Model, signed in August</td>
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<td>Significantly improved and EU accession process</td>
<td>Joined the IMF</td>
<td>Signing Accession (European) Agreement with the EU</td>
<td>Opening of account registration with Estonia</td>
<td>Estonia’s European Agreement entered into force</td>
<td>Estonia joining the EU</td>
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<td>Transposition of the EU banking directives</td>
<td>2002/87/EC on the supervision of credit institutions and control of large exposures of credit institutions</td>
<td>92/106/EC on the supervision of credit institutions on a consolidated basis</td>
<td>2003/51/EC on the supervision of credit institutions</td>
<td>92/221/EEC on the supervision of credit institutions on a consolidated basis</td>
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<td>92/311/EEC on the monitoring and control of large exposures of credit institutions</td>
<td>88/366/EEC on the supervision of credit institutions on a consolidated basis</td>
<td>92/106/EC</td>
<td>88/409/EEC on the supervision of credit institutions</td>
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| Source: author’s elaboration

1. Implicit transpositions of the directive by repealing the legislation of 1991-1993 on restrictions on non-residents’ possession of the shares of Estonian commercial banks, on foreign currency transactions (allow and restrict), requirement to earmark foreign financial institutions (warrant, swaps, OTC financial derivatives, etc.), regulations on commodities trading and commodity markets, the possibility for contractual selling, and obligations on option risk, trading book credit and counterparty risks, based on the Directives 93/6/EC and 93/6/EC, the latter with its annexes being basically translated into Estonian legislation.

2. Introduction of credit risk mitigation, operational risk, internal ratings based approach, and the regulation of securitization transactions with majority of the provisions of the directive being implemented into Estonian law by more or less identical provisions. Several regulatory provisions were not transposed due to relevance and practicalities in the institutional structure of the Estonian financial system, e.g. FSA not being responsible for any supervisors on a consolidated basis or existence of an credit institution whose parent company would be an investment firm. The adoption of options and disclosures provided by the Directives was based on the principle of risk-based approach, avoidance of unjustified differences with other countries of high importance for Estonia, and the following of the options other countries have already taken (see Verheugt-Van Vlijmen 2000).

3. Amendments included the grounds for common decision-making procedures for ensuring capital adequacy of banking groups operating cross-border, defining significant branches, and operating in the colleges of supervisors. Significant changes with regard to own funds were associated with the inclusion of the so-called hybrid instruments in the own funds. The acts also specified the requirements related to securitization.

4. Amendments in the Credit Institutions Act were mostly related to the principles of remuneration of personnel, requirements on the disclosures of securitization instruments and trading book portfolio, the regulation of “re-securitisation”, capital requirement for additional – default and migration - risks (calculation, methods, risk mitigation), and capital requirement on counterparty credit risk from unsecured securitization transactions.

5. Principles of the directive adopted in the national legislation concerned the consolidated and sub-consolidated supervision, calculation of large exposures, delegation of supervisory responsibility, cross-border cooperation between competent authorities that were introduced for the first time in 1999 for supervisory purposes.

6. Legal harmonization included the introduction of a single “close link”, the grounds for an exchange of information between competent authorities and other authorities (information from an obligation to provide information to the central bank and the Ministry of Finance), and the regulation on professional secrecy and confidential information.

7. The regulation covered the terms and definitions for a financial complement with the regulation on short-term transactions, internal control, and supplementary supervision on a group-wide basis. Regulation on financial conglomerates was only provided in the Insurance Activities Act that covered the structure and the wording of the directives. Regulation on financial conglomerates was introduced into Credit Institutions Act in 2013.

8. Both Directives 92/221/EEC and 2004/49/EC were transposed into Securities Market Act, but relevant provisions were also incorporated into Credit Institutions Act due to the universal banking system in Estonia.

9. The Deposit Guarantee Act of 1998 was harmonized with the directive, but the full implementation of the directive was not undertaken with the transition period until 2007 for full harmonization. Provisions on definitions, range and scope of the guarantee coverage, membership conditions in the guarantee scheme, two-home country guarantee schemes in case of cross-border banking activities were adopted during that period.

10. Before the 2004 amendments in the Credit Institutions Act, the regulation on winding-up and reorganisation was too narrow and did not address the cases of cross-border banking, including information sharing and dialogue between the competent authorities of different member states. The new section in the act established antecedent procedures, publication and language requirements with regard to winding-up operations, and provided the basis for cooperation between competent authorities of member states, associated with liquidation proceedings.
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THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation?; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?
This project has received funding from the European Union’s Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

THE PARTNERS IN THE CONSORTIUM ARE:

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<td>2</td>
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