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Estonian banking regulation as a "world of 'dead letters'" – the interplay of Europeanization process and national idiosyncrasies

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Abstract

Depolitization of public finances, majority foreign ownership of the banking industry and transition economy elements, accompanied by re-occurring banking crises in the 1990s have posed significant challenges for the regulatory framework in Estonia. Furthermore, the EU accession anchored the legislative development to external institutions and actors. Although banking regulation has been exemplary on paper, there have been significant weaknesses in implementation due to both internal incapacities and inadequacy of the formal EU law based regulatory principles for addressing the cross-border banking issues (accountability and responsibility for stability). Consequently, the established institutional setting in Estonia has not been able to address the division of two main functions of the banking sector between domestic and external actors: the functioning and safe payment systems by domestic actors and the financing of productive investments by external actors through foreign investments.

1. Introduction

The 2008 financial crisis revealed the shortcomings of financial policies on both national and international level. Though views have differed on the exact causes of the crisis and policy failures, meager requirements in trading, lack of transparency in complex financial instruments and freedom left to unregulated non-bank actors have been presented as some of the reasons behind the turmoil in the financial markets (see European Commission, 2010; Montanaro & Tonveronachi, 2011). Still, deeper understanding of the implications of regulatory environments has been a challenging task, in particular, in the European Union (EU) context, where limited real convergence of policies and institutions has been observed, that is, inconsistencies in the adjustment to EU policies and more specifically to the *acquis communautaire* across policy areas and countries (see eds. Kohler-Koch & Eising, 1999; Héritier, 2001; Jacoby, 2004).

Inside the EU, Central and Eastern European countries (CEEC) stand out for deep integration with international markets, including for capital markets and various financial services, which explains why and how they were hit to greater or smaller extent by the 2008 global crisis. The crisis itself revealed several vulnerabilities of these economies, particularly dependence on high-volume cross-border funding via internal capital markets within the banking groups (see Bohle & Greskovits, 2012; Lehmann et al, 2011; De Haas & Naaborg, 2005, 2006). That being the case, CEECs have found themselves in a position, where the governance of finance, dictated by regional or global regimes has disabled national governments to shield their economies against the crises as evidenced by their unsuccessful attempts to control the credit boom of 2000s (see Pistor, 2009). Therefore, the challenges in the governance of finance for CEECs arise from the multidimensionality of the financial regulation in terms of the interplay of national and supranational actors as well as institutions that could be addressed from both the Europeanization and 'regulatory state' thesis (see ed. Majone, 1996).

So far, the scope of the Eastward Europeanization research has been rather wide with the focus on the entire *acquis* without any single country or issue on the agenda. Most of the research attention has been also placed on the output level, that is, legislative decisions with the focus on explanatory factors that affect the correct and timely transposition of the EU policies, and not so much on outcomes in terms of implementation performance (see Falkner et al, 2005; Treib, 2008). Hence, in light of the regulatory failures in finance and the impact of the EU on the evolution of financial policies at the national level, the current paper addresses the development of the banking legislation in one of the CEECs – Estonia – during the period of 1991-2011. Compared to other CEECs, the peculiarity of the Estonian financial system stems from the operation of the currency board system operating until 2011 and substantial foreign ownership in the banking industry with the four largest foreign-owned 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, when it comes to compliance with the EU regulation (see Sedelmeier, 2010; 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. In this regard, the current chapter aims to explain the factors affecting the formation of the regulatory practices and also to understand the implications of the alignment with the EU banking regulation for the financial supervision and overall stability.

The following analysis will be undertaken within the conceptual framework of Europeanization and the institutionalist tradition. 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. The second part of the study 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 supervision.

2. Multifaceted concept of Europeanization

Europeanization as a reflection of the convergence process has been presented in several ways: 1) 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 & Sedelmeier, 2005a; Kaeding, 2006), 2) substitution of national policy-making with supranational one that modify patterns of political and administrative behavior (Radaelli, 2000; ed. Majone, 1996), or 3) 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, it is the mechanisms of the Europeanization and the constructs behind them that give a better 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 (see Grabbe, 2006; Jacoby, 2006). In that respect, theoretically-informed studies on the Eastward Europeanization that reason compliance, enforcement and policy changes could be built around: 1) a rational choice insitutitonalist 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 (see Radaelli, 2000; Schimmelfennig & Sedelmeier, 2002; Schimmelfennig & Sedelmeier, 2005a; Börzel & Risse, 2003; Pollack, 2010; Etienne 2011).

