THE IMPACT OF THE MONEY AND CAPITAL MARKETS ON THE FINANCING OF THE BANKS IS INCREASING

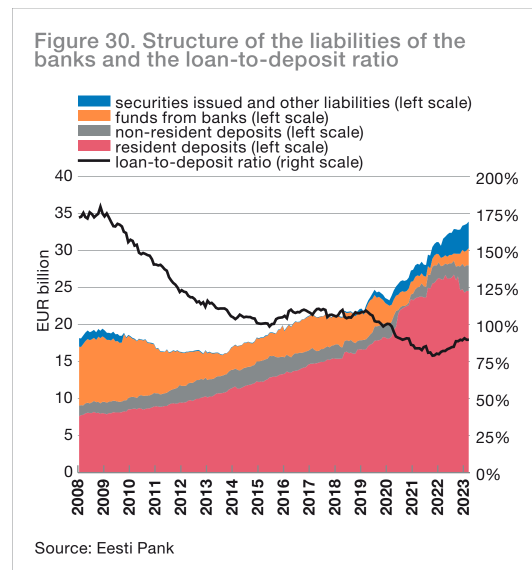
The loan-to-deposit ratio of the banks has started to rise again having spent a couple of years at record low levels. This means that although the Estonian banking sector mainly funds the loans it issues from local deposits, the need to support the growth in the loan portfolio from other sources of funds has increased. Other sources of funds have a higher price than deposits and are more sensitive to a rise in market interest rates, as the average price of those funds rises faster than that of non-financial sector deposits if interest rates rise. If there are tensions in financial markets, other additional funds may become harder to access.

THE NEED OF THE BANKS FOR ADDITIONAL FINANCING HAS INCREASED

Although the Estonian banking sector mainly funds the loans it issues from local deposits, the need for other sources of funds has increased. The loan-to-deposit ratio of the banks has started to rise again having spent a couple of years at record low levels (see Figure 30). Strong growth in domestic deposits reduced the need for additional funding as recently as 2020-2021, but the growth in deposits was much weaker last year while the loan portfolio was still growing quite fast. The share of other financing alongside deposits had increased by the start of this year from 9% to 17%. If loans continue to grow faster than deposits, the banks will need to find alternative funds. The loan-to-deposit ratios of the banks are quite different, but it is noticeable that the median ratio is a little higher than it was a year ago and the gap between the largest and smallest ratios at the banks has widened (see Figure 31).

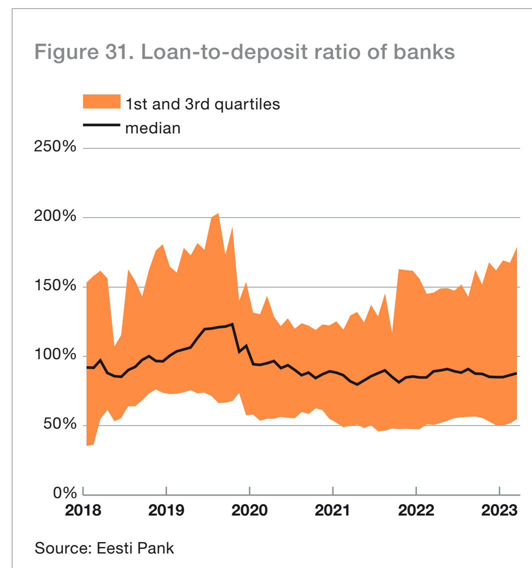
The price of accessing additional funding is higher than that of deposits, and they are more sensitive to changes in market interest rates. It has historically been cheaper for banks operating in Estonia to use financing from the non-financial sector, mainly deposits. Other additional funding has been more expensive and more dependent on money market interest rates. The interest rates on bonds issued closely reflect the prevailing market interest rates, while funds from parent banks are strongly linked to market interest rates as the parent banks fund their activities to a relatively large degree using funds from financial markets. As the banks operating in Estonia increasingly need additional funding, this means that the price of their funds will start to be affected more than before by market interest rates.

