

TENSIONS IN THE MONEY AND CAPITAL MARKETS ARE AFFECTING THE FUNDING OF THE BANKS

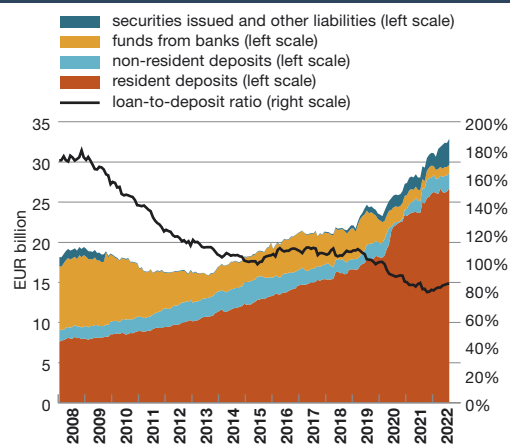
The steep jump in inflation, the war launched by Russia in Ukraine, and the gloomier outlook for economic growth have increased general uncertainty and tensions in the money and capital markets. Estonia is further affected by its geographical proximity to the conflict area, while the climate for financing has become more difficult and interest rates are rising. Several of the banks operating in Estonia partly finance themselves by issuing bonds, and so events in the money and capital markets directly affect their funding. The funding of banking sector in Estonia is also affected indirectly as several banks are exposed to movements in the money and capital markets through their parent banks, which partly finance their activities by issuing bonds. Increased tensions in the money and capital markets could make borrowing more expensive for the non-financial economy, and if access to financing were to deteriorate substantially, the supply of loans may be reduced. As the share of the funding of the whole sector that comes from bonds remains small though, the risk remains limited.

Although the Estonian banking sector is mainly funded from local deposits, money has increasingly been raised by issuing bonds. The strong growth in domestic deposits has helped reduce the need of the banking sector as a whole for additional resources. A decade ago the loan portfolio of the whole Estonian banking sector exceeded its deposits, as the loan-to-deposit ratio was 112% at the end of 2012, but in August this year deposits were substantially greater in value than the loan portfolio, and the loan-to-deposit ratio had fallen to 85% (see Figure 33). The importance of funding from banks, including parent banks, has diminished consistently, while funding from issuing bonds has come to play more of a role over the past three years. The bonds issued by the banks accounted for 10% of all the liabilities at the end of August 2022, and the banks that had issued bonds most actively in the last three years had a market share of 23%.

The funding models of the banks vary. There have been fewer banks in recent years that have a loan portfolio that exceeds their deposits and so are dependent on additional funding, and their market share has declined. Those banks are mainly financed either by their parent banks, or by issuing bonds. There are few banks that rely mainly on funding from parent banks, and they are small and had market share of around 5% in August (see Figure 34). The other banks that fund themselves from bonds have market share of 10% and have issued both covered bonds and unsecured bonds.

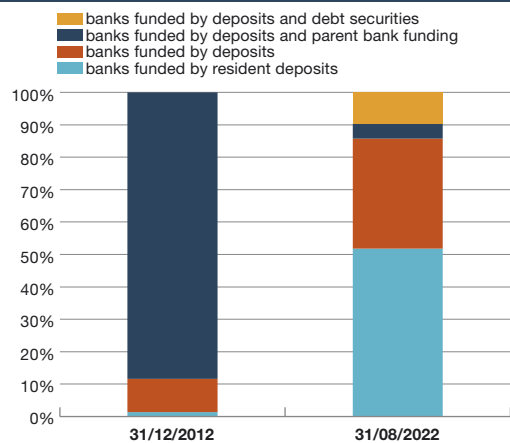
A few banks have used non-resident deposits alongside the domestic deposits to fund their activities, and the non-resident deposits at some banks are much larger than the local deposits. For some banks this reflects a specific business line that they have pursued, and several

Figure 33. Structure of the liabilities of banks and their loan-to-deposit ratios



Source: Eesti Pank

Figure 34. Market shares of banks with different funding models



Source: Eesti Pank

banks use specialised online platforms to take deposits from large markets²². The market share of the banks where non-resident deposits are more than half of total deposits has increased in the past

²² The banks themselves have stated publicly that the deposits come mainly from large European Union countries like Austria and Germany.