Schimmelfennig & 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 also 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 this regard, CEECs have eventually got locked in the Europeanization process in terms of setting in path-dependencies in externally directed policy formulation and implementation (Grabbe, 2006; Fink-Hafner, 2007).

Most of the research on the Europeanization process along these three main traditions has mainly focused on explanatory factors like misfit ('goodness of fit'), veto players or national bureaucracies, including administrative capacity and coordination as more broadly defined independent variables affecting the transposition of EU legislation and explaining deadlocks as well as delays (see Pollack, 2010; Young 2010; Falkner et al., 2005; Toshkov, 2007, 2008; Haverland, 2000; Hille & Knill, 2006; Knill & Lenschow, 1998; Héritier, 2001; Steunenberg, 2006; Berglund et al, 2006). By criticizing the veto player argument and misfit hypothesis, Falkner et al (2005, 2007) and Falkner & Treib (2008) have proposed an alternative approach that theorizes on the intuitive notion of the culture. They presented four worlds – obedience, domestic politics, neglect and 'dead letters' – as typical patterns in implementing EU policies, where national cultures, ideology and preferences on both political and administrative level significantly affect the implementation performance. In their analysis, a world of 'dead letters' applies to new member states, where formal rules exist as a result of transposition ('obedience'), but they do not get implemented in practice ('neglect'). In a similar way, Goetz (2002) identifies "Four Worlds of Europeanization" – Nordic world, North-West world, Mediterranean world, and 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.

However, as already stated, existing theoretical and empirical studies on Eastward Europeanization within all these traditions have had a rather narrow scope with the focus on factors affecting the implementation process in universal, homogeneous areas of study, such as social policy (e.g. Linos, 2007; Falkner et al, 2005) and environment (e.g. Héritier, 2001). 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

Already in the early years of the independence in the 1990s, there was a clear tendency towards a 'regulatory state' model in socio-economic reforms in Estonia, as public institutions were not supposed to intervene in the economy other than regulate (see Bohle & 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, p. 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 & Gilbert, 1994). This was manifest in the monetary institutions, that is, the currency board arrangement, which in essence de-politicized monetary policy and limited the function of the central bank as lender of last resort, but also was 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 & 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 the financing of productive investment into restructuring of the economy.

Though 1995 marks the beginning of the integration process into international (banking) community, when modern Credit Institutions Act, Accounting Act and Commercial Code were adopted, the starting point for the Estonian banking regulation could be considered 1989, when a bill was passed to allow the establishment of commercial banks. On the grounds of the specifics of main reforms and legislative amendments, the following 25 years of the evolution of the Estonian banking regulation and supervision can be divided into six periods (see also Zirnask, 2002; Sõrg & Tuusis, 2008), punctuated by critical junctures in both Europeanization and institutional progress of the banking sector, as presented in Table 1 at the end of the article:

1990-1992 – period of the monetary reform and a multitude of restrictions on capital account transactions, including a legal prohibition on foreign ownership of local banks, but no measures adopted to restore the solvency of banks in light of the first banking crisis (Sõrg, 2003; Lainela & Sutela, 1994). 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).

1993-1994 – first attempts at regulating banking activities with prudential ratios – solvency ratio[1], liquidity ratio[2], risk concentration ratio[3], net foreign exchange position ratio – in order to restrict the excess risks taken by banks (Bank of Estonia, 1994a). 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 preemptive 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).

1995-1997 – qualitative changes in the regulatory framework with the enactment of the *Credit Institutions Act 1995*. 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 aims of 1995 law and following amendments was to restrict lending to banks' staff and owners as well as to prevent large exposures.

1998-2004 – modern banking period with the focus on requirements arising from macroeconomic and international, in particular, the EU developments. In the aftermath of the 1997-1998 banking crisis, Estonia introduced the institution of deposit guarantee and adopted a European-type *Credit Institutions Act 1999*, based on the EU banking directives and

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1 the ratio of a bank's own means to the total of risk weighted assets and liabilities.
2 the ratio of a bank's liquid assets to current liabilities.
3 the ratio of total liabilities of high risk-concentration clients to the bank's own means.

materials from the Basel Committee on Banking Supervision. The 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, the Estonian legislation on banking activities, accounting practices and organization of supervision was harmonized with the Western practices, except for the deposit guarantee 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 joining the EU in 2004.