Figure 30. Structure of the liabilities of the banks and the loan-to-deposit ratio



Source: Eesti Pank

Figure 31. Loan-to-deposit ratio of banks



Source: Eesti Pank

THE RISKS FROM SWEDISH PARENT BANKS HAVE INCREASED

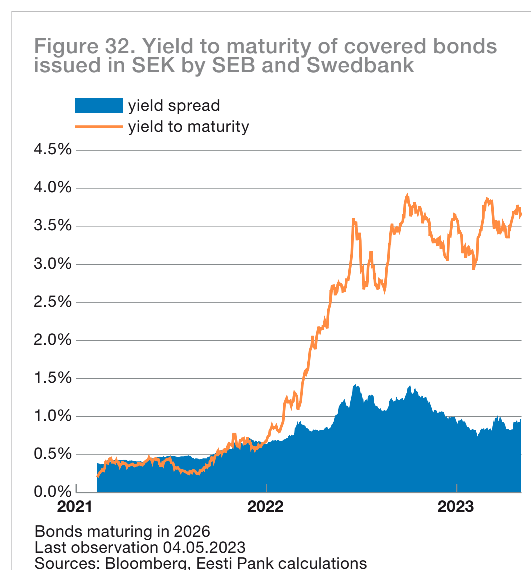
The loan-to-deposit ratios of the subsidiaries of Swedish banks operating in Estonia have risen and the role of the parent banks in

funding them has increased. Small banks operating as branches used funds from parent banks throughout last year, but at the start of this year funding from parents also became more important again for the larger banks, as the amount of funds received from Swedish parent banks or other units within the group at the start of this year was twice what it was a year earlier. This is still only a small part of the funding of the banking sector at 6%, but an increase in the funding from parent banks could increase the risks to the subsidiaries in Estonia. Were the financial positions of the Swedish parent banks to come under pressure, the impact could be passed on to the subsidiaries operating in Estonia.

The Swedish banks largely fund themselves with resources from the money and capital markets, and so they are exposed to the risks from those markets. The funding of the Swedish parent banks depends on depositors and investors retaining confidence, and on the domestic and international capital markets functioning well. Loan growth in Sweden was notably faster than that in deposits, like it was in Estonia, and by the end of last year the Swedish parents of both Swedbank and SEB in Estonia had more loans than deposits[9]. This increases their need for funding from the money and capital markets. Higher interest rates have made financing more expensive for the Swedish parent banks (see Figure 32).

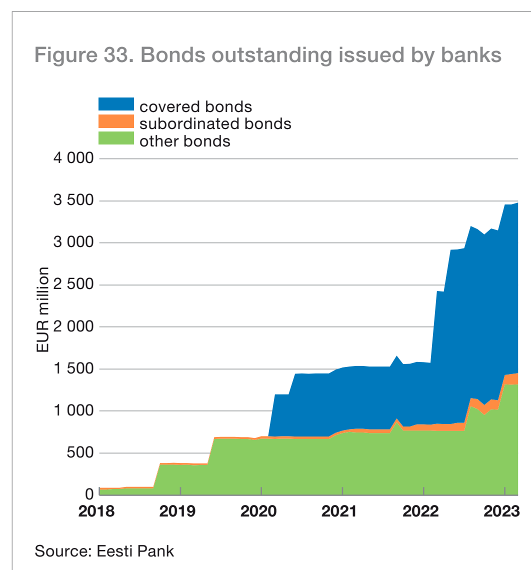
Large real estate exposures have opened the Swedish banks up to the risks from real estate (see Box 3). Commercial real estate loans and housing loans were a large share of their loans at 78% for Swedbank and 50% for SEB.

Figure 32. Yield to maturity of covered bonds issued in SEK by SEB and Swedbank



Bonds maturing in 2026
Last observation 04.05.2023
Sources: Bloomberg, Eesti Pank calculations

Figure 33. Bonds outstanding issued by banks



Source: Eesti Pank

THE BANKS ARE INCREASINGLY ISSUING BONDS TO ACCESS ADDITIONAL FUNDS

Over half of the stock of bonds issued by banks in Estonia are covered bonds (see Figure 33). Covered bonds need to be backed by assets that are eligible as collateral. Financing accessed through covered bonds is generally cheaper than that from other bonds. Other bonds are estimated to be predominantly unsecured bonds, which are more expensive since their risk level is higher.