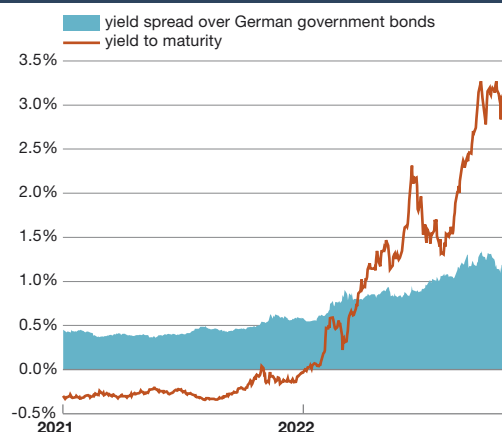
three years, but it remains relatively small at a little over 3% at the end of August 2022.

Tensions and risks have increased in financial markets. The sharp rise in inflation and the gloomy outlook for economic growth have combined with tighter monetary policy to increase tensions and risks in the global financial markets. Market interest rates have become more volatile, as market participants are constantly adjusting their expectations for inflation and the risks to the outlook for the economy.

Increased tensions in financial markets and the general rise in interest rates are also reflected by the rise in market interest rates on the bonds of the banks. As interest rates rose generally in 2022, so the market interest rates on the bonds issued by banks continue to climb. On top of that, investors clearly consider the risks to be greater than before, as the risk assessments by market participants shown in the interest rate spread over sovereign bonds have also become more pessimistic (see Figure 35). Higher market interest rates not only affect the financing of the banks, but they also affect their compliance with the minimum requirement for own funds and eligible liabilities (MREL), as the market interest rates also rise on the bonds that the banks use to meet that minimum requirement.

Intra-group liquidity management means that the movements in money and capital markets also affect the subsidiaries of Swedish banks operating in Estonia. Strong growth in domestic deposits has helped reduce the dependence of subsidiaries in Estonia on financing from their parent banks, but tensions in financial markets can still have an impact at the level of the parent group

Figure 35. Yield to maturity of covered bonds issued in euros by LHV and Luminor

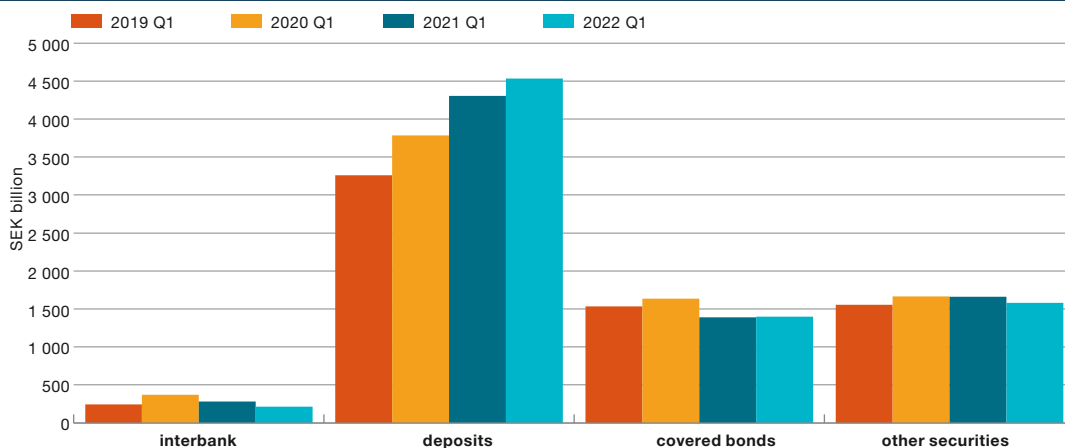


Bonds maturing in 2025
Data as at 09/11/2022
Sources: Bloomberg, Eesti Pank calculations

and so affect the loan supply from the subsidiaries in Estonia, or their liquidity through group-level liquidity management, as the parent banks based in Sweden get part of their funding from the money and capital markets. The parent banks were net lenders to the subsidiaries and branches operating in Estonia during the previous financial crisis, but the subsidiaries now have more deposits than loans and so if there were major tensions in the financial markets it could happen that the subsidiaries help to ease the liquidity situation at the parent bank, or help to fund the parent.