2005-2008 – continuous adaptation to the existing and new banking regulation of the EU. Further strengthening of capital adequacy regulation was caused by the need to adopt new Basel II framework.

2009-… – 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 Act 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 stages in the banking sector development: 1) a rapid increase in the number of banks as result of the liberalization of the banking environment in 1991-1992, 2) a decrease in the number of banks and stabilization period until 1997-98, as regulatory environment was made more stricter, and 3) a growth phase after 1998 with increasing share of foreign ownership through organic growth and takeovers (Myant & Drahokoupil 2011, p. 261). Such a periodization of institutional developments with general trends in the banking sector also reveals potential factors that have affected the banking legislation.

3.1 National idiosyncrasies and perseverant Europeanization

In light of the developments in 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, one has to bear in mind that the Estonian banking regulation in the early 1990s was accompanied by the elimination of restrictions on capital movement and full convertibility of current account transactions under the general liberalization agenda (see De Castello Branco et al, 1996; Kattel & 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 the 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 conditions 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 the EU directives were used as source of inspiration to the extent it was appropriate and possible, given the circumstances at that time (Bank of Estonia, 1994b; Bank of Estonia, 1998; Khoury & Wihlborg, 2006). 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 gained the leverage to spell out the content of legislation that had to be adopted as a precondition for membership, implying a rather political commitment and reasoning in adjusting the legislation to the *acquis*. Thus, the start of pre-accession negotiations can be considered as a critical juncture in the institutional adaptation. First, the adaptation to the 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 the EU financial institutions to operate in Estonia by the end of a transition period at the latest, although the Europe Agreement contained transitional rules (see EBRD, 1998; Tison, 2002, p. 39; also Table 1 on specific examples). Second and more important development was the inclusion of Estonia in the first group of membership negotiations in 1997 and the enforcement of Association Agreement in 1998, which explain major harmonization efforts in the banking legislation around the turn of the millennium in 1998-99, as can be seen from the Table 1. 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 on EU's input (see Grabbe, 2006; Schimmelfennig & Sedelmeier, 2005b on asymmetry issue in the EU governance) that has allowed the EU an unprecedented influence on domestic institutions and policies in the private finance. In the words of Bohle & 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 the 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 introduced into the legislation only as a result of the 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-dependence in policy formulation from the late 1990s and essentially being locked in the Europeanization process, supported by the statements by the Ministry of Finance and the FSA:

> "Since the financial sector regulation is pretty much harmonized with the European Union law, then all the reforms and changes generally start from there. In this sense, one cannot talk about specific changes and reforms. ...Financial stability policy is quite successful in Estonia [given the developments in the banking

> sector for the last 15 years], but there are also indirect external factors [operational in Estonia] that are beyond the control of the Estonian state". (Senior civil servant at the Ministry of Finance, 2014)

> "If we look at the Estonian legislation on financial markets, 95 percent is comprised of the European Union law, while the share of the domestic input is minuscule. The domestic component consists basically of two things: the second pillar of the pension system, even though it is partly built upon the UCITS Directive, and the Estonian Central Register of Securities..." (Member of the Management Board at the Financial Supervision Authority, 2014)

This kind of embedded socialization in terms of the "stickiness" of formal rules and institutions transposed to Estonia, emphasized in the historical institutionalist tradition, has been also supported by the prevalence of 'simple polities' approach. Namely, 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 & Raudla, 2013; Bohle & Greskovits 2012).

It can be concluded that despite the strengths of both rationalist and constructivist arguments in explaining the adoption of the EU rules in the 1990s and 2000s, the realization of several idiosyncratic risks during these times caused *ad hoc* reactive actions and were guided by more pragmatic considerations due to high political salience of the issue, namely dealing with several rounds of banking 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, that is, simultaneous Europeanization, liberalization and (re-/de-)regulation (see Eberlein & Grande, 2005). However, none of the theoretical discourses has addressed the issue of potential impact, not to mention the significance of discussed regulatory tendencies for the institutional development of the banking sector.