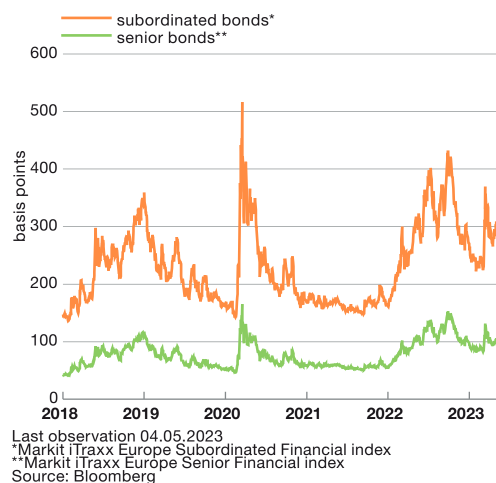
The banks have also issued a small amount of subordinated bonds. Issuing additional equity reduces the part of profits that comes to current shareholders, and so an alternative for banks is to issue securities that are similar to equity. These are subordinated bonds and Additional Tier 1 bonds (AT1). Subordinated bonds are generally more expensive than the usual unsecured bonds, as they may in some cases be used to cover losses or converted into equity. AT1 securities are even more expensive and are riskier for investors, and they are generally perpetual with no final maturity; banks can use them to cover losses and can also pay less interest than promised on such securities.

It is important to note in terms of financing that stresses in financial markets affect different types of bond to different degrees. The

9 Public reports of SEB and Swedbank for the fourth quarter of 2022.

Estonian local securities market is relatively small, and so bonds above a certain volume must be issued outside Estonia, making the prevailing conditions in money and capital markets and investor sentiment particularly important. The covered bond market has been affected less by stresses last year and at the start of this than the money and capital markets, while the risk assessments in the market for subordinated bonds, where the securities are notably riskier, have been notably more volatile throughout Europe (see Figure 34). As subordinated bonds are riskier, a serious crisis could quickly make investors much more risk averse, making it harder for the banks to access funding through such instruments and also making it much more expensive to do so. Banks facing difficulties in recent years or needing bridge financing have accessed funding from deposit platforms intended for European clients and taken loans from the central bank.

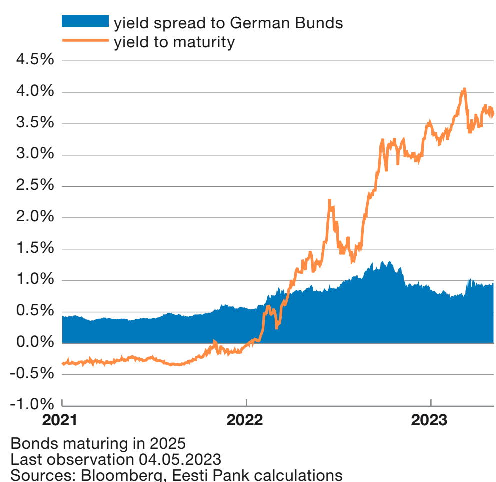
Figure 34. Senior and subordinated CDS spreads for European financial entities



Last observation 04.05.2023
*Markit iTraxx Europe Subordinated Financial index
**Markit iTraxx Europe Senior Financial index
Source: Bloomberg

The market interest rates for the bonds of Estonian banks have risen. The market interest rates on the covered bonds of the Estonian banks rose sharply in the second half of 2022. The rise has continued this year, though at a slower rate (see Figure 35). The market interest rates on covered bonds as a low-risk instrument rose by less in the first three months of 2023 than the interest rates on other bonds did.

