Financial Regulation in ESTONIA AND SLOVENIA

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SLOVENIA & ESTONIA IN FIGURES I

Area:
- Slovenia: 20 273 sq km, 66% forests;
- Estonia: 45 227 sq km, 47% forests.

Population:
- Slovenia: 2.02 millions;
- Estonia: 1.29 millions.

Language:
- Slovenia: Slovenian (Italian, Hungarian minorities);
- Estonia: Estonian (Russian minority).

Political Arrangement:
- Slovenia: parliamentary democracy, coalition governments, “left” or “right”
- Estonia: parliamentary democracy, mostly “right-wing”-dominated coalitions.

History:
- Slovenia: until 1918 part of Austro-Hungarian empire; 1919-1941: part of Kingdom of Yugoslavia; 1941-1945: occupied by Germany, Italy and Hungary; 1945-1991: Yugoslav republic; 1990: political transition; 1991: independence June 25, short war, Brioni agreement, October 8; May 1, 2004: EU member state and NATO; January 1, 2007: EMU member; 2010: OECD.
The level of GDP (per capita in PPP) and GDP growth in Estonia and Slovenia during 1980-2010.
STARTING POSITION: level of development; openness of the country; costs and benefits of separation from Yugoslavia; 58% of “foreign” market, heritage of self-management and social property; survival of the old economic and political elite;

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1. PRIVATIZATION: a model of decentralized, distributional, and gradual transformation of social property; creation of 2.000.000 “capitalists”:

2. MACROECONOMIC STABILIZATION: benefits of ignoring Washington consensus with assumption S<D, gradualism versus shock therapy, floating exchange rate;

3. MICROECONOMIC RESTRUCTURING: gradualism versus shock therapy, slow decentralized restructuring, retiring rather than firing, cautious approach to FDI;

4. CREATION OF A NEW ECONOMIC SYSTEM: EU convergence, “acquis” and transition from a country to a region;
BASIC FEATURES OF ESTONIAN TRANSITION MODEL

STARTING POSITION: transition from socialist socio-economic production system into capitalist mode; destruction of the Soviet legacy and reorientation towards new markets; opening up the economy; success of small South-East Asian states and Scandinavian countries as a role model; the collapse of output and the breakdown of the economy - loss of skills and complexity that were created and embedded in the Soviet cross-border production networks.

1. PRIVATIZATION: mass privatization (Treuhand model approach – rapid and centralized privatization to strategic foreign investors with the sale of majority ownership (completed largely by 1996)); the privatization of land and dwellings with national capital bonds - by 2001, 98.5% of housing units in the hands of private persons --> real estate as a collateral for housing loans.

2. MACROECONOMIC STABILIZATION: the neo-liberal model, coupled with non-corporatist and national-conservative attitudes by copying policies from Washington Consensus toolbox and EU policies; shock therapy (liberalization of trade barriers, price controls and non-existent state support); currency board arrangement; overall exposure of the economy to the developments outside Estonia, i.e. the monetary policies of the European Central Bank, the EU fiscal transfers, decisions by the Scandinavian parent banks, external demand for foreign-owned companies in Estonia.

3. MICROECONOMIC RESTRUCTURING: economic Darwinism; rapid restructuring – from complex cluster-like vertically integrated economic structures in manufacturing to SMEs in services/commerce; one of the most resolute and strictly followed bankruptcy laws in the CEE region; emphasis on attracting FDI with trade and capital flow liberalization, price stability, and low taxes - FDI-led economic transformation (enclaves, lack of embeddedness), (unsustainable) growth, and (de)industrialization.