3.2 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 the banking sector, while the communist legacy endowed no institutional resistance to EU policies (see Schimmelfennig & Sedelmeier, 2005b; Grabbe, 2002 on misfit and veto player discussion in CEECs). 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). Similarly, nationalist sentiments on the premise of safety nets against the 'eastern' influence implied openness to foreign ownership in the banking (Bonin et al, 2009; Bohle & Greskovits, 2012). 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 (Kattel & Raudla, 2013; Börzel, 2010; Kaik, 2002; Bohle & 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).

> "The whole legislative body embraces to large extent, and will do it even more in the future, the European Union law. Legislation will become directly applicable and the role of the Estonian parliament and ministries here disappears altogether." (Member of the Management Board at the Financial Supervision Authority, 2014)

However, because of low administrative capacity and priority given to speed in improving banking regulation, legal acts were of low quality with technical inaccuracies (Kasemets, 2000; Bonin et al, 2009). This implied prolonged transposition of the EU directives into national legislation, evidenced by several rounds of amendments in banking-related legal acts in consequent years in the late 1990s and the 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 mobiles phones, were drafted only at the beginning of 2014 (Valdre, 2014).

> “As distinctive from the European Union reforms, Ministry of Finance has developed a regulation on how SMS-loan providers would go under the supervision of the Financial Supervision Authority. This is not directly related to financial stability, as the SMS-loan providers do not pose a risk to financial stability... rather, as their behavior has caused social problems, and secondly, the business is relatively opaque, then the state has decided to pinch a bit and take control over their activities. The supervision of these loan providers is related to more social issues, where there is clearer political will and agenda, while in the case of major [EU level] reforms, no political pressure has been felt”. (Senior civil servant at the Ministry of Finance, 2014)

3.2.1 ‘Dead letters’ manifestations

Grabbe (2006) raised concerns over the encouragement of institutional isomorphism for gaining political legitimacy for institutional and policy changes during the post-communist transition period, as that could lead to functional dualism whereby institutions resemble to the EU ones, but are not functional. Hence, questions 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 institutionalization.

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 transactions and instruments were legislated, although being not practiced in the banking sector (Rahandusministeerium, 2010a). 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 & Tõrs, 2002). Essentially, mortgages denominated in foreign currency, not complex financial structured instruments such as CDOs, CDSs etc., were considered as innovative financial products that proved to be risky practices in Estonia and other CEECs (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.

> "As the Estonian financial sector is still small and we do not have quite a number of these financial services or sophisticated financial instruments on the local market as found in the rest of the world, we do not possess any significant expertise here to have an opinion on one or another EU proposal or impact. … And there is really no one to discuss on [these issues]. Estonia's problem is that in some areas there is not really any knowledge". (Senior civil servant at the Ministry of Finance, 2014)

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 (Rahandusministeerium, 2010b). 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 financial practices.

Furthermore, when analyzing the cases of the worlds of 'dead letters', Falkner & 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 & 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 (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 (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 in this policy field. In principle, one can observe both path-dependence 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[4]. Consequently, operational functionality of regulation has been reduced with repercussions for financial supervision.

3.3 Supervisory Obstacles and Challenges

In contrast to the 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 (Tonveronachi, 2010). This has been evident in the failures to enforce policies, including the transposed EU legislation, due to constrained administrative and judicial capacities in new EU member states. Weak enforcement of contracts, legal restrictions on disposal of assets backed by real estate, difficult access to collateral and low collateral recovery were just a few examples of problems in the 1990s and early 2000s (see De Castello Branco et al, 1996; Steinherr, 1997; EBRD, 1998; Schimmelfennig & Sedelmeier, 2005a; Falkner & Treib, 2008; Sedelmeier, 2008, 2010; Scholtens 2000). Even banks perceive legal enforcement as the weakest area, although capital regulation in Estonia is seen strict and the local legal system considered as adequate (EBRD 2011). In the words of Wagner & Iakova (2001), 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 and also bank owners. 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

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4 In a study on the Hungarian banking sector, Petrick (2002) found that neither *acquis communautaire* nor the Basle rules were similarly appropriate to deal with the situation that Hungary was faced with, that is, dominating state-ownership, a newly formed but financially weak and inexperienced banking sector, and a pervasiveness of inter-enterprise debt relations.