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

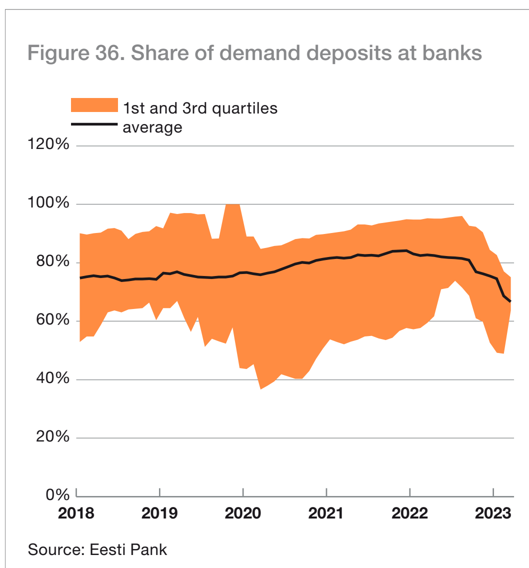


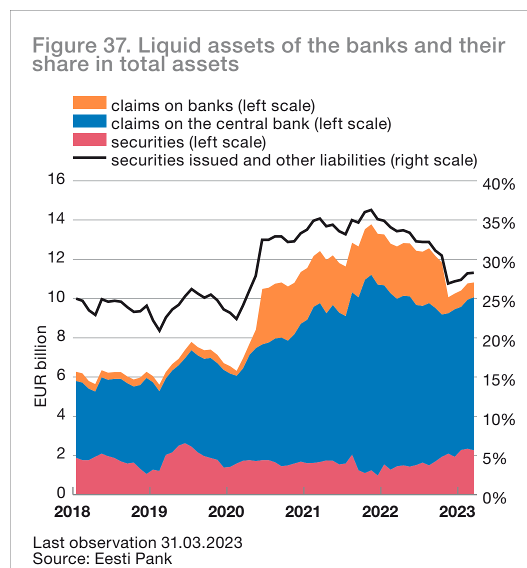
Bonds maturing in 2025
Last observation 04.05.2023
Sources: Bloomberg, Eesti Pank calculations

FINANCING FROM DEPOSITS IS BECOMING MORE EXPENSIVE FOR THE BANKS

Competition for deposits has pushed the banks to raise the interest rates on term deposits, and so their clients have started to make more use of term deposits than before. The banks started to raise interest rates on term deposits in summer 2022 when money market interest rates started to rise, and they continued doing so in the second half of the year as monetary policy interest rates also started going up. Higher interest rates for term deposits encouraged the clients of the banks to use term deposits more instead of demand deposits. When interest rates on deposits were close to zero in previous years, demand deposits accounted for 80% of bank deposits on average, but by the end of March 2023 that share had fallen below 70% as term deposits increased to 17% of all deposits and overnight deposits to 11%. As competition for deposits has become tighter and all the banks have started to raise their deposit interest rates, the share of demand deposits has fallen at the majority of the banks (see Figure 36). Demand deposits are one of the cheapest forms of financing, and so a reduction in the share of them means that it has become more expensive than before for the banks to get funding from deposits.

Some smaller banks have increased the funding they get from deposit platforms aimed at European clients. Non-resident deposits account for 13% of the deposits of the banks, and are largely in the form of deposits of residents of the European Union received through online platforms. The banks consider this source of funding to be simple and quick to access, albeit expensive, and so the large majority, or 85%, of the non-resident deposits of Estonian banks are deposits of residents of the European Union. Deposits from





other countries are only a very small part of the total deposits of the banks and have held at 2-4% for the past four years.

THE RESILIENCE OF THE BANKS TO SHORT-TERM LIQUIDITY SHOCKS IS STRONG

The level of liquid assets in the banking sector remains high. Liquid assets were 28% of total assets at the end of March 2023 (see Figure 37). One of the larger banks ended its participation in the third series of targeted longer-term refinancing operations (TLTRO-III) in the final quarter of last year and returned the loans taken under it. This returned the volume of securities in the banking sector back down to its earlier level and so reduced the share of liquid assets in total assets. The share of liquid assets in total assets was still above its long-term average at the start of March, and it was below 10% only at some individual banks. The good resilience is confirmed by the liquidity coverage ratios of the banks, which show that their liquid assets were notably larger than the estimated net outflow of funds during a 30-day stress period.

Box 3: Risks from the real estate market in Sweden

The main risks to financial stability in Sweden come from the high levels of household debt, the overvaluation of the housing market, and the large share of corporate real estate loans in the loan portfolios of the banks.

Economic activity in Sweden could in the near future be hurt by the high debt levels of households. The share of loans that have floating interest rates or rates that are fixed for a short period has increased, and households are more exposed to changes in interest rates than before. Increased household savings and government support measures ease the risks. A rise in interest rates would probably not on its own cause very large loan losses, but the high debt levels of households could cause them to reduce consumption, so reducing economic activity.

Prices for residential real estate have come down a long way over the year as a consequence of higher interest rates and lower real wages, and confidence has declined. The forecast published recently by the Swedish central bank says that housing prices may in total fall by as much as 20% from their peak of last year. This would bring the prices of residential property down to where they were before the pandemic. A reduction in overvaluation and imbalance could generally be positive from the point of view of financial stability.

The market for commercial real estate in Sweden has become more difficult. Construction volumes for residential property have declined as demand has weakened, and the Riksbank finds that in 2024 it may be at half the level it was at its peak in 2021[10]. Lower levels of private consumption increased the risks to companies handling retail space. Companies working with office space face reduced demand and an increase in vacancies, as more work than before is now done in hybrid form. The profitability of commercial real estate companies is reduced by rental prices not rising at the same rate as inflation, while any fall in real estate prices would reduce the collateral of loans. The returns, ratings and ability to access funding from financial markets of Swedish commercial real estate companies have all come under pressure.

