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Nordic Debt Capital Markets

Review and Outlook for Public Sector and FIG markets

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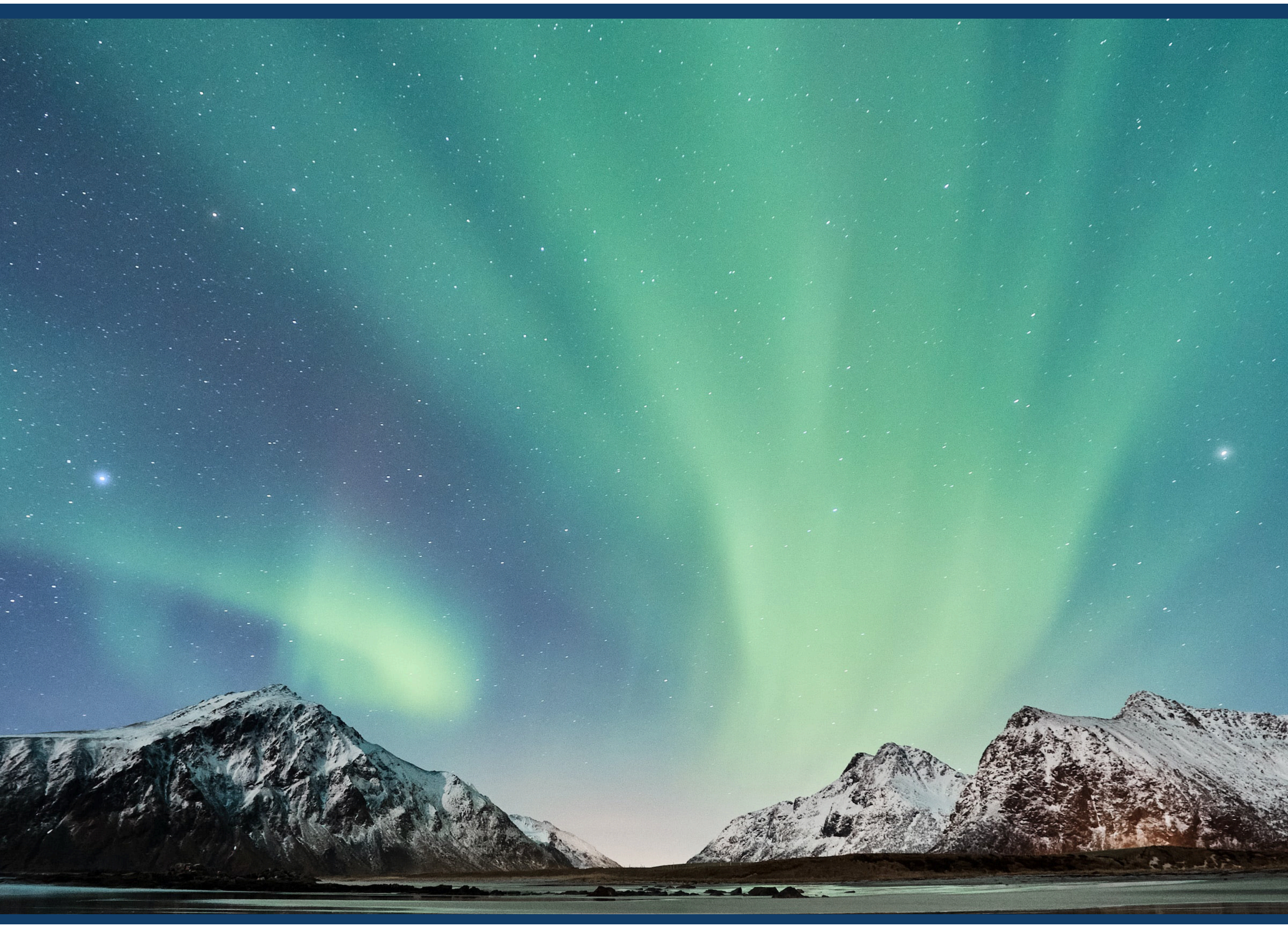

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DZ BANK

Review and Outlook for Public Sector and FIG markets

At the end of 2022,, DZ BANK brought together a group of senior funding officials from some of the Nordic region's leading public sector and financial institution borrowers, and investors in these markets, to discuss and analyse the key capital markets trends and developments across the year, and their expectations for the year ahead.

The event in Oslo, comprising a luncheon and roundtables dedicated to the public sector and FIG markets, had plenty to focus on given the disruptive impact of several macro risks – from the war in Ukraine, to rocketing energy costs, high inflation, and rising rates – on the capital markets and some borrowers' funding plans.

Some of the key overlapping issues discussed, include:

- How the market volatility has impacted issuance in 2022,, and how 2023 fundings plans may need to adjust
- How issuers and investors are navigating this new market environment and new pricing levels
- Where the opportunities are for issuers and investors at the short and long-end of the curve
- Where the opportunities are for issuers in local and foreign currencies
- Appetite and interest in green and sustainable bonds
- How investor relations and primary market practices are adjusting
- Key risk factors and drivers of new issue supply in 2023

From left to right: Richard Kemmish, GC; Patrik Götzinger, DZ BANK; ? TBC; Jenny Lale Petersen, DZ BANK; Angela Brusas, NIB; Sanna Eriksson, OP; Kerstin Ahlqvist, Swedbank; Matthias Ebert, DZ BANK; Dag Hjelle, SR BANK

Nordic public sector borrowers benefit from safe haven status and funding dexterity

Nordic public sector issuers skilfully managed through the market turbulence of the past year, capitalising on their credit strength and funding flexibility to seize the often rare windows of opportunity to execute issuance across public and private markets in good size and different structures. To discuss their experience, DZ BANK and GlobalCapital brought together some leading Nordic public sector issuers and investors to analyse the key trends and developments that shaped the market across the year, and what they expect to see as we move into 2023.

Left to right: Petersen; Kontio; Brusas; Kemmish

Participants in the roundtable were:

Antti Kontio, head of funding and sustainability, Municipality Finance, Finland

Angela Brusas, director of funding and investor relations, Nordic Investment Bank, Finland

Daniel Aagaard Pedersen, head of funding and investor relations, KommuneKredit, Denmark

Jenny Lale Petersen, SSA origination, DZ BANK

Richard Kemmish, moderator and GlobalCapital contributing editor

GlobalCapital: The biggest story of the year has been the Russian invasion of Ukraine. How has that changed your organisation's activities and what has been the impact on your funding need?

Brusas: First of all, obviously NIB condemns the war. It has been a shock to all of us and that is where our main thoughts have been.

NIB's direct exposure to Russia and Belarus is very limited, less than €10m. We haven't signed any new loans to Russia since 2014 and to Belarus not since 2012. So far, the indirect impact of the war also seems to be limited.

What we have seen is a flight to quality. Normally when there is turbulence in the world, people tend to turn to high quality names. So, also, this time around. This has actually been a record year for us. There has been a big demand for lending, which has meant our funding programme has grown substantially. We came to the market pretty soon after the war broke out with both a green bond in euros and also a dollar benchmark. Both transactions were oversubscribed and we were able to upsize the dollar benchmark — so, we can see investor confidence was there.

So, at the end of the year now, we can actually say it has been business as normal — or even a better year. Although it has been horrible with all of the news, the impact on our business has not been bad.

Kontio: The war itself has not had a direct impact on our clients. Our clients still need to do long-term investment and that need hasn't disappeared. I guess the only place where it has had an impact is on the lending side with the energy companies. Normally we are outside the energy company financing because it is a competitive market, but now there is approval for us to finance the municipal energy companies, we get the 100% guarantee from the municipality and we can finance the collateral. This is a big thing; we haven't seen much lending coming from that source yet but this could change, of course, depending on the hedging costs.

Where there has been an indirect impact is on inflation. So, for example, the cost of construction is going up. We don't really know how much impact that will have on social housing production.

Putting this all together, it's very small changes. But on the funding side, like NIB I would say we have been flexible. We have changed our plans many times this year and we have been very successful, even though funding volumes have been quite stable. When the year started, we planned to issue between €9bn and €10bn and most likely that's where we will end up.

We have been more active on the tactical side — for example, Norwegian kroner, sterling, these kind of markets — and we have done fewer strategic benchmarks this year, so that has been the biggest change in our funding.

Antti Kontio, head of funding and sustainability, Municipality Finance, Finland

Pedersen: The first tier elements – the direct balance sheet impact – I would say have been negligible to Kommunekredit and Denmark. Overall, the Danish municipalities have not set forth any immediately relatable initiatives to the war in Ukraine — at least, not that directly hit KK's balance sheet. There are some elements of helping the NGOs in the area but nothing that hits us directly.

But the second tier projects and movements have begun. District heating is a major part of Kommunekredit's lending portfolio. As a result of the energy crisis, district heating has really taken the political centre stage — not just for politicians but for the general public as well. This has accelerated the already ambitious plans to increase district heating in Denmark with our members and municipalities, to reduce the dependence on gas.

GlobalCapital: On the energy point, you all benefit from very solid ratings. To what extent is your potential exposure to energy problems a credit issue?