(Lainela & 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 also managers could make deals with themselves (Khoury & 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 & Sutela, 1994; Hansson, 1995, p. 156; De Castello Branco et al, 1996; Myant & Drahokoupil, 2011, p. 266). Thus, fraud was present mostly due to lax enforcement of laws in the 1990s, 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, p. 159). 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). 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 the 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, the powers of the Financial Supervision Authority were expanded by giving 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 to make a proposal to amend or supplement the organizational structure of a credit institution among others (Finantsinspektsiooni seaduse, investeerimisfondide seaduse, krediidiasutuste seaduse ja tagatisfondi seaduse muutmise seadus, 2010; Investeerimisfondide seaduse ja sellega seonduvate seaduste muutmise seadus, 2011). 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 consumer protection. This indicates that the emphasis has been laid on market conduct supervision by the FSA, whereas prudential supervision has been challenged by the broader internationalization of the banking activities.

3.3.1 Challenges in addressing cross-border banking activities

As suggested by Pollack (2010) and Bohle & Greskovits (2007), the substantial presence of foreign ownership in the banking sector has implied that policy priorities in CEECs have been influenced by the outside players form other 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.

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 not so distinct, given the provisions in the legal acts that provide the opportunity to transfer the supervisory duty to the home country authorities (Credit Institutions Act, 1999). Further, the local supervision of subsidiaries is rendered ineffective, given that banks tend to treat subsidiaries increasingly as branch offices. Within the 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 fiscal policies (see Kudrna & Gabor, 2013 on political risks). 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 (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. Duty of corporate income tax that has been levied in Estonia only in case of profit distribution (re-invested profits exempted from taxation) 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 (author's calculation based on Bank of Estonia statistics), and none of the foreign subsidiaries had paid out dividends before 2014. Out of 1.4 billion Euros as net profit of four largest banks for the period of 2010-2013 (3rd quarter), only 21 million Euros were 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[5], asset management and other non-bank financial institutions within the same group that are not included in the banking statistics (Pistor, 2010; Atanas & 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 that eventually resulted in credit institutions growing into banking groups (Lepik & Tõrs, 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. 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 Kregel, 2014 for a general discussion of this issue). This, however, has not been seen as a problem by the public authorities.

> "In the case of a small environment, this [micro and macro-prudential regulation] is nebulous... actually, one can achieve with micro-prudential instruments the same as with macro-prudential instruments, because there are few market participants and they

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

> have such a large market share. Therefore, this issue is not so important to deal with ...” (Member of the Management Board at the Financial Supervision Authority, 2014)

Nonetheless, 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 at the banking group level but entails systemic risks for the financial sector in Estonia (see Bonin et al, 2009; EBRD, 2012). In that respect, the liquidity and credit squeeze pose significant threats to the Estonian financial sector and the economy as a whole, should the liquid assets be repatriated from Estonia, when parent banks face funding difficulties. 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 (Pistor, 2009; Khoury & Wihlborg, 2006). The outsourced nature of supervision was exemplified during the crisis by the emergency loan taken by the Swedish central bank to cover the potential losses of Swedish banks in Estonia and elsewhere in the Baltic States. Hence, Estonia has been lacking an effective governance regime for finance that has addressed only the credibility aspect of finance (and thus, security of the payment systems), but not money supply – two sides of the same coin that are conventionally interlinked. As stated above, this division of labor within the banking sector follows in Estonia the dividing line between domestic and foreign actors.

And even if any ‘bottom-up’ domestic regulatory efforts for financial stability could be well reasoned on economic grounds, the Europeanization process has put brakes on these initiatives. 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 in mid-2000s. 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 would have contradicted with the broader process of harmonization of regulations (see Sutt et al, 2011; Ross, 2013). As it happened, petition by the Estonian supervisors for stricter capital requirements, when the economy was booming, was rejected by the Swedish peers on the grounds of sufficient capitalization at the group level (EBRD, 2012).

As a response to the regulatory voids left by the EU legislation in addressing cross-border financial stability and the allocation of responsibility, new types of informal institutions have been introduced such as 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 (Eberlein & Grande, 2005). The Baltic-Nordic MoU, signed in August 2010 has been considered as one of the most specific burden-sharing models, which considered the asset share of the financial groups in a given country and introduced exacerbating and mitigating factors (Kudrna, 2012).