The funding structure of the commercial real estate sector increases risks to the Swedish financial system. The commercial real estate sector is more vulnerable to cyclical risks as the debt burden is large and the sector is tightly linked into the financial system. Some 10-25% of the loans issued by Swedish banks to the private sector have been issued to commercial real estate companies[11]. Driven by historically low interest rates, Swedish commercial real estate companies increased their funding by issuing bonds. The cost of funding has risen however, and that is eroding the profitability of companies, especially those with lower ratings. A little over half of the bonds issued by real estate companies by volume are held by foreign investors. This exposes the commercial real estate sector to rapid selloffs, should tensions increase in global markets. For commercial real estate companies to repay the bonds or access the funding that they need, they may have to take additional loans from the banks, but whether they can get funding from the banks depends on the risk appetite of the banks and it may be that they prefer first of all to provide support for existing clients.

The Swedish financial supervisor considers that market and interest risks are hedged for the short term through fixed-rate instruments and derivatives[12]. Interest rates remaining high for a longer time could however cause stress for the funding of commercial real estate companies and push them to sell assets, so increasing the risk of forced sales and price falls in the market. The commercial real estate sector has become more concentrated of late, as some real estate companies in a weaker position have merged with others. It may be argued that the larger companies are in a stronger financial position, but greater concentration could increase the impact if risks were to be realised.

The liquidity of the Swedish banking sector is high and the banks are well capitalised. The profitability of the larger banks has remained good, and loan losses are small. The capitalisation indicators for the three largest banks exceeded 21% at the end of the year. The Swedish financial supervisor announced on 29 March that it was proposing levels of the risk weight floors of 35% average risk weight for Swedish corporate exposures secured by commercial properties and 25% average risk weight for Swedish corporate exposures secured by residential properties.

10 Monetary Policy Report. February 2023. Sveriges Riksbank.

11 IMF. Sweden's Corporate Vulnerabilities: A Focus on Commercial Real Estate: Sweden. March 2023.

12 Stability in the Financial System, November 2022.

Box 4. Tensions in financial markets are making it harder for the banks to meet the MREL

The banks have since 2017 had to meet the minimum requirement for own funds and eligible liabilities (MREL), which was introduced as part of the European Union's uniform rules for crisis prevention and resolution. The MREL has two parts, with an amount to cover losses and an amount for recapitalisation for recovering the funds of a bank so it can continue operations after crisis resolution measures have been applied. This helps make sure that the impact on financial

stability of applying crisis resolution measures would be as small as possible and that the accompanying costs would be covered by the funds that the banks themselves have accumulated. The MREL is applied to the larger banks by the Single Resolution Board (SRB), and the amounts required of such banks are usually larger. Finantsinspektsioon applies or sets the MREL for all the banks. The requirement that is set takes account of the size of the credit institution, its business and financing models, its risk profile, and its connection to other participants in the financial sector, and how insolvency of the credit institution would affect financial stability.

The MREL can be met from Tier 1 and Tier 2 own funds or eligible liabilities. Bonds issued in financial markets are eligible for example, as are subordinated liabilities that can be converted into capital if needed. Subsidiaries can meet the MREL in intragroup accounting using debts to the parent bank. It should be noted that the own funds used by a bank to meet combined capital buffer requirements cannot be used at the same time to meet the MREL.

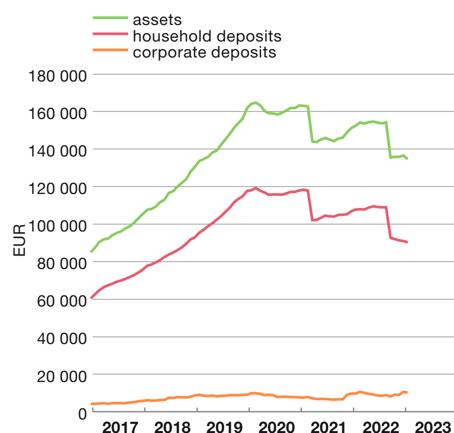
As the volume of loans issued by the banks has increased, so the MREL and the volume of funds needed to meet it have increased as well. The MREL ratio must be calculated against two indicators, which are total risk assets and the leverage ratio exposure. The volume of loans, or risk assets, issued by the banks has increased rapidly in the past couple of years. This has meant that the banks have had to allow a larger amount of eligible funds to meet the MREL. The rise in some of the macroprudential capital requirements has also raised the MREL. The increased profits earned through higher interest revenues have equally though helped in meeting the MREL with own funds.