The funding of the largest banks in Sweden depends on depositors and investors retaining confidence, and on the domestic and international capital markets functioning well. The banks are funded by roughly equal shares of deposits from households and businesses, and securities issued in the capital markets (see Figure 36). At the same time, the banking sector

Figure 36. The funding of the major Swedish banks



Source: Riksbank

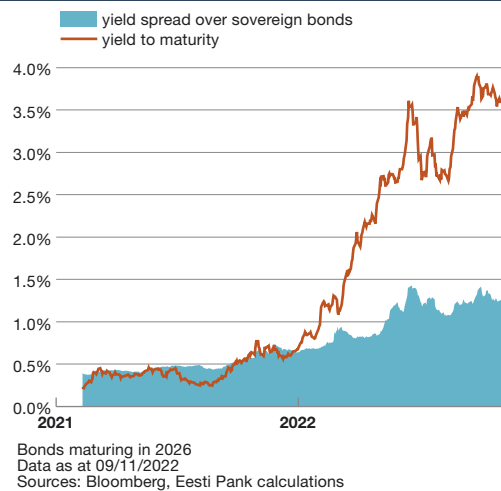
has increasingly funded its activities through deposits, which has reduced the need for long-term market-based financing, and made funding more stable. The loan-to-deposit ratio in the Swedish banking sector fell from 162% in 2018 to 139% in the first quarter of 2022. Some two thirds of the securities issued are denominated in foreign currency though, and the short-term funding of the banks comes mainly from securities issued in dollars. When the volatility in the securities markets was increased significantly by the war in Ukraine, inflation and rising interest rates, uncertainty was also transmitted to the US dollar markets. For a short time this made it harder for Swedish banks to issue securities in dollars. If this were to happen again and to last for longer, the banks may face some problems in accessing funding, and in meeting their US dollar liquidity requirements.

Like the market interest rates on the bonds issued by banks in Estonia, the interest rates on the covered bonds of the Swedish banks increased as interest rates rose generally.

Risks are also assessed to have increased, which is illustrated by the wider interest rate spreads of the bonds of the banks over sovereign bonds (see Figure 37). Investors clearly consider the risks to be larger than they were before.

The Swedish banking sector is also vulnerable to risks coming from the high levels of household debt, the overvaluation of real estate, and the large share of corporate real estate loans in the loan portfolios of the banks. Long-term covered bonds provide a substantial part of the financing structure of the banks, and so the rise in interest rates is also transmitted into the interest rates on long-term housing loans. This increases the loan servicing costs of households. Higher monetary policy interest rates have a major effect on loans for commercial real estate. Swedish commercial real estate companies have

Figure 37. Yield to maturity of covered bonds issued in SEK by SEB and Swedbank



become increasingly indebted in recent years, and this makes them more vulnerable to a rise in loan servicing costs. If the economy were to turn down and financing conditions to change, the market value of real estate could fall, increasing the risks to the financial companies that have funded projects and to the developers themselves.

It is highly probable that the uncertainty and tensions will continue in the money and capital markets moving forward. This means it will be harder and more expensive for the banks to access additional funds from money and capital markets, increasing the risks to financial stability. However the Estonian banking sector as a whole is now less vulnerable to the stresses in money and capital markets because of the strong growth in domestic deposits, and a relatively small part of the Estonian banking sector is currently directly exposed to those risks. The indirect exposure to the parent banking groups in Sweden has also been reduced, as deposits have grown fast at the banking-group level and so reduced the need for market-based funding.