> "... The monitoring of the entire group is located in Sweden ... for which a college of supervisors has been established, where supervisors from Estonia, Latvia and Lithuania are invited ... and basically information is exchanged on what is happening down here [in Estonia] and what we think of things. In such a debate or dialogue, decision-making takes place that is implemented across the group level. Sweden is good in the sense that this college system originates from the Nordic countries, where the culture of consensus prevails, which means that a lot is contributed to discussions and all taken decisions are implemented." (Member of the Management Board at the Financial Supervision Authority, 2014)

Compared to other similar agreements, it was peculiar for including *ex ante* burden-sharing procedures and 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 (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 in the credit boom in the mid-2000s that was encouraged by the limited control by the Estonian authorities over the crediting of the economy and insufficient cross-border coordination that impaired prudential regulation to halt the overheating of the economy (see 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 the EU-wide lender of last resort facility.

4. 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[6], 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 the EU and other international principles and practices, as seen from the Table 1. This has been supported by the position of the Ministry of Finance:

> "It could be even argued that the financial sector is overregulated. ... In the past 5-10 years, a lot of new rules or new proposals have been adopted that we considered as excessive regulation... especially, considering that our market is small and the new requirements or charges may be too hard to deal with. So, we have tried to fight as much as possible against such a heavy regulation, which we have not been very successful at". (Senior civil servant at the Ministry of Finance, 2014)

Nonetheless, 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 and 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,

6 Estonia was a 'path-setter' not only in the number of banking sector bankruptcies in the whole Eastern Europe in the early 1990s, but also the responsiveness by the central bank to the growing problems of the banking sector (Lainela & Sutela, 1994). In 1992, the authorities closed one bank without rescuing its depositors and merged two banks with a partial bailout. 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, p. 143; Khoury & Wihlborg, 2006).

1998). 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 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 banks and also the EU accession aspirations, while the 2000s marked 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, 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 for 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. This in turn compromises the government's responsibility for general financial stability that has run 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 settings that tend to reproduce, but also contribute to financial fragility.

Table 1. **Transposition of the EU banking directives and the Europeanization of the Estonian banking sector, 1992-2011**

	1992	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Institutional developments & crises	1st banking crisis	2nd banking crisis. Repeal of capital controls	First Credit Institutions Act		Stock market crash & 3rd banking crisis. Take-over of banks by foreign investors. Introduction of the deposit guarantee institution in 1998		Second Credit Institutions Act		Creation of joint banking, insurance and securities supervision: FSA				Division of FSA's work: Supervision of capital and Services		Collapse of real estate and consumption bubble			The Baltic-Nordic MoU, signed in August	
Internationalization and the EU accession process	Joining the IMF		Signing Association (Europe) Agreement with the EU		Opening of accession negotiations with Estonia	Estonia's Europe Agreement entered into force						Estonia joining the EU							Estonia joining the euro-zone
Transposition of the EU banking directives		88/361/EEC on liberalization of capital movements (1)										2001/24/EC on the reorganisation and winding up of credit institutions (14)					2007/44/EC on acquisitions and increase of holdings in the financial sector		
			Second Banking Directive 89/646/EEC on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions (2)										2004/39/EC on markets in financial instruments					2009/111/EC on amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC (8)	
			89/229/EEC on the own funds of credit institutions (3)											2006/48/EC relating to the taking up and pursuit of the business of credit institutions and 2006/49/EC on the capital adequacy of investment firms and credit institutions (7)					2010/76/EC on amending Directives 2006/48/EC and 2006/49/EC (9)
			89/647/EEC on a solvency ratio for credit institutions (3, 4)																
			92/121/EEC on the monitoring and control of large exposures of credit institutions (5)							92/121/EEC on the monitoring and control of large exposures of credit institutions									
				92/30/EEC on the supervision of credit institutions on a consolidated basis (10)						2002/87/EC on supplementary supervision in a financial conglomerate (12)									
				86/635/EEC on the annual and consolidated accounts of banks and other financial institutions															
						94/19/EC on deposit-guarantee schemes (13)												2009/14/EC amending Directive 94/19/EC	
							95/26/EC on amending Directives 77/780/EEC and 89/646/EEC (11)												
						93/6/EEC on the capital adequacy of investments firms and credit institutions (6)													
									93/22/EEC on investment services in the securities field										
										98/31/EC on amending the Directive 93/6/EEC (6)									

Source: author's elaboration, based on the comparison of the Estonian legal acts and the EU directives

(1) Implicit transposition of the directive by repealing the legislation on restrictions on non-residents' possession of shares of the Estonian commercial banks, on foreign currency transactions (inflow and outflow of foreign cash), requirements on registration of foreign loans and on residens' foreign accounts. The obligation to renounce capital account restrictions stemmed also from the IMF Agreement.