Higher interest rates and stresses in financial markets make it harder for the banks to issue bonds into financial markets. The banks in Estonia have used funds from the domestic market and from foreign financial markets to meet the MREL. As bond issues can be quite large in size, it is necessary to turn to foreign investors. The banks report that the geopolitical circumstances have made it harder to access funds from financial markets, and interest rates on bonds are much higher than they were. Data from December 2022 show that the additional funds needed by the banks to cover the missing part of their capital can be up to around 6% of the balance sheet, depending on the bank.

Box 5: The risks from savings and loan associations have not gone anywhere

There were 21 savings and loan associations (SLAs) operating in Estonia at the end of February, and their total assets were around 134 million euros. These assets had declined by around 20 million euros over the year, which was primarily because one SLA when bankrupt in September last year. Largely for the same reason, the volume of deposits and number of depositors also declined, though there was a further moderate decline in deposits later as well (see Figure B5.1). SLAs had some 13,500 members in total at the end of 2022, of whom around 7000 had deposits and 1800 had loan liabilities.

Figure B5.1. Assets and deposits taken in of Savings and Loan Associations

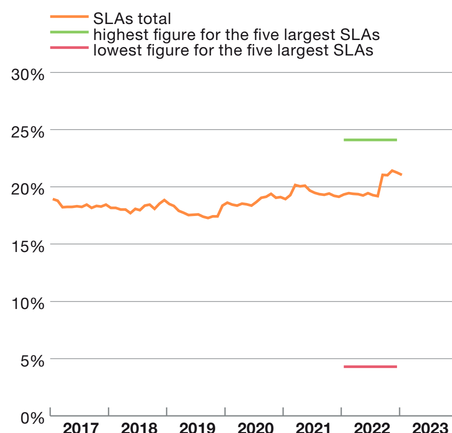


Source: Eesti Pank

Not all the SLAs necessarily have sufficient capital and liquidity buffers. The own funds of SLAs

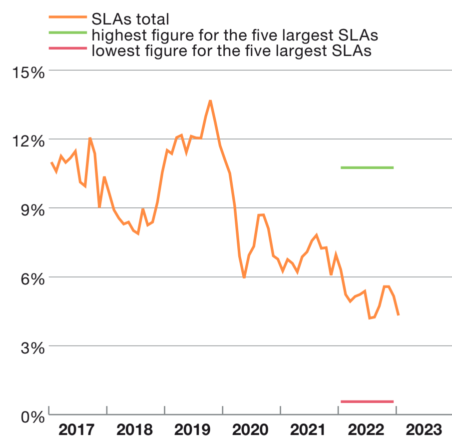
are on average around 20% of total assets, but for some SLAs this is below 10%, which may not be enough to cover possible loan losses (see Figure B5.2). It may also not be in compliance with the Savings and Loan Associations Act, which states that the total of balance sheet claims on clients of SLAs and their off-balance sheet liabilities may not exceed 10 times the amount of own funds. SLAs have also been impeded in accumulating sufficient capital because their profitability has been modest and around half of them finished 2022 with a loss[13]. Some SLAs have very few liquid funds that could be used to cover deposits quickly if needed. Cash and claims on the central bank and commercial banks are on average only around 5% of the total assets of SLAs (see Figure B5.3), while the share of assets of commercial banks that are liquid is by comparison around 25%. Some SLAs equally fail to meet the liquidity requirement in the Savings and Loan Associations Act that requires SLAs to hold at least 5% of the deposits of their members as demand deposits at credit institutions in Estonia or another EEA state.

Figure B5.2. Equity of SLAs as a share of total assets



Source: Eesti Pank

Figure B5.3. Cash and claims on the central bank and commercial banks as a share of the total assets of SLAs



Source: Eesti Pank

Eesti Pank is in favour of stricter capital requirements for SLAs and of applying national financial supervision to them. This would help to make sure that the SLAs had sufficient capital to cover the risks from their lending, and that deposits were better protected. Stricter requirements and supervision would also be required for deposits to be backed by the state in the same way as bank deposits. Many of the SLAs operate today all across Estonia and take in public deposits, meaning that their activities are not very different to those of banks. The proposal made last year by the Ministry of Finance that SLAs should apply for authorisation as credit institutions is consequently a reasonable one.

13 The SLAs earned total profits of around a million euros in 2022, and the average return on assets has been 0.6% in the past five years.