Brusas: The minor impact on spreads is mostly because of general market volatility. As a result of the energy crises, there is an increased need for energy security and independence. But this is also the moment to accelerate the green transition. For a bank with an environmental mandate, financing renewable energy sources and companies in transition comes naturally. That is a long-term strategy of ours.

Petersen: We were roadshowing with Nordic issuers and they were expecting questions on the war and on the situation regarding the border with Russia. But the questions investors had were only related to energy. How is the energy situation? How is the supply going? Any shortfalls to be expected in winter? This is the main worry that everybody has, as Daniel said, for the upcoming cool season.

GlobalCapital**: In general, with the volatility around the war, how has it affected the spreads of your bonds?**

Kontio: I am actually surprised that there has been very minimal impact on spreads. When we look at government bonds, they have been pretty volatile as a result of some technicalities but agencies have been quite illiquid. Our euro curve has been pretty stable. But now, as we go into next year, volatility is going to be there. In euros I guess the swap spread may be going down, so most likely there will be some impact on the credit spreads as well.

GlobalCapital**: Govvie spreads or swap spreads? Which changes have more impact on your bonds?**

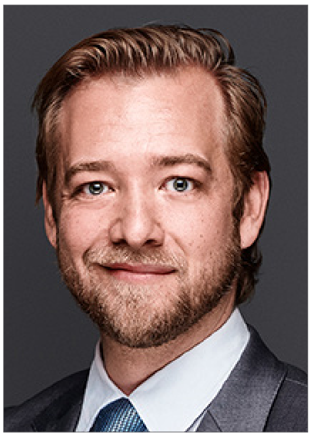
Pedersen: We always take everything back against asset swaps, so I completely agree with the points already raised. On an asset swap level, I won't say it's unchanged but it's not far off, either.

The big metric here is the govvie spread but, as has also been raised, it's a function of what the swap spreads have been doing. The technical needs in the repo market and for collateral are not something that we have seen in the asset swap pricing in our bonds. We have obviously widened some, but I think there is a fantastic amount of insulation in the SSA market.

There has been little to no influence from our proximity to Russia on our asset swap spreads. The movement is a consequence of the market pulling us slightly wider, rather than any proximity to Russia and Ukraine, in my opinion.

GlobalCapital**: You raise lots of points that I would like to come on to. Jenny, can I ask you more generally about the SSA market and how it compares with other markets, bearing in mind all these factors that we have been discussing. Compared with covered bonds, FIG or corporates, for example?**

Petersen: I agree with what has been said already about the flight to safe havens. That has helped the market. But it also helps that that this funding is reliable, that funding sizes have been pretty much unchanged and that investor work has been undertaken — including virtually in recent years. That has helped a lot to give investors confidence.



Daniel Aagaard Pedersen, head of funding and investor relations, KommuneKredit, Denmark

The most interesting shift that we have seen this year was the extremely strong request for private placements. Structured is something that has come back significantly, especially because of the change in rates. Investor targets that have been very far off are now being fulfilled pretty easily.

Covered bonds have had a record year. So, I would say, comparing sizes in different markets, it's a difficult question to answer. It is more about what investors really want and rely on and it is also about what is going to come along next year. Are covered bonds going to have another record year or are SSAs taking over again?

GlobalCapital**: If you compare covered bonds and SSA bonds, which is the more able to cope with the volatility? Which has the better deal execution? Has covered bond supply been an issue for SSAs**?

Petersen: I would have answered that question differently a couple of months ago. Now I would say it is difficult for both. It just has to be about the right window. If a bond does not work, it is not so much about the spread — it is more about the investors not wanting that name.

GlobalCapital**: We hear the word 'window' a lot more nowadays. What has been your approach as issuers towards timing of deals and flexibility?**

Brusas: It is always crucial to find the right windows. But being a smaller issuer is actually a benefit in times of turbulence, since we don't have to be in the market all the time. This year, for sure, the windows have been fewer and shorter and they required issuers to take fast decisions. Also, diversification is really important. We have done it through the years to be visible in different markets — in Australia, in sterling, in New Zealand and, of course, in the Nordics — in case there is one market that doesn't work for a while. This year we have been able to adjust to circumstances and carry out our usual funding strategy.

GlobalCapital: Presumably when windows are narrow, and there is a lot of volatility, it is easier for the big issuers to dominate those windows. How do you navigate around them?

Kontio: I can only agree with Angela that you need to have the tools in place, as many tools as possible. A good example happened this spring, when the market was closed but the private placement market was booming. We issued roughly €1bn in private placements during that time. So, there was no kind of deal execution risk. We just found a new way to do things.

But then, of course, it is not ideal from the continuity perspective when you want to be active in the longer benchmarks in euros. As I mentioned, we have been a bit too reliant on the tactical markets this year, but this takes away the pressure that you need to print on a certain day.

GlobalCapital: Daniel, are you also using the tactical markets such as MTNs?

Pedersen: We definitely have the same idea about reducing risks by using PPs or taps. KommuneKredit has a concentration rule: we cannot exceed €1bn in any one ISIN, so use of our PPs and taps, in particular, can be slightly more difficult for us.

With regard to the reduction of risks, I am reminded by a podcast I listened to recently about aviation. When flying a commercial airline and on approach for landing, the pilots will continuously ask themselves, "is there any reason I shouldn't land?" They are scanning their equipment, position and using their experience to look for a reason, a risk — and if one thing falls outside the scope of what they have agreed upon before going in they will do a go-around. That's very much what we did as issuers a year or 18 months ago. We were looking at a window and saying, "is there a larger player occupying the window? Is there a too familiar credit that we going up against? Too much congestion? Something that feels awkward?"

I think that has changed. We are now actively looking at "can we land?" rather than "is there a reason for a go-around?" We do that because there is a difference between the aviation model and the issuance model now. The assumption in the aviation model is that the landscape will be the same if you do a go-around — that is, you will get the same opportunity, the same 'market'. This assumption held in funding too, a year ago, but I think we can all see windows opening and — especially — closing much quicker nowadays.

Kontio: I like Daniel's phrase. Each issuer is a plane, and only one plane can use the runway at a time usually. We may also run out of fuel. The problem we have is we don't have the air traffic control tower. No one is telling you that it is safe to land.

Petersen: It is, sadly, a fact that windows are narrower. The runway has got shorter, so you need to push the aeroplane down. It also means you sometimes don't get exactly what you would like, but you get a deal printed. If you have the flexibility — a full fuel tank — then you have a backup. The problem is at a certain point in time you need to be in the market, so you do not have four months of flexibility but rather you have one month — but in the one month there could be two good windows. Flexibility is key – you have to be prepared and have everything ready.

What was a 'go/no go call' was 99% of the time a 'go call'. Until recently, there was not so big a possibility of it being a 'no go call'. Younger colleagues have perhaps never seen anything but a very stable SSA market, where all transactions have worked. We are going back to a shakier environment and you come back to the question of how you will tell investors that sometimes it's a 'no go call', nothing will happen. It's not the case with Nordic issuers this year.

GlobalCapital**: The passengers expect to land. Investors in SSAs traditionally want a lot of predictability about when the plane is going to land. But they also want a lot of liquidity in the bonds. How do you avoid the stigma of pulling a deal? Have you had difficult conversations with investors?**

Brusas: No, not really. We have been lucky enough to carry out the normal funding strategy this year. So, the timing has been good when we have decided to come to market with benchmarks. The execution window is smaller and risker, but we have managed to pick good execution windows, and haven't had to pull anything.

When you run out of fuel, you can put on the electricity instead. It has been really good that we have the MTN market that has been functioning really well this year. We also usually do 60 to 70 private placements a year. Obviously, because of interest rates, this year we are going to end up doing 100, roughly. So that market has again worked very well.

Kontio: I think it is important to have an established profile. When you have a liquid curve you are committed to issue, so then investors will understand that you are going to come back. Of course, if you do only one benchmark per year and then you change your plans, it is going to be very difficult to explain that to investors.

GlobalCapital**: With this market volatility, with short windows and with the bund/swap spread rates being volatile, how do you set a starting point for price when you are trying to launch a deal? is it just a large new issue premium?**

Petersen: For the Nordic issuers, the new issue premiums we have seen were not that different from recent years. When a deal hasn't worked, it hasn't just been about the price. It has been about investors not really wanting that name at that time. I doubt if you can sell it if you just add 5bp, 8bp or 10bp of new issue premium.

Jenny Lale Petersen, SSA origination, DZ BANK

The problem is rather at the long end — do the investors like that or not? — but you have the option to go shorter. And when the curve is flat, how much do you put on the end? Or do you take the safer option and just go shorter?

GlobalCapital**: Issuers, I'm sure you pay what you have to pay in terms of new issue premium to get a successful deal. But at what stage do you say this is actually starting to reprice my secondary curve?**

Brusas: It is always tricky to get the price right. It's not just secondary market performance you need to look at; you have to look at other issuers' recent issuance and then have the conversations. You need to get it right — the investors have the choice of staying away. But, again, it is important that you have the fundamentals in place and access to different markets. If it is getting really expensive doing dollars, you can turn around and do euros or other currencies. Or do other maturities. We are not doing very long funding anyway, but if you are you can then choose to go shorter, for example. You need to have the toolbox, to have other options.

GlobalCapital**: Daniel, do you have any concerns about repricing your existing curve by paying too much of a new issue premium?**

Pedersen: Constantly. That's our job, right?

But I don't think in the current market we should be very bullish. We have a long tradition in the KommuneKredit funding team — I would almost call it a mantra: today's transaction is the first marketing tool for the next transaction. With us being relatively small, compared with the EUs and KfWs out there, what is really important is that when we do something we get a deal that works. We cannot turn around next week and make up for lost ground by doing a new benchmark with a slightly larger new issue premium and make everyone happy again.

Angela has been touching on many of the same elements that we have been thinking about. If we can, as much as the balance sheet allows us to, we choose a tenor that we know works for investors, we choose the product — whether that's dollars or euros or a tactical currency, and we choose something that has some ground to it from our side *and* from the investors' side.

Other than that, the sobering reality is that we are relatively small vessels in a giant vortex in the sea. We cannot change gravity or the market. So, regardless of what we might think, our perception of secondary and everything, at the end of the day we need money and we need investors to lend that to us. I diligently try to make sure that I do that at the lowest cost, but there will be costs — especially now — and I'm very worried about coming out with something that's needlessly tight just because I think that's the right price.

Kontio: I fully agree with the recent comments. On pricing, I am pretty confident that the banks that we usually have on our trades know where our curve is. They know the market. I am not so worried about the pricing.

I am more worried about timing, if there is good karma on a particular day. If you choose a bad day, you will end up with a disaster. That is what we have seen this year. It may be one or two investors who don't participate for some reason — it's normally not the pricing — and that can build up to a very different outcome. And that's very difficult to fix.

GlobalCapital: **In investor relations, everything changed completely because of Covid. How is your approach to investor dialogue and roadshows changing?**

Brusas: We are back travelling now. We found it a little bit challenging during the pandemic. Of course, we organised virtual meetings but you can't say that it's the same thing. It depends which investors you are talking to, it depends on the jurisdiction. It's a different approach. During the pandemic portfolio managers have changed and issuers have changed, so it is important to get out again, to meet up and to get on the same page.

I still think its super important to meet up in person. In Asia you can have lots of long meetings, but then it's the walk to the elevator when one big important thing comes up and that makes the difference — and you can't get that over Teams. Naturally, we need to find a balance between actual travelling and virtual meetings.

Kontio: We have the same approach. Yes, we have some virtual meetings but they are not that fruitful. We all understand that, especially now there is a smaller investor base.

We are also trying to take advantage of virtual meetings, though. I am not saying that everything has to be virtual, but we can do more because we don't need to be travelling all the time. If there is only one meeting somewhere, maybe it is best to do that virtually and concentrate on areas where you can meet more investors. But we are back, so that's good.

Pedersen: It has changed less than I feared it would have a year ago. I feel we are much closer to something that makes sense and something that's sustainable. We are travelling less, but we are travelling. And we – as an industry – have rekindled the love of meeting people again and I feel that it's mutually beneficial. Investors are more or less voicing the same fatigue with virtual.

Having said that, the entire industry has historically been deprived of a lot of working days simply because of travel. When looking at our carbon footprint, travel has also been a huge contributor. It makes a lot of sense to integrate virtual meetings, but I will be a fierce advocate that virtual can only be a supplement, it cannot be the backbone of building relationships. I do believe that investors buy into the width of the bond, not just the one bond in particular on its pricing date. That's what we are doing at an investor relations meeting. We are showing them our mentality, what our strategy is, what they are buying into with this bond and the next one, and hopefully the one after that. It is more difficult to do that solely virtually.

GlobalCapital: **Jenny, when the issuers aren't there and you are speaking to investors, do they actually want these meetings?**

Petersen: Yes. It's a clear yes. It's a people business. We have been roadshowing with MunFin recently, it makes a big difference. But it's better to have a virtual meeting than no meeting at all.

With requests for virtual meetings you are often getting the answer no. The fatigue is definitely there. With physical meetings it is sometimes yes, sometimes no. It depends. When are the work from home days? Sometimes, when people really want to see that issuer they will come into the office.

On the other hand, virtual meetings were very exciting at the beginning. It was very good to see each other. But in the second year of the pandemic, with half the people working from home — probably not properly dressed with a tie, and the camera off — then you just mentioned the most important details of the presentation, what has changed and some things you want to highlight. Virtual is good for that. But to hear the feedback, having investors share their concerns, that was clearly missing. To me it felt more and more like a one-way street.

GlobalCapital: Angela, you have issued in Australian and New Zealand dollars – not an obvious choice for a Nordic investment bank. What are the lessons from that?

Brusas: I can only emphasise again that diversification is important. It has been great to be active in sterling and in the Australian and New Zealand dollar markets, in addition to the US dollar and the euro. We need to swap into euros, since I don't have a real need for sterling, Australian or New Zealand dollars, and that doesn't always work. This year the New Zealand dollar hasn't worked for us. But, for example, in the Australian dollar we have done a fair amount. We always compare the cost for funding in these currencies versus our US dollar benchmark curve.

Angela Brusas, director of funding and investor relations, Nordic Investment Bank, Finland

GlobalCapital: But it's not a free option. Presumably it's more difficult from a documentation and disclosure point of view?

Brusas: Not really. We have the programmes for the Aussie and New Zealand dollar. It is very straightforward. And we have been doing this for years, so the lawyers are very familiar with the documentation.

Pedersen: We are all looking at more or less the same markets. KommuneKredit isn't looking a lot at Kiwi but it is looking at Aussie. We haven't had a chance to go there for funding for a while but, as Angela was saying, it's very much a basis swap inefficiency.

We are trying to employ a strategy where the tactical currency that we have done more recently has a lower threshold to meet in terms of cost of funds. For us, that has been sterling — especially in 2021, when there was a lot of issuance. We have really made good progress with that.

Our tactical currencies, we aren't afraid to admit, are very much driven by our cost of funds. We try to see if we can do more in fewer markets in selective periods of time. Sterling has been the market and currency that has been working recently, and therefore it probably has a lower threshold in terms of cost of funds versus, let's say, a Canadian dollar or an Australian dollar — which, if it's the first funding activity for a few years, probably has to beat something (such as sterling) by more than a few basis points for us to take a new leap of faith.

Having said that, diversification is important, especially in the year that's coming up. It is actually one of the most fun bits of funding. There is really some strategising going into this. It might be only a single basis point or two that makes the difference — and, to be honest, when you have a balance sheet of €40bn-€42bn, it doesn't change the needle much if you are taking out 1bp on A$250m. But taking that leap of faith into a market can definitely change your funding perspective. It's a thing that we spend a great deal of time strategising on.

Kontio: It's the same story for Munifin on tactical markets. In addition to all of these comments, the reason tactical is good is that you can smooth your redemption profile— so, if you do only €2bn benchmarks then you are going to have big peaks that may be difficult from the refinancing perspective. So, we try to smoothen the redemption profile.

We always compare pricing to our euro benchmark curve. Whenever we do Nokkie or sterling, it needs to do better compared with euros — and if it's not, then what we say is it doesn't make sense to us.

But, yes, it's a lot of fun. Especially this year, the euro callable product has been there. We have done €2bn of euro callables because of the volatility going up — so, with these call options, it makes the coupon quite attractive. So, it has been a nice way to do something new.

GlobalCapital: Is the increase in MTNs entirely because of the volatility?

Petersen: I would say it's because of the volatility, but mostly because it's a different market to target. And there is the chicken and egg thing: the investors asked for structured products and the issuers were happy to fill that gap instead of going for benchmarks. It's not that volatility is currently the driver, it's more the rates.

GlobalCapital: And the shape of the yield curve, the flattening?

Brusas: In general we have seen shorter maturities this year. It has been a game changer having access to different markets, including the MTN market. We have seen many more private placements going through than previously. We don't do a lot of structures but the callable product is one that has really worked well. Plus a little bit of CMS spread product as well.

GlobalCapital: Antti, you mentioned Nokkie. I would like to ask generally about funding in the Norwegian, Swedish and Danish markets. With all of the things we have been talking about, is it the same in the three markets — or are they buffered from the external shocks?

Brusas: Nordics we need on the lending side, so we don't have to do cross-currency swaps. So, whenever we are able to take in Norwegian, Swedish or Danish currency we are happy to do so. But again, with the pricing we also compare everything with dollars or euros — so it has to make sense. It is not like we need it on the lending side, that we have to come to the market. It also has to work price-wise.

And then, if we think about the Nordics this year, what is common for all of them is that we have been able to issue green bonds denominated in these currencies. We issued the inaugural green bond in Danish kroner early this year. As we have seen in all markets, the sustainable label makes a difference these days. It doesn't matter which currency you are talking about.

GlobalCapital: Daniel, are you finding that Scandinavian market trends mirror euro trends, or is it different in its behaviour?

Pedersen: We spend a good deal of time looking at Danish kroner. It's somewhere in between a tactical and a strategic currency for us. It is strategic, so we want to be there and it makes so much sense, but it's a market that we cannot rely on, as we can euros and dollars, simply because the market movements have ben asymmetric to what has been happening in euros. Danish kroner, at the start of this, were very volatile. It felt as though we had the worst performing currency and assets before we politely passed that to the UK!

On this backdrop, Danish kroner have not been hugely productive for us this year, especially because the covered bond market in Denmark has been very difficult. Early in the fourth quarter of last year, a 30 year Danish covered bond had about a 1% or 1.5% yield – and we have topped out at close to 6% this year.

We continually talk to banks about what's possible. But sometimes there are forces here that are stronger than what you are able to combat, and obviously there has been a big outflow from Danish kroner investment pools. Danish kroner, Norwegian kroner and Swedish kronor are close to our heart. We have a very good reach with investors and will continue to develop that further. What is unique about these markets is that they work for us at the long end and at and the short end. Our balance sheet needs funding very long from time to time, so it's very important for us.

Kontio: This has been a very busy year in Nokkie. We have done almost 20% here. I don't have one reason for why that is, but we have been constantly active in this market — so we do have an established investor base. For some reason, they seem to like the Finnish issuer – possibly also because we are zero percent risk weighted. We are happy to be here and it's the Nordic family — so we want to be as present here as possible. Unlike NIB, we don't have lending in these currencies so it is purely based on pricing.

GlobalCapital: **Historically, Nordic rates issuers have been very popular with Japanese investors. Is that still the case? Are you seeing enquiries from Japanese investors on MTNs or even benchmarks?**

Kontio: Over the past few years, this market has been getting smaller. As in Europe, there has been more discussion on the retail side about what people understand and what they can buy, and there is more regulation around that. That is happening in Japan and it means that some of the houses have stopped providing these opportunities for retail. Time will show whether the structured note Uridashi market will return or not.

Brusas: We haven't been that active in Uridashi for the past few years. It is a very small part of our funding. What we are also missing is the Japanese investors in the long end of the Australian dollar market. We used to see more of the 10 year or longer issuance going into Japan and that has been lagging. Some of the Japanese investors take part in benchmarks, but in general we would hope to see more interest out of Japan.

GlobalCapital: **You have all done green or social bonds relatively recently. Is that a market that is still growing as fast as before? What is the outlook?**

Brusas: We do see a continued interest for it. Of course, there are a lot of developments in the market but we do see demand for the normal use-of-proceeds green bond. This has been a record year for us — we are at €1.1bn equivalent. Whatever currency you choose, the first question is: can you do green? We are still in the situation that we don't have enough eligible assets. Demand is bigger than supply.

But there is a changing focus. Investors are not only looking at the green bond — and what projects you are going to finance — but also at me as an issuer, so you need to have your governance issues and your environmental and social risk assessment in place.

GlobalCapital: **Does that potentially invalidate the whole use-of-proceeds model? What matters is the whole organisation, not the use of these particular funds?**

Brusas: That's a good question. We still see demand for use of proceeds bonds because there are dedicated green funds, for example. But we are being innovative; there are new products coming up. We started a year ago to give out sustainability-linked loans on the lending side, trying to move the hard-to-abate-sector companies into a more sustainable future. This is something that investors are also interested in but there is no good product for it right now. We don't like the sustainability-linked bond, being a bank. But, as mentioned before, there is also more focus on how sustainable the issuer is, in addition to the labelled bonds.

Kontio: The smallest execution risk you have is euro green. For many issuers who now have green programmes in place, maybe 5%-10% of the lending is green and 90%-95% something else. So, then, how can you have an impact on the other side of the business as well? That's where the holistic approach comes into play — but it's not good either if you wrap everything as sustainable. Everything we do is sustainable and that's it, no impact reports. Investors really want to see impact metrics. How is this going to improve the situation?

I fully agree that the green bond market is there. It's going to be there at least for the time being —but it would be nice if there could be a clear way to look for investors, not just green side but everything. We have ESG ratings now in place. Is that the way forward? Are the ESG risks the way to look at it? What is going to be the main way to look at this holistically? I don't know.

GlobalCapital: **Daniel, do you buy the line that everything you do is in line with sustainability goals?**

Pedersen: Absolutely, I would definitely buy that! But I would also say that I think it's the right move. I have had a little bit of an issue with green bonds in the SSA market versus corporates, for instance. Our role in society is holistic, for all of us. We are servicing something that's much bigger than ourselves. KommuneKredit is proud to drive the transition to green in Denmark. I completely understand the current 'use of proceeds' with a carve-out of the balance sheet — but, to be honest, I think we need to be rated on our entirety.

A green bond and a carve-out of the balance sheet makes sense for a shipping company that has an actual vessel they can buy, if they get proceeds at a better financing cost. They then buy a vessel that's more green. That makes sense, and that's direct: here is funding, here is something that is better for the environment. If we are being completely honest, that's not necessarily the same impact that we have, because our general funding purposes are much more holistic. I completely agree that currently using the carve-out method is right. That's why we have updated to a new Green Bond Framework that is partially aligned with the EU taxonomy, and we have ratings from Cicero. I just hope that in the future we are transitioning much more to the holistic. It should not be the cherry-picking of assets; it should be our entire governance, our entire being in my mind that will drive the transition further and faster.

Petersen: What has just been said covers all the layers that this topic has. The first layer is the euro green market for SSA issuers. It is the easiest to pick. Daniel is right, we need to service society. And I agree with what Antti has said about what the market is doing here. Having this holistic approach is an easy one. You can just tick the box.

But the deeper you go into this discussion — and we see it with the green taxonomy — is it just nice to play with the clean kids? The ones that are green already? Or do we want to have a say with the muddy kids? The dirty ones? Not just greenwash them, but take a holistic approach? If a company that has nuclear energy issues one green bond, what does that mean? Is it something that goes in the right direction.

I really liked the development just 10 years back. Now, it is so established. Then, at a certain point, the impact reporting also picked up. This is really something that investors are waiting for.

The green bond market is so well established — there is no question at all. But what about the social bond market? What about weapons delivery? And providers? Is there something social? Everyone would have answered that question a year ago with a clear no; now, we have this question of how to incorporate them. It's interesting where this is going.

Speaking of DZ BANK and Nordic issuers, it is very easy to serve our co-operative network base because they do have this holistic approach. They always looked at the issuer itself — but it makes it difficult sometimes for them to invest with that approach because it excludes a lot of other, non-Nordic green bonds, and there I question whether we are yet there with that approach.

GlobalCapital: **Will there be a social taxonomy ever, or will it be a market-defined sector rather than an EU definition?**

Brusas: Discussing the usability, just a couple of weeks ago there were efforts to give guidance on how to use the taxonomy and the EU green bond standard — because right now there are big challenges with the usability, so hopefully they will take on board all of the advice that the market, those with hands on, are giving them. I think they are picking up something. Maybe at some point we will arrive at something that is actually usable.

Kontio: Munifin has been active in social bonds for the past two years and I see that the topic is difficult. What is social in a Nordic context compared with developing countries?

The ICMA principles are very clear: you have the target population and that's how you build your framework. But if you have a taxonomy, it becomes very, very difficult. You come up with all of these pan-European problems: what is social in Spain might not be the same in Finland. So, I agree, it would be difficult.

Petersen: I fully agree. We need something that is handy and applies both to the green taxonomy, which is partially adapted, and the social taxonomy. We need to have a tool that we can work with, not just something that covers every little piece of what is upcoming all over Europe.

Pedersen: I very much agree. It's a classic case of what can happen when regulation is introduced to the industry. There are a lot of non-too-distant memories on this for MiFID and other regulatory implementations. There was a clear need for regulation, post-financial crisis, but the first generation of rules and regulations employed made it almost impossible to actually do what you wanted to do. It hindered a lot of stuff. We are seeing the same in the EU taxonomy. It's so nitty-gritty that it makes it difficult to achieve what we want to achieve. Hopefully, a feedback model — where the market participants can give inputs on what we are actually looking for — can be quicker than it was with regulation after the financial crisis. I worked in a bank at that time and it was not a fun period to actually do deals, because the amount of documentation you had to do was big.

The holistic approach makes a lot of sense. I will, of course, admit that it is a little bit of a fairy tale to believe that the holistic simple model will prevail throughout the economy and across all assets because it is a lot more nitty-gritty, for instance, for corporates.

Brusas: On the EU taxonomy, we all find it frustrating and difficult and all that, but we also decided that we are going to try to align ourselves with it and we started out with the green fund pool. So, we did the first attempt last year and we are going to continue doing it. It is just a start. Being transparent is the key.

The drivers here have really been the investors because they were calling us up and asking, have you done the alignment? Will you do it? Can we have a discussion around it? And it was a really good discussion with dark green investors, because they already needed to disclose the alignment of their investments. More important than having everything fully aligned seems to be the attempt by issuers to do the exercise. So, for our *Impact* report we added an estimated alignment to the EU taxonomy. It goes with a disclaimer, but we are being super-transparent and giving arguments for the result. It is important to remember that when we started out with the green bonds as well, everything — including impact reporting — seemed very complicated as well. But we worked it out, so you just have to start somewhere, be super-transparent and then develop the reporting as we get more guidance.

Pedersen: That's a super-important point. What the EU taxonomy has done with flying colours is set some direction. It has given us something to debate. Let's hope that we can get it moving along the value chain — but it has definitely managed to set ESG at the forefront for the entire market.

Kontio: Now everything is voluntary. You can decide to become a green bond issuer, you can adapt the taxonomy into processes, or whatever. But you also have the regulation and the taxonomy is coming from that side. For us, because we are supervised by the ECB, there will be certain metrics that we have to report – for example, the green asset ratio, the amount of taxonomy aligned assets in your portfolio.

GlobalCapital**: In one sentence or less, what will be the dominant theme for funding SSAs in 2023?**

Brusas: Inflation, interest rates, recession.

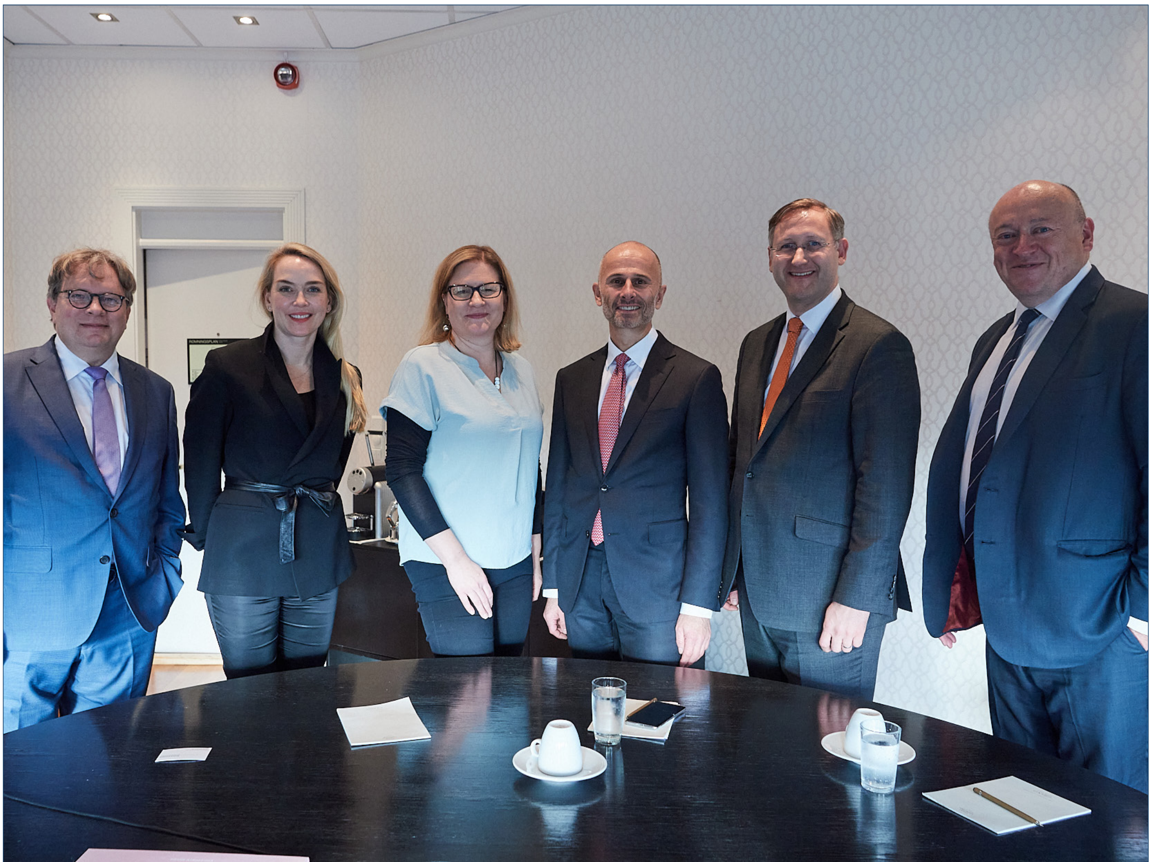
Kontio: I had inflation too.

Pedersen: Central banks. There are recent examples of where central banks have had a surprising reaction function that led to a big move in markets. It's not easy being a central banker right now, and I fear 2023 is not going to be any easier.

Petersen: I was going to say that as well: central banks. The other thing is exogenous shocks. We need to manage the unmanageable in 2023. GC

Nordic financial institutions demonstrate resilience and agility amid market turbulence

Nordic financial institutions needed to navigate a series of macro risks across the year which impacted issuance plans and demanded extra agility from them in adjusting their funding mix, price expectations, and in seizing the windows of opportunity to successfully raise 2022 funding and some 2023 pre-funding. As tough market conditions persist, DZ BANK and GlobalCapital brought together some leading Nordic FIG issuers and investors to discuss how they navigated the turbulence, together with the key trends and developments shaping the FIG market as we move into 2023.



Left to right: Patrik Götzinger, DZ BANK; Ahlqvist; Eriksson; Hjelle; Ebert; Kemmish

Participants in the roundtable were:

Dag Hjelle, treasurer, SR BANK / SR Boligkreditt

Sanna Eriksson, managing director, OP / OP Mortgage Bank

Kerstin Ahlqvist, head of long-term funding, Swedbank

Henrik Stille, senior portfolio manager, Nordea Investment Management

Matthias Ebert, head of FIG DCM, DZ BANK

Richard Kemmish, moderator and GlobalCapital contributing editor

GlobalCapital: It has been a very busy year for covered bonds. Why? Is that because it has been a volatile market and covered bonds are a defensive product? Because of the end of QE and cyclical factors such as that? Or is it a permanent shift towards covered bonds being a larger proportion of total funding?

Ebert: First of all, for issuers the collateral value has significantly increased, making covered bonds much more attractive as a funding instrument. That's probably the key reason. But other cyclical factors like the end of QE and the expectation for higher yields have boosted supply as well. One factor is that mortgage loan growth was stronger than expected in the first half of financial year 2023, as a number of borrowers wanted to secure the low yields. And issuers thought that they would like to replace their TLTRO funding with wholesale funding before QT starts.

Matthias Ebert, head of FIG DCM, DZ BANK

Then we had other cyclical factors, like TLAC/MREL. A number of European and non-European banks progressed with their TLAC/MREL funding in 2021 and that gave more room for covered bond funding in the course of 2022. And, last but not least, some banks also had some question marks around the stickiness of deposits that came on balance sheet during the Covid crisis — and as a result we have seen more covered bond funding.

I do not believe that in future covered bond funding will have a larger share in banks' wholesale funding overall, but I do believe that next year will be a good year for covered bonds.

GlobalCapital: Issuers, have you issued more this year?

Hjelle: In SR Bank and SR Boligkreditt we have done about what we expected. For MREL funding, we didn't have any plans in euros. We did our first benchmark in 2022, and had no plans for this year. We did a little bit more covered funding than expected. We wanted to do more senior but the market was too expensive, so we opted for more covered bond funding. So, it was almost as planned, but a little skewed towards covered bonds because of the pricing.

Ahlqvist: We have also done somewhat more than expected. We saw attractive conditions in the Swedish market at the beginning of the year and took advantage of that. Otherwise, we have not issued more covered bonds than in 2021 – in fact, rather less. It has been an effect of QE and the subsequent influx of deposits – as well as MREL: in Sweden we have January 2024 to work towards. But we did the re-entry to the euro covered bond market, which was really good. We hadn't done anything since 2019; we had been focusing on local currency covered bonds because of the lower funding need generally in covered bonds for the past three years.

Eriksson: We have done two covered bonds a year. At the beginning of the year we said 'OK, it's perhaps not the easiest market', so we went a little bit shorter than we have before and we did it green — so that we put all the good things in at the same time and it was successful. But, of course, with the new law and the covered bond directive it took us time to get our programme ready.

Ahlqvist: We observe the interplay between the two covered bond markets that we are active in: domestic currency and the euro market. The Swedish domestic market is an "on-tap-market" and we are active throughout the year. The relative costs is one aspect when we decide when to issue non-domestic. In early summer there was a shift: for years the Swedish krona has been more attractive than the euro and then that suddenly reversed – euros were much more attractive, so we took advantage of that when issuing the euro covered bond in May.

GlobalCapital: Why was that?

Ahlqvist: The Swedish domestic covered bond market has historically been resilient to international volatility but this year's global rates turbulence has affected Sweden as well. Another factor adding to the domestic covered bond market volatility has been international fast money, which has been less active this year.

Ebert: Was that also because the Swedish central bank stopped its purchase programme for covered bonds?

Ahlqvist: So far the Swedish Riksbank has not stopped the purchase programme, but it has taken volumes down since the summer. The market expects the programme to discontinue from 2023.

GlobalCapital: Henrik [Stille]: Is this volume the new norm or has this year been the exception?

Stille: I think we will probably have this higher volume for a while but it will depend on what happens in the real estate market next year. You can also see a scenario where activity in the mortgage market slows down and then we will have less supply as a result. I don't think we are there yet. There are still factors like TLTRO repayments that are pushing up supply.

GlobalCapital: Clearly, this has been a very volatile year. How flexible have your issuance plans been?

Hjelle: We had to change a little bit because of the dreadful situation, the invasion of Ukraine. We did not plan to have our first transaction in euros as a covered bond; we planned for senior. Then we had to wait for a while and we saw the market was almost fully open again at the very end of March that lasted almost a month, so we did something in late March and that was a covered bond. So, the war did have an effect on our planning.

Dag Hjelle, treasurer, SR BANK / SR Boligkreditt

Ahlqvist: We have seen enormous volatility this year; the windows have been short and infrequent. When we see a good window we need to de-risk the most risky product. That has been our strategy.

All of us here are stable names. If you are a high rated issuer, you have been able to issue and markets have stayed open. But then, and Henrik you can probably fill in here, we have been more vigilant to demand for tenors, for example, and what would work at a particular time. Investor demand has been a big factor in deciding on asset class, choice of tenor and currency. We haven't seen as many three-year bonds, for example, in the past but this year we have seen quite a few of them. Otherwise, you would go as long as you can if the demand is there; it has not been the case recently and issuers have adapted. That is also about planning well — so you don't have to issue a seven year when the demand is only in the short end of the curve.

Eriksson: You have to be ready at all times. It's not like you can make these plans for the whole year and then stick to the plan. The more products and the more currencies you can issue, the more diversification and flexibility you have as an issuer.

GlobalCapital: Matthias, what are you telling issuers at the moment about next year's plans? Obviously, volatility is here to stay. What's the advice?

Ebert: I like what Sanna just said about currencies. In the past, issuers could exclusively focus on the euro market and investor demand was there from three to 15 or 20 years. Now there is an advantage if you are more flexible on currencies — maybe sterling, dollars, Swiss francs, euros and your domestic currency. We would strongly advise issuers to keep their eyes open for opportunities in different currencies.

I believe that the dollar market will present itself as an attractive alternative for more issuers as soon as the ECB's distortions fade from the euro market.

Second, investor marketing remains key. Transparency is important in how the forthcoming recession affects your balance sheet, how it affects your loan book. Issuers should look out for new investors, or old investors that have come back to the euro covered bond market. We roadshowed an Asian central bank in Germany that was keen on investing into euro Pfandbrief. These are investors that issuers should have on the radar screen. Asia is a region that some issuers neglected for some time. That region is coming back. But there are also European investors that come back from the senior preferred into the covered bond market after the increase in absolute yields.

Last but not least, timing will be key next year. You might be better off issuing the more defensive product at the start of the year. Then later on, as the European economy improves, demand might be stronger in senior as we come out of the recession.

GlobalCapital: Henrik, you have got to invest, they have got to issue. What would your advice be about planning for next year's issuance?

Stille: What is interesting for us is that over the past year we have had much more spread widening in the domestic Scandinavian currencies than in euros, so from the relative value perspective we strongly prefer to buy covered bonds in Swedish kronor, Danish kroner and Norwegian kroner at current levels — so my advice would be to issue in these currencies. The differences are quite large. If you take the short end of the Norwegian krone covered bond market, the carry, roll-down in the curve is significantly better than in the euro market. The same in the Danish market – and the Swedish market to some extent, depending on whether you buy the bonds in the long-only fund or you repo fund the purchase. But overall, euros are very expensive relative to the Scandinavian currencies.

GlobalCapital: **Kerstin mentioned duration, and shorter transactions. Do you want to see more short-dated issuance or more flexibility on duration?**

Stille: In the Scandinavian markets they are currently issuing mainly out to five years. This makes it very difficult for the euro market to compete in shorter tenors. This is what we have been saying to syndicates for some time. If we are going to buy, it is actually better for us if it's a longer tenor, because there is no competition from the Scandinavian market. So, we can argue that it's still OK to buy a covered bond in euros, but very different in the shorter tenors. In euros we prefer longer ones. I know that's not in line with most investors, many of whom don't follow the Scandinavian markets as much as we do.

GlobalCapital: **One of the issues with longer issuance is that it is more difficult to price. First, from an investor point of view, with all the volatility around new issue pricing and the difficulty of finding a fair value, is that an opportunity? Or is it a problem in between you and where you want to be as an investor?**

Henrik Stille, senior portfolio manager, Nordea Investment Management

Stille: The main problem is always to know at what level we can sell something, if we are going to buy a new bond in primary. We always get these fair values that syndicates send us and they are always 10-15bp tighter than the indicated guidance of the new bonds. But then we cannot find any bids close to those fair values. That's the difficult thing. We need to spend some time figuring out where the real bid is before we can put in an order in the primary market, especially outside the large prime issuers from the eurozone. As soon as we get into the smaller issuers, countries in eastern Europe or southeast Asia, there the screen prices are not a good fit at all to where the real bids are, so this is a bit of a challenge.

Ebert: What could be a challenge next year is investor demand. In case investor appetite stays at the short end of the curve — because people expect credit curves to steepen and yield curves to remain volatile — one could question whether bank treasuries, as the main buyers of short-dated covered bonds, will still have enough credit lines for the expected supply next year. The ECB is behind the other central banks by about six months, which means that the bid for the longer tenors could come back to in other currencies earlier than in the euro market. I'm not saying that there won't be windows of opportunity at the longer end in the euro market, but

at least in the first quarter of 2023 we will still have the sweet spot at the short end.

GlobalCapital: **What about the point about the fair values not being realistic? Secondaries are very difficult to base new issue pricing on. What is the strategy? Is it just a large new issue premium?**

Ebert: First, I hope that the signalling power of secondary markets will improve as the ECB retracts from the euro covered bond market. Most of the bonds are with the central bank and that reduces liquidity. Second, uncertainty about the fair value needs to be offset by a higher new issue concession. Otherwise, investors will not feel comfortable to buy into the long end of the curve.

GlobalCapital: **How do the issuers respond to that? What new issue premium did you put on your recent transactions and how did you arrive at that? Is there anything you can do to reduce it?**

Ahlqvist: Back in May it was 2bp-3bp, and the market was quite different then. You probably experienced the same, it was pretty stable. But the NIC is clearly constantly changing and it is also issuer-dependent.

Hejelle: We did a billion in August and I don't think we paid very much for that. I can't even remember what the new issue premium was.

GlobalCapital: **Was that just because it was nice timing?**

Hjelle: We were quite fortunate with the timing and the market backdrop was good. We were out fairly early in August. September wasn't that good. You have to choose the right timing. If you are pre-funded you can sit and wait and chose your time.

Ahlqvist: Covered bonds are the least of our worries when talking about new issue concessions. As I mentioned before, if we have a very strong window in front of us, we will choose a higher beta asset class to issue.

Eriksson: Covered bonds have shown their character, what the product is really about. It's the one product that you could go to the market with at any time, when other windows were closed. So, in that case it was very important for the banks.

Ebert: Recently, what we have seen is that the price sensitivity of investors is decreasing with tenor. Issuers that paid up a high new issue concession at the shorter end got large order books. It still worked in the five-year bucket, but going out to seven — even paying up — did not result in a large order book. That price sensitivity to a new issue concession has its limitations, so what you need for a trade at the longer end is willingness to pay up as well as a strong issuance window.

Ahlqvist: If you look at the euro swaps, you don't get compensated as an investor to go from three to seven years – you have five basis points currently.

GlobalCapital: **Because the curve is shallow?**

Ahlqvist: Exactly. It has never been as important as it is now. When you as an issuer choose a window you are aware of how this is moving and what that means for demand. Obviously, Henrik, you have another perspective, but it doesn't make sense to go to 10 years because it means compensating for the flatness of the curve by paying higher spread.

Kerstin Ahlqvist, head of long-term funding, Swedbank

Stille: And that's what we are looking for!

GlobalCapital: **Do you agree with Matthias's point about the price sensitivity being more at the short end?**

Stille: Yes. Also, when I speak to other investors, they are much more towards the short end of the curve. That's why there is the sensitivity there.

GlobalCapital: **Can we look at next year's funding needs and potential drivers of supply. Let's start with deposits. Clearly there has been a lot of volatility. We saw a lot of Covid deposits but now we have 'catch up spending' and inflation reversing that. What are you seeing**?

Eriksson: We don't see the decrease yet. If you compare third-quarter figures with the year before, it's a 1% increase but there is a lot of discussion. We will have to see. I don't have the answer. Historically, smaller banks in Finland especially have started to offer term deposits when interest rates rise. We have started to see the first signs of this phenomenon.

Hjelle: We are growing at 7%-8% year-on-year. But we can expect the volumes of deposits to trickle back. But we also had almost 10% growth in lending, so lending was more than deposits. Probably it will go a little bit down but we are not seeing it yet.

GlobalCapital: **Kerstin, are you also seeing strong deposits but stronger loan growth?**

Ahlqvist: Yes, we do. The deposit growth has been strong over the last 10-12 years but has accelerated over the last two years because of QE. The loan to deposit ratio was 212% in 2012 and we are now at 137%. It has now stabilised from the extreme acceleration, and we expect it will be a gradual decrease. Even though we have some outflow of deposits, it doesn't mean that we need to fill it up with wholesale funding per se.

GlobalCapital: **Matthias, are you hearing from any issuers about pressure on deposits or on regulatory or rating treatment of deposits?**

Ebert: Deposits are quite a hot potato. Some regulators have more questions about the stickiness of deposits, in particular for those deposits that were rolling on to the balance sheet during Covid. That can be for good reasons, particularly in the light of high inflation, high energy costs and higher interest rates on mortgages in Europe.

But one always has to look under the surface. How much of the deposits are sight and term deposits and what is the share between retail and corporate deposits. Corporate deposits have low stickiness and are price sensitive; retail deposits are not. One could argue that for the whole financial system in a country it's just a question of how the deposits are shifted around from one client to another. However, we need to take into consideration that there are more attractive options for retail clients, as bonds are positive yielding again. And some countries, such as Germany, are net importers of energy. The environment has changed overall and this needs to be taken into consideration. It's really hard to judge on the impact on deposits for a banking system, as clients are affected very differently in each country. If mortgages are 95% variable, rate hikes have a much larger impact on savings than, for example, in Germany, where most retail clients took mortgage loans with a fixed rate of 10 to 15 years.

Ahlqvist: I think we see it more like a closed system. If retail deposits are going into funds instead, they come back to us at some point anyway. What will really have an impact is QT and Riksbank taking out money from the system. That will shrink the volume and that is what we will be looking at more, to be vigilant on the potential affects from QT.

GlobalCapital: **Sanna, I'll let you respond to the point about floating rate mortgages. Obviously in Finland they are almost exclusively floating rate.**

Eriksson: We stress test our mortgages with a 6% interest rate for 25 years to maturity and our average maturity of a new loan is 21 years. We want to be careful. What they can also do is have an interest rate cap: 32% of our mortgages are secured with a cap, so the customers are doing pretty well, even though the interest rates are higher and the bank is enjoying it. All in all, the situation is not worrying. But everyone is asking about it because in Finland the market is so different from most other countries.

GlobalCapital: **Can I move on to another driver of covered bond supply, MREL. In the past, two or three years ago, a lot of covered bond issuance was held back by the necessity of MREL build-up. Are we there yet? Have we built up our MREL buffers? Is that going to be a constraint?**

Ahlqvist: We have until January 2024, so we are still in the build-up phase. If we look to January 2025 and onwards, the steady state outstanding volume will be quite a bit higher than what we had before the MREL build-up. So, by default, that means that the covered bond volume outstanding can be lower.

Eriksson: In our case, we have to issue more of everything. It doesn't affect that much on the covered bond side what we are doing on the co-operative side or our senior bonds, and so on. So, it's different issuers and different characters in that sense.

Hjelle: We are building up also towards January 1 2024. We need to follow a linear path and I think we are spot on. Next year, if the market allows, we will do one more senior non-preferred in the euro market benchmark format — and, of course, if we didn't have to use this expensive instrument, we would go for a cheaper one!

Ebert: The overall MREL shortfall is €21.2bn against the final 2024 targets for all European banks, as of the first quarter of 2022. In fact, €21bn doesn't seem a lot. However, 58% of that shortfall is with non-Pillar 1 banks, 38% is with top tier banks where the balance sheet is larger than €100bn, 3% is with other Pillar 1 banks and 0.3% is with GSIBs. So the bigger banks are fine; the shortfall is more of a problem for the smaller banks. Maybe it is more difficult for them to access the market in more volatile times or maybe they are more price sensitive.

With the recession that is kicking in, we will see RWAs go up. I do believe that we will also see buffers go up, which will create some additional MREL needs. However, loan growth will probably suffer, so RWA migration needs to be compared with lower levels of loan growth. I don't know what the net number will be but we will have to keep the MREL needs of the smaller banks on the radar screen.

GlobalCapital: **How much pressure are you getting for higher duration funding, long-dated mortgages, more focus on short-dated funding. Are you under any pressure to put on funding duration?**

Hjelle: No. We have a healthy maturity profile, and also a healthy duration. If this continues, if we only issue three year paper — we will end up with average 1.5 year funding and that would be too short. But I think the market will open up again. I don't know when.

GlobalCapital: **But at the moment there are constraints from rating agencies saying there is a duration gap? Or regulators?**

Ahlqvist: No. Not for us.

Eriksson: There were so many years when we did mostly seven or 10 year issuances and built up the outstanding secondary curve. Our funding profile is therefore stable and strong. Even if the demand is now in shorter tenors, we don't see it as a problem. Our funding limits are conservative and they make sure that our maturity profile will stay stable. Of course, always when we issue something we take into account the market sentiment, price and demand.

GlobalCapital: **Henrik, you mentioned wanting long-dated issuance in euros. But in general?**

Stille: That's more to avoid the competition from the Scandinavian currencies. We would hedge the duration of the longer-dated issues; we wouldn't add the duration. It's spread that we are adding.

Ebert: Are you of the opinion that the credit curve will stay reasonably flat? You can hedge the interest rate risk but you can't hedge the credit risk.

Stille: The spread curve should steepen. Everyone expects that when we are in this phase but what happens is that there is no supply in the long end, so then you don't get the steepening. When the supply comes back in the long end it is usually because the demand is also back. So we might have a little steepening of the credit curve but I don't think we will have a significant steepening.

Ahlqvist: The tenor is not what is driving the funding. We will adapt to demand. We have several metrics that we need to conform with — such as NSFR and Survival Horizon. All these metrics which are steering us mean that we can be flexible on the tenor.

If we issue more three year bonds, then of course it will roll off sooner — which will increase the funding need earlier, but it is nothing that is hindering us and it will never be the reason to go to 10 years and pay up massively. Funding planning is key. If it is prudent enough, then hopefully you don't need to be forced to issue a certain tenor.

GlobalCapital: **Can we talk about alternative currencies? We have already spoken about the Scandinavian markets and your shift, Kerstin, from kronor and kroner being more attractive to euros being more attractive. In general terms, do you look at other currencies? There has been a lot of dollar issuance this year – not particularly from this region, but could it make sense? is it diversification in a volatile market?**

Hjelle: 2017 was a favourable year for swaps. After that it has been too expensive, or the euro market has been so cheap. When the credit spreads are increasing, the dollar market could be interesting again. We are agnostic to currencies but we don't have that much to issue. We could do some dollars because we have some natural needs but so far the [sterling] market has not been an alternative for us. It has been Norwegian kroner. We could do something in Swedish kronor but I don't think so. The euro is our main motor — and then potentially dollars, if that came cheap enough.

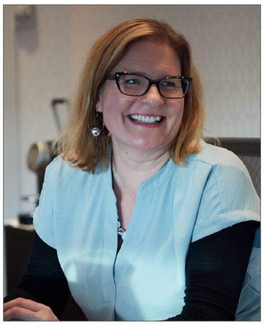
GlobalCapital: Swiss franc ever?

Hjelle: We have done in the past, although not covered bonds. We could — that is such a small size that it wouldn't jeopardise our euro market presence.

Eriksson: On the senior side we are open to the currencies but in covered bonds we just stick with euros.

GlobalCapital: Why is that?

Eriksson: Well, I had never really thought of it! I think the euro market has worked fine for us, so there has not been a need — but that doesn't mean that it couldn't be that in the future.



Sanna Eriksson, managing director, OP / OP Mortgage Bank

Ahlqvist: For the last two years we have issued half of the covered bonds we used to issue, so we have focused on the Swedish kronor market. It's our bread and butter and it has proved to be a very stable market over time. We want to stay present there and so the smaller volume we need has been focused on staying present in the market and providing market liquidity. It has meant we have funded rather more covered bonds than needed from a pure funding need perspective.

But then we also did a euro this year as the pricing dynamics changed versus Swedish kronor. Also [we wanted] to not be out of the market too long, as we see that market as a very complementary. Swedish domestic markets and euros complement each other and we are vigilant about how the pricing changes over time.

We issued in the dollar market once — but currently, with lower funding needs, we focus on Swedish kronor and euros.

When we talk about attractiveness, it is more of a hypothetical relative play as we don't need to swap back from euros to Swedish kronor immediately when we do a transaction. We have a risk mandate that means we can sit with the risk and swap back when we want to. Nevertheless, it makes sense to evaluate it like this.

GlobalCapital: Henrik, presumably you can buy any currency — but then you just do a straight 'swapped back' comparison. Or is it more complicated than that?

Stille: It's more complicated. We can do what we want but the only thing we cannot have is the FX risk outright. So, either we can just do a complete basis swap back to euros or we can just do rolling FX forwards and keep the non-euro rates. So, if we buy Swedish kronor or Norwegian kroner we can basis swap them but we can also just do the FX hedge. For example, in Swedish kronor at the moment it is expensive to do the FX hedge, so there we prefer to do the complete basis swap and also to repo-fund the purchases to get rid of the FX risk that way.

When it comes to the non-Scandinavian, non-euro currencies – for example, the US dollar —we have not been buying anything this year, but that might be something that we will start to look at again next year. That will depend a lot on our general views on the US economy versus the euro economy — because if we buy covered bonds in US dollars we typically do it when we like to have the US dollar rates risk. For example, at the beginning of 2020 we bought quite a lot of US dollar covered bonds where we didn't hedge the rates risk to have better protection against the pandemic uncertainty — where you have much more protection in US dollar rates. In general, depending on how severe the recession will be here, that can also be something to look at — even though, right now, the economic outlook looks poorer in Europe than in the US. But, of course, that's not the ultimate situation. It's something we will monitor next year.

Ebert: I believe in a revival of the US dollar covered bond market, but it will be an interesting process. Ten years ago, we had issuers from France, the Nordics, Australia — and most recently Japan, Canada and Korea — playing in the 144A/Reg S dollar market. As the ECB has distorted the market and has made euro covered bond funding so much more attractive than US dollar covered bond funding, some of the issuers who were natural dollar funders have moved into the euro market. The Koreans are a good example.

If you look at the order book split, you see that even on 144A/Reg S dollar trades roughly 45%-50% of the demand is coming from European and Asian accounts, so issuers looking at Reg S dollars will find a reasonably well-established investor base. However, that market only works for €500m trades. If you look for larger trades, like the Canadians or Australians do — a billion or above — you need the US buyers as well and I think that market is not very well developed simply because there was not much supply over the past few years. The investor base is always a chicken and egg game: there is no supply, there are no investors. Once the supply comes back, the investors come back as well. I think that for issuers that want to go into the US dollar market for the first time, it will be harder in 144A/Reg S, at the beginning at least, to find a sufficiently large, granular investor base than for those that look at Reg S dollars.

On the other hand, for Reg S dollars you often pay up. Just look at the German issuers that have natural US dollar exposure. When they came to the dollar covered bond market, they were willing to pay up a few basis points because they save credit lines on the cross currency swap and the currency match pleased rating agencies. So there was a tendency in the Reg S market to pay up versus euros on a currency adjusted basis. Some of the investors are used to that — so, if you take everything into account, I think the most promising option for smaller issuers is the US dollar Reg S market, and for larger issuers it will be a journey to develop the US QIB investor base.

One last point: it depends also on the investors. If large investors can look at a Reg S only covered bond trade, then it will be easier for issuers to return to that market. Are you a buyer of Reg S paper only? Or does it have to be a 144A/Reg S format to get you on board?

Stille: We can buy only Reg S securities.

Ebert: Would it be a precondition for you that it is a dual tranche 144A/Reg S to have a higher level of liquidity on the bond, or are you fine if it is just a Reg S?

Stille: As long as you can do a $500m issue with only a Reg S, this is fine for us.

GlobalCapital**: Let's move on to the ESG market. With the expense, the amount of data mining you have to do, is it actually worth it in terms of basis points saved?**

Eriksson: If you look at just one issuance, of course not. The greenium for us was 1bp or less. What we did was to build up the system. Now we have already done two, and hopefully [we will do] some more in the future. What we hear from investors is that the houses that are able to issue green or sustainable or social is that their regular products are of more interest. When you build up your sustainable products, you also widen the investor base for your other products as well. For green finance, I think it is really important that we are all there. Of course, we are all in different places on the path: you need the pioneers and you need the rest to follow.

GlobalCapital**: One basis point or less than a basis point. What do you think the greenium is now for all covered bond issues? Can you even come up with a single number and is that going to widen or narrow?**

Ebert: One basis point on average is probably right. With higher credit spreads and higher yields, there is a likelihood that we will see a larger greenium.

Moreover, the ECB purchasing programmes diluted differences between green and brown as well. Issuers got a 40% order from the ECB on both types of bonds. There was no differentiation. When this distortion goes out of the market, then the greenium might increase. However, I do not believe that the greeniums will become large in the covered bond market. The average 1bp greenium was not achieved by comparing apples with apples. Often the green trade was a €500m "will not grow" transaction that people compared with an outstanding brown curve of €1bn trades. So, I am not sure whether the greenium you saw in some of the trades was actually a result of the capped size on the trade or the green collateral behind it.

But I hope — and I think — that the greenium will increase over time with a decreasing bid from the ECB and higher yields and spreads.

GlobalCapital: **Henrik, what do you think? Are there good reasons to accept different yields — such as the new reporting standards that you have got?**

Stille: For us it's still very much a data issue. It's difficult to get hold of the data that we need, especially on the cover pools. This is what our clients are asking about. They want to have this data but they are probably not prepared to pay much for it — by paying, I mean that they are not prepared to say you can buy these covered bonds significantly tighter than other issuers.

This is very much now driven by our clients because we are trying to just deliver what the clients are asking us to deliver. We cannot deliver the data ourselves but we need to tell the issuers that we want to have this data. In the end, I expect that it will be pretty much the same type of data from all issuers but we are not there yet and it will probably take some time. It feels like the regulation is probably two years ahead of the data availability.

GlobalCapital: **When you talk about data there, you mean specific to the cover pool or more holistic about the issuer?**

Stille: I mean specifically on the cover pool — for example, the energy efficiency on the mortgages. I don't only mean the green bonds that are issued. I think the whole cover pool. They will probably get them on the cover pool then the next step will be on the whole lending book. But the cover pool will be a good starting point. That would satisfy most clients.

Eriksson: Then when issuing not just green covereds but also green bonds we find out that investors like their questions. We start off from the green side and they ask, for example, about the cyber risk, and so on. Then we go to the regular products and their questions are still the same — so, I truly think the same that Henrik thinks.

Stille: That's also what our clients are asking us. They want to know the whole cover. They don't focus so much on the individual issues, they want the data on the whole cover pool. So, that's why [we have] the same questions on the green bonds as on the non-green bonds.

Eriksson: Whether you are a green issuer or not, we have to be prepared. It's really important that we have these discussions so that we can learn, like Henrik said, they don't have the data — and neither do we — so have to ask the clients to give us the data. Then we have some reporting to do. It's not something that any of us can do alone; we need the whole thing aligning.

Stille: The best way would probably be if you could incorporate it into the ECBC label, to have some kind of database of this data.

Eriksson: That's exactly what they are doing.

Ahlqvist: We have been very active in green bonds and have outstanding bonds in all major currencies, plus Swedish kronor, and have a total of five bonds in green format outstanding. As the first major Nordic bank, we have just updated and built out our green bond framework to a Sustainable Funding Framework which also includes social categories. The reason we work so actively with this is that we see bonds as a tool to facilitate the lending business and to actually increase it that way. So what we have implemented from the start in 2017 is that every basis point of greenium – if we achieve one — is transferred back to the business areas to incentivise them. That we will also apply on the social side, so that is one very large incentive.

Beyond the importance of greenium, because of the funds transfer price mechanism that we have there are two other important reasons we focus so much on sustainable funding. Adding the green label to a transaction normally takes down the execution risk. That is why we chose to issue green in non-preferred or preferred senior format, instead of covered bonds.

Normally we get higher demand, which is great in times of turbulence, as we are experiencing now. And the third point is that green bonds trade better, if you look at trading data and research and at outstanding curves. So by issuing green, for example in a senior non-preferred, we help the outstanding curve and provide a better reference point for future issuance of conventional bonds.

However, we primarily look at ESG from a broader and holistic basis. Only 5% of our outstanding senior bonds are green, meaning 95% are non-green, and so it is on that majority that we are focusing our efforts to ensuring future funding for. We believe that the success of achieving access to funding and capital is linked to our internal efforts on ESG. It is one of the reasons we as a bank work intensively with the ESG agenda: what KPIs and targets do we have in place at the top of the bank to transform our overall balance sheet? How do keep up to speed on ESG reporting and disclosures? How do we ensure a strong ESG rating? If Swedbank can be best in class in all aspects of ESG, we can ensure good and stable funding, outperform versus peers, and even affect our bottom line by reducing funding cost and raising ROE.

Hjelle: We take what we have in green lending, put it in a pool and then issue senior non-preferred and covered out of that pool — and we will probably continue to do so. In covered we don't see much greenium. But to your point, when we do senior non-preferred we see that we find funds that are more interested in the green. I'm not sure whether we can put it down to a number of basis points, but you actually have bigger orders or more orders. We were very early in this. I think the reporting from the investors will be tougher and that will come back to the banks. What we have today in green lending is going to evolve rapidly over the next few years. It's not what we have in assets that are green, it's the footprint, the transition for the bank and our clients — but then we need the data. How are going to get that? It's a big job.

GlobalCapital: Henrik, with all of the concerns about house price declines and affordability, as a rates investor are you starting to have concerns about credit anywhere? Or in the Nordic region specifically?

Stille: I can have concerns about the credit but I don't think it's a covered bond credit issue. For example, if you look at Sweden it would be more of these smaller real estate developers and not so much the major banks. If this becomes a large topic next year it is further down in the capital structure that we would be worried. Not for covered bonds.

Countries with their own currencies have a bit of an advantage because for the central bank in Sweden or Norway, for example, it is not difficult to see if you have more variable rate mortgages — in which case, you cannot hide as much as you can if you have more fixed rate mortgages. So, all else being equal, I think its fair to assume that you will have less hiking in those countries that have an independent central bank and more variable rate mortgages. That is a factor that central banks in these countries take into account.

Ebert: One question. Does that not also make the currency a bit weaker, because you always have the risk that with lower interest rates you still have imported inflation?

Stille: Yes, definitely. It will have an impact on the currency. Over the last 50 years, the Swedish central bank has always chosen this path. If they have to chose between inflation or killing the housing market, they will always choose inflation.

GlobalCapital: In one sentence or less, what is going to be the biggest factor in the covered bond market next year?

Ahlqvist: Central banks.

Eriksson: Demand.

Hjelle: The end of the purchasing programmes — so, central banks.

Ahlqvist: That incorporates QT, rate hikes and TLTRO.

Ebert: Balance sheet dynamics.

Stille: Central banks will continue to dominate the agenda. GC