(2) The transposition process lasted until 204 due to harmonization with the amending directive 2000/12/EC. In 1995, mostly the principles of the First Banking directive 77/80/EEC were transposed, while the regulation on authorization and supervision of foreign branches according to the principles of mutual recognition of banking licenses and home country control was adopted in 1999. Estonia had much broader and stringent requirements for application for authorization and bases for refusal as well as withdrawal of authorization and acquiring a holding, but also on the principles of the management, that is, requirements for the members of and tasks for council and board of credit institutions. Also, provisions on the cross-border establishment of subsidiaries and branches of foreign credit institutions were specified in 2004 pursuant to amended articles of the Directive 2000/12/EC.

(3) Although the principles on own funds, risk exposures and risk categorization on the balance-sheet assets for the calculation of the solvency ratio were present already in 1993, they did not comply fully with the principles of the EU directives. Given the non-membership in the EU and the development level of the banking sectors at that time, these directives were adopted gradually by broadening the regulatory principles according to the needs and possibilities, and often being even stricter than EU regulation, e.g. in relation subordinated liabilities, possibility to exceed the thresholds and limits, etc.

(4) Estonia did not adhere to the same allocation of asset items between 4 categories as was stated in the directive and in comparison with the directive, not all listed assets items were incorporated into the legislation. Solvency regulaton was again stricter in terms of applying higher weightings on particular assets and capital adequacy ratio set at 10 percent level (8 per cen was the EU's minimum).

(5) Strictness position in the transposition of the directive, e.g. renouncing the possibilities for exemptions in the calculation of exposure limits and transitional provisions relating to exposures in excess of the limits.

(6) Introduction of regulation on market risks and capital requirement in relation to trading-book business. Furhter, the possibility to delegate the

responsibility for supervising solvency of subsidiary of a parent undertaking situated in another member state to a competent authority that authorized and supervised the parent undertaking, which was adopted in 1999 in Credit Institutions Act. 2002 amendments in the regulation included the introduction of specific definitions of previously undefined financial instruments (warrants, repos, OTC financial derivatives, underwriting commitments, etc.), regulation on commodities trading and commodity instruments, the possibility for contractual netting, and elaboration on option risk, commodity risk, trading-book credit and counterparty risks, based on the Directives 93/6/EEC and 98/31/EC, the latter being essentially translated into the Estonian legislation with its annexes.

(7) Introduction of credit risk mitigation, operational risk, internal ratings based approach, the regulation of securitization transactions with majority of the provisions of the directives being implemented into the Estonian law by more or less identical provisions. Several regular provisions were not transposed due to irrelevance and peculiarities in the institutitonal structure of the Estonian financial system, e.g. FSA has not been responsible for any supervision on a consolidated basis or existence of any credit institution whose parent company would be an investment firm.

(8) 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. The inclusion of the so-called hybrid instruments in the calculation of own funds. The acts also specified the requirements related to securitization.

(9) Amendments in the Credit Institutions Act were mostly related to the principles of remuneration of managers and employees, requirements on the disclosure of securitization instruments and trading-book portfolios, the regulation of "re-securitization", capital requirement for additional – default and migration - risks (calculation, methods, risk mitigation), and capital requirement on counterparty credit risk from unregulated securities transfers/transactions.

(10) 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.

(11) Legal harmonization included the introduction of a notion 'close links', the grounds for an exchange of information between competent

authorities and other authorities (information from and an obligation to provide information to the central bank and the Ministry of Finance), and the regulation on professional secrecy and confidential information.

(12) The regulation covered the thresholds for identifying a financial conglomerate with regulation on intra-group transactions, internal control, and supplementary supervision on a group-wide basis. Regulation on financial conglomerates was only provided in the Insurance Activities Act that copied the structure and the the wording of the directive. Regulation on financial conglomerates was introduced into Credit Institutions Act in 2013.

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

(14) Before the 2004 amendments in the Credit Institutions Act, the regulation on winding-up and reorganization was too narrow and did not address the cases of cross-border banking, including information sharing and disclosure between the competent authorities of different member states. The new sections in the act established uniform 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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