4. CREATION OF A NEW ECONOMIC SYSTEM: EU convergence, “acquis”, and industrial, commercial, and financial integration with (dependence on) the Scandinavian countries.
MAJOR FEATURES OF MONETARY AND BANKING SYSTEMS IN SLOVENIA, 1991-2000

MONETARY POLICY:
- managed floating, prevention of real appreciation of the currency SIT;
- sterilization of foreign exchange flows;
- restrictions of portfolio investments inflows of capital;
- foreign exchange minimum;
- restrictions on borrowing abroad;
- indexation of interest rates BASE RATE (TOM) calculated by inflation;
- gradual de-indexation of BS bonds 1991-1999

REHABILITATION OF BANKS:
- transition, independence and privatization;
- bad loans, negative capital of the banks;
- Agency for Rehabilitation, “bad bank” replacing bad loans by bonds;
MAJOR FEATURES OF MONETARY AND BANKING SYSTEMS IN ESTONIA, 1994-2011

MONETARY POLICY:
- fixed exchange rate (currency board system) -> real appreciation of the currency EEK, interest and exchange rate determination “outsourced”;
- no sterilization of foreign exchange flows;
- no restrictions on capital inflows for portfolio or direct investments (existed on foreign currency accounts and direct investments (requirement to get a license for acquisition of a holding in a bank) between 1992-1994);
- no restrictions on borrowing abroad (requirement to register foreign loans until 1994);
- no government bonds;
- conservative reserve policy: liquidity ratio (30%) and minimum reserve requirement (10% (1993)->13% (1997)->15% (2006)->2% (2011)) - holding sufficient reserves of domestic currency or assets that can be freely converted into foreign currency.

REHABILITATION OF BANKS:
• Severely restricted LOLR function of the central bank;
• Transition period (dismantling of ex-Soviet all-union specialized banks); rescuing banks, wrecked by the crises in the 1990s (“nationalization”) with subsequent privatization; and the acquisition of banks by Scandinavian banks (four largest foreign banks account for over 95% of the market in terms of both total assets and share capital);
• In the 1990s (1992, 1994, 1997/98) three crises due to the collapse of the Soviet regime, bad loans and speculation on the capital markets. No agency for rehabilitation, three options for troubled banks: bankruptcy, loosing license, or merging with newly established commercial banks. Lack of assistance from the Bank of Estonia by buying up illiquid assets, writing off debts, or granting loans to problematic credit institutions.
INITIAL DOMESTIC REGULATION: (June, 1991): together with the Constitutional Act on the Implementation of the Basic Constitutional Charter
- Bank of Slovenia Act,
- Banks and Savings Banks Act,
- Foreign Exchange Transactions Act,
- Pre-rehabilitation, Rehabilitation, Bankruptcy and Liquidation of Banks and Savings Banks Act;

EXPANSION OF REGULATION:
- Banks and Savings Banks Act (1991) – 5006 word
- Banking Act (1999) – 25185 words
- Banking Act (2006) – 47532 words

INSTABILITY CAUSED BY CHANGES IN REGULATION
- 70 decisions by BS in the period 2006-2013 related to capital, capital adequacy and risk management:
- pro-cyclical behavior of the regulators- from credit addiction to credit crunch
FINANCIAL REGULATION IN ESTONIA

initial regulation and its expansion

- The Banking Bill (1989-1994, of Soviet period),
- Foreign Investments Act (1991-2000),
- Foreign Currency Act (1992-1994),
- Bank of Estonia Act (1993-…),
- Securities Market Act (1993-…),

EXPANSION AND HARMONIZATION OF REGULATION WITH THE EU (1995-…):
- Credit Institutions Act (1995) – 102§ (10194 words); Credit Institutions Act (1999) – 143§ (16251 words); Credit Institutions Act (2008) – 240§ (37111 words)
- Money Laundering Prevention Act (1998)
- Savings and Loan Associations Act (1999)

RE- AND DE-REGULATION -> MIS-REGULATION
- rigorous transposition of the EU directives into national legislation from 1995 onwards -> constant changes in the regulations (core principles + incremental adjustments), e.g. capital requirements in the decrees of the Bank of Estonia amended almost annually during 1994-2002;
- mismatches in the regulation: detailed regulation of securities markets (to same degree as commercial banks), although virtually non-existing securities markets and investment firms in Estonia + regulation of financial instruments (e.g. hybrid instruments in own funds) and institutions (e.g. e-money institutions) that have not been used or have not existed in the market.
- on the other hand, lack of regulation of non-bank finance providers (SMS-loans).
- rather counter-cyclical behavior of the central bank (but not government), but nevertheless insufficient to prevent from credit addiction to credit crunch
Subjects:

- liberalization of capital movements, credit institutions and investment firms, supervision on a consolidated basis, supervision of financial groups and conglomerates, large exposures, investment services, deposit guarantee, crisis management schemes, cross border competition and permitted activities, capital requirements, accounting:
  - Directive 2006/48/EC relating to the taking up and pursuit of the business of credit institutions,
  - Directive 2006/49/EC on the capital adequacy of investment firms and credit institutions,
  - Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions,
  - Directive 94/19/EC on deposit-guarantee schemes,
  - Directive 2001/24/EC on the reorganization and winding up of credit institutions,
  - Directive 89/117/EEC on obligations of branches regarding the publication of annual accounts

Decisions by BS based on the Banking Act by subjects in the period 2006-2013:

- **Capital, capital adequacy and risk management:** 70 decisions
- **Accounting and auditing:** 2 decisions
- **Licensing:** 6 decisions
- **Deposit guarantee:** 2 decisions
- **Other:** 3 decisions
EU DIRECTIVES IN THE CREDIT INSTITUTIONS ACT (ESTONIA)

Separate, doubled and overlapping regulation for credit institutions and securities markets (investment firms)

Subjects in the Credit Institutions Act:
- General provisions and definitions, authorization of credit institution - cross border competition and permitted activities, share capital and qualifying holdings, management and organizational structure – requirements on managers/employees, division and merger of credit institutions, guarantee of financial soundness (prudential ratios, methods for calculating capital requirements, payment and settlement systems & protection of clients, large exposures), disclosure and reporting (accounting), supervision on a consolidated basis, moratorium, crisis management schemes (reorganization & winding-up), liability:
  - Directive 2006/48/EC (2009/111/EC; 2010/76/EC) relating to the taking up and pursuit of the business of credit institutions,
  - Directive 2006/49/EC (2009/111/EC; 2010/76/EC) on the capital adequacy of investment firms and credit institutions,
  - Directive 86/635/EEC (2003/51/EC) on the annual accounts and consolidated accounts of banks and other financial institutions,
  - Directive 2001/24/EC on the reorganization and winding up of credit institutions,
  - Directive 89/117/EEC on obligations of branches regarding the publication of annual account,
  - Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate.

Related decrees of the Bank of Estonia, based on the Credit Institutions Act by subjects in the period 1995-2013:
- Decree on capital, capital adequacy and risk management: 17 amendments
- Decree on annual accounts and reports: 23 amendments
- Decree on licensing: 5 amendments

Deposit Guarantee Act: separate law from 1998, based on Directive 94/19/EC (2009/14/EC) on deposit-guarantee schemes,

Relevance of FDI

Estonia and Slovenia FDI inward stocks and % of GDP

FDI stocks inward (million USD) % of GDP

- EST FDI stocks inward
- SLO FDI stocks inward
- EST FDI % of GDP
- SLO FDI % of GDP
Income distribution

Share of wages in GDP

- Estonia
- Slovenia
Sectoral balances (ESTONIA)
Sectoral balances (Slovenia)

Slovenia

-3000.00
-2000.00
-1000.00
0.00
1000.00
2000.00
3000.00


-3000.00 -2000.00 -1000.00 0.00 1000.00 2000.00 3000.00

foreign sector balance
private sector balance
government balance
Some conclusions

• Est/Slo initial reforms almost complete opposites: open vs managed financial/economic system
• The EU as a strong driver of regulatory/systemic convergence
• Financial fragility not seriously dealt with by financial regulations / regulators (credit addiction), esp with rising importance of the EU
• Government financial position makes the difference in post-crisis developments