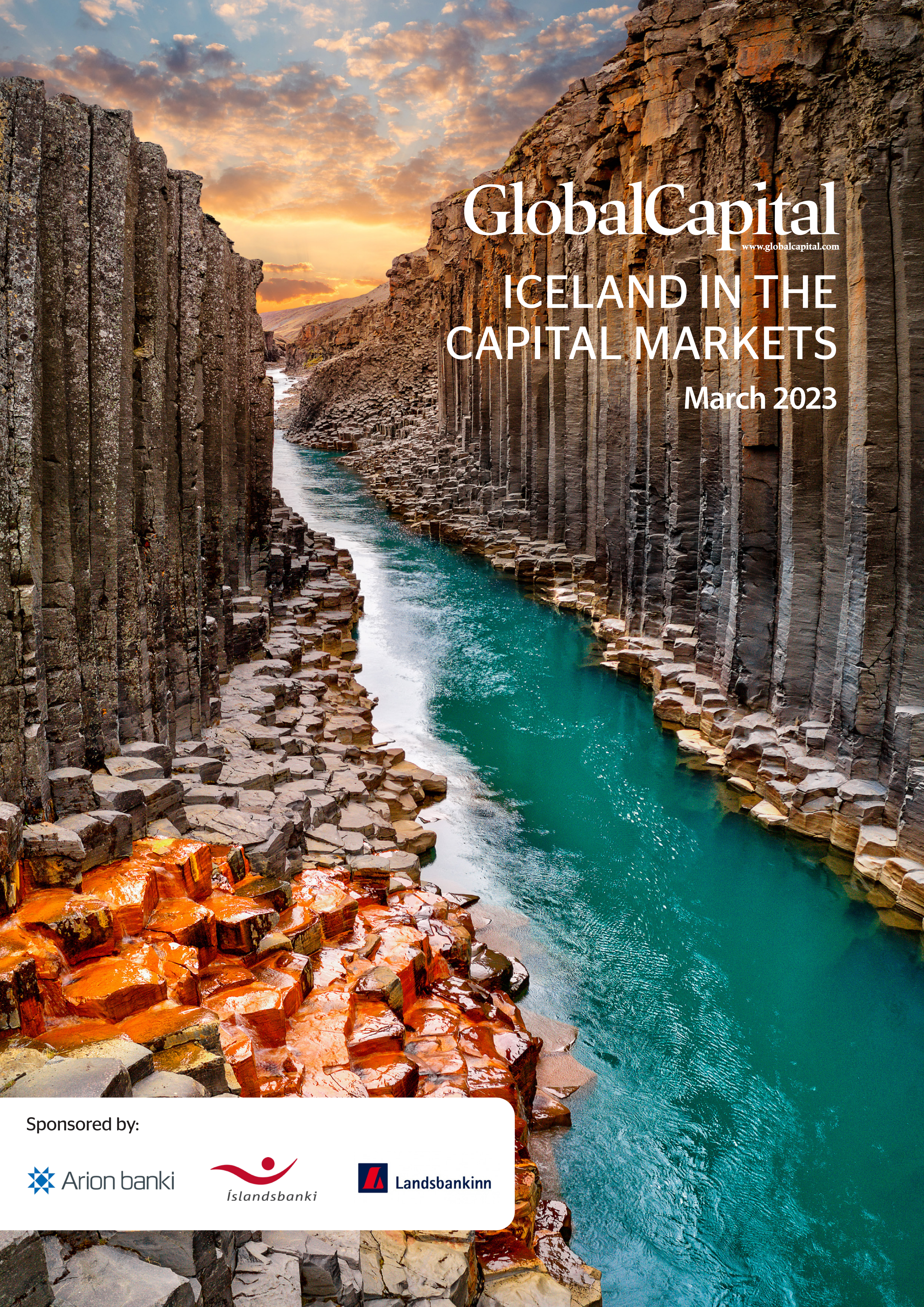

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ICELAND IN THE CAPITAL MARKETS

March 2023

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Iceland's strong post-Covid recovery enhanced by diversification

Iceland has bounced back strongly after the pandemic, with tourism leading the way. But there are signs that a more balanced economy is developing. **Philip Moore** reports

You don't get to preserve a flourishing parliament for over 1,000 years without maintaining a healthy respect for consensual democracy.

That's one reason why local economists are worried by this year's industrial action in Iceland, which briefly saw about 700 hotel workers down their tools. The disruption was short-lived and not remotely comparable with the unrest that rocked Iceland at the height of its financial crisis. But economists were especially unnerved by the recalcitrance of Iceland's second largest union, Efling, and its firebrand leader, described by one local banker as "an old-fashioned communist who wants to bring an end to capitalism".

Efling has 30,000 members, based largely in and around the Reykjavik area. In a country with a labour force of a little over 220,000, that is a sizeable number. And in an economy with an unemployment rate of about 3.5%, the threat of further disruption from 13.5% of its workers does not sit well with Iceland's Central Bank (CBI).

Among those uneasy about the influence of Efling is Jón Bjarki Bentsson, chief economist at Íslandsbanki in Reykjavik. "We used to have a reasonably solid consensus in the labour market that focused on real wages and resisted being excessively aggressive in their wage negotiations," he says. "We now have a new leadership across many of the private sector unions which simply doesn't believe in that paradigm."

Inflation builds

The implications for inflation are unsettling. As Fitch commented recently, inflationary pressures have already been appreciably stronger than expected this year. In February, inflation reached 10.2%, compared with 2.4% in February 2022. This spike has led Fitch to forecast that inflation in 2023 will remain stubbornly elevated at 7.5%.

Unlike the prognosis for inflation elsewhere in Europe, this suggests little more than a modest decline from 2022, when Iceland's inflation rate was 8.3% — still well above the central bank's target of 2.5%.

While some of Iceland's inflation is an imported by-product of the relative weakness of the króna, much of it is homegrown. "The make-up of our inflation bears more similarities with the US than Europe," says Bentsson. "Because we're self-sufficient in both our electricity needs and geothermal power to heat our homes, we didn't face the energy price shock that most of Europe has suffered. Imported inflation is actually on the decline, with most of the pressure coming from services, housing and wages."

That pressure is exacerbated by the inclusion of housing as a component of consumer price inflation (CPI) in Iceland. As the CBI advises, Iceland's CPI has historically risen faster than the CPIXH (CPI excluding housing). The difference between the two measures of inflation has increased over the last five years, according to the central bank, with CPI averaging 3% compared with 2.2% for CPIXH.

The trouble with Iceland's inflation is that subduing domestically-generated price rises generally requires more aggressively restrictive monetary policy. This explains why the CBI hiked rates by another 100bp at the end of March, rather than the 75bp most economists were expecting.

This lifted the seven-day term deposit rate to 7.5%, its highest level since 2010, and brought the overall rise in the key policy rate since May 2021 to 675bp. That is way ahead of monetary policy tightening in other developed regions, and is in part driven by the recent history of inflation in Iceland as well as strong economic growth. "Because we have struggled in the past to get inflation expectations down, we need to take bigger steps to control them than the Federal Reserve, the Bank of England and the European Central Bank," says Erna Björg Sverrisdóttir, chief economist at Arion banki in Reykjavik.

Thórarinn Pétursson, chief economist at the CBI, recognises that the 100bp hike came as a surprise to markets. He says that the Bank was of course sensitive to the spill-over risks for banking systems of monetary policy tightening elsewhere. But he adds that the CBI concluded that Iceland's banks are now highly resilient, with their funding generated chiefly through deposits. It also calculated that the strength of the economy and tightness of the labour market provided enough room for manoeuvre on monetary policy to counter inflationary pressures that Petursson says are broad-based.

"Several relatively new Icelandic companies are already making their mark on the global economy"

Benedikt Gíslason, Arion banki

In 2022, rising rates had little if any impact on Iceland's economic recovery. Buoyed by a post-pandemic surge in domestic demand, and by a striking rebound in tourism arrivals, GDP expanded by 6.4% last year. Adjusted for population growth, GDP per capita increased by a more modest 3.7%. Nevertheless, Iceland's growth rate in 2022 exceeded most economists' expectations.

Against the backdrop of persistent inflationary pressures and a hawkish central bank not bashful about responding decisively, the outlook for growth in 2023 is rather less rosy. Fitch is now forecasting that it will slow to 2.1%, which is considerably below the 2.8% projected by the CBI in March.

Bentsson says that Íslandsbanki is rather more optimistic about growth than Fitch, and is hopeful that the

Iceland's self-sufficiency in geothermal power cushioned it from the energy price shock in Europe

economy will expand at 3% or more this year. Much of this forecast — like all projections of Icelandic growth — is predicated on the continued recovery of the tourism industry.

Inbound tourism was the saviour of the Icelandic economy in the aftermath of the country's devastating crisis in 2008. According to Standard & Poor's, tourism accounted for 8% of GDP before the pandemic. Between 2010 and 2019, the number of visitors to Iceland increased fivefold, with the inflows paradoxically helped rather than hindered by widespread international media coverage of the Eyjafjallajökull volcano in 2010.

Covid-19 temporarily put paid to Iceland's tourism boom. Arrival numbers nosedived to a little under 480,000 in 2020, which was a far cry from the 2.3 million who visited in 2018.

Flocking back

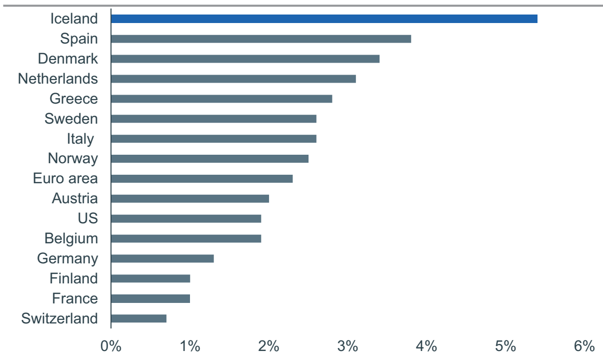
Today, those tourists are pouring back. As recently as May 2022, Íslandsbanki was predicting that Iceland would attract between 1.5 million and 1.6 million tourists in 2022, rising to 1.9 million in 2023 and 2.1 million in 2024. Those forecasts will now probably have to be scrapped and revised upwards, given that 1.7 million tourists arrived last year, an increase of 147% since 2021.

Arrival numbers in January continued to exceed expectations. According to Statistics Iceland, there were just under 450,000 overnight stays in the country in January. This was an increase of 86% on the corresponding month in 2021 and gave Iceland's tourism industry its strongest ever start to the year. These encouraging numbers were underpinned by robust demand from British tourists apparently undeterred by the cost-of-living crisis in the UK.

Bentsson at Íslandsbanki says that January's data and other indicators suggest that this will be a bumper year for Iceland's tourism sector. "We are a significant lender to the tourism industry, and the major players are telling us that Iceland is already more or less sold out for the high season," he says. "Prices for accommodation are rising quite rapidly and bookings

GDP growth — Q3 2022

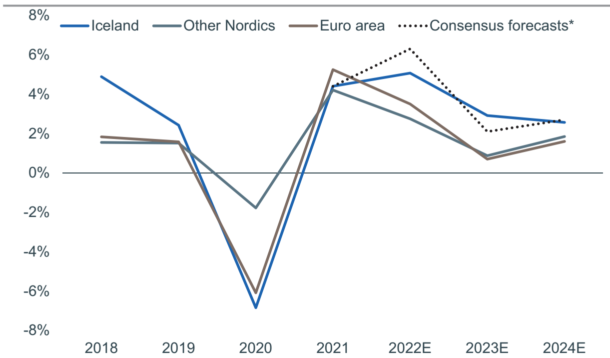
YoY % change, seasonally adjusted



Source: Arion banki

GDP growth

IMF forecast



Source: Arion banki

are if anything increasing."

Tourist inflows should be further supported by the continued weakness of the Icelandic króna, which lost almost a fifth of its value against the euro and sterling between the summer of 2018 and the beginning of 2023. As Bentsson points out, the impact on the króna of inbound tourism is counteracted by outflows of pension fund money, now running at about Ikr10bn each month. According to IMF numbers, Iceland's super-liquid pension funds now control assets in excess of 200% of GDP, which can't all be absorbed domestically.

"Because we have struggled in the past to get inflation expectations down, we need to take bigger steps to control them"

Erna Björg Sverrisdóttir, Arion banki

Outwardly, this is all good news for the Icelandic economy, safeguarding the 30,000 or so jobs accounted for by the tourism industry and limiting the current account deficit. This reached Ikr58bn, or 1.5% of GDP, in 2022, compared with surpluses of 4.3% in 2018 and 6.5% in 2019. The CBI's latest forecasts are for an average deficit of 3% of GDP over the next three years.

The less positive news about the big recovery in the Icelandic tourism industry is that it potentially heightens the risk of Dutch Disease. S&P, for one, has cautioned that its ratings on Iceland could be lowered in the event of a shift in global travel preferences. The agency adds that a drop in tourist arrivals could occur if there is "a surge in Covid-19 cases, particularly due to new, more dangerous coronavirus variants".

"In such a scenario," S&P adds, "we believe it could be more difficult for Iceland's monetary and fiscal authorities to provide further policy support, given currently elevated inflation and previously large deficits. Net general government debt would rise materially beyond our expectations."

Iceland's potential vulnerability to a drop-off in tourist arrivals was one reason why this year's industrial action was regarded as such a big deal. At the height of the dispute, there were concerns that short-staffed hotels in Reykjavik would have to start relocating tourists elsewhere.

Iceland's vulnerability to a severe downturn in tourism is reflected in the structure of the leading banks' loan books. At the end of 2021, about 42% of Arion's loans that were either in default or subject to moratoria or forbearance were in the tourism sector heavily impacted by the Covid lockdowns.

Iceland's leading banks could argue, with some justification, that the performance of their tourism portfolios attests to the resilience of their loan books. "We were conservative regarding provisions at the start of the pandemic, says Theódór Friðbertsson, head of investor relations at Arion banki in Reykjavik. "A large part of our tourism-related loans have recovered. Even numerous exposures that we categorised as stage three [non-performing] are now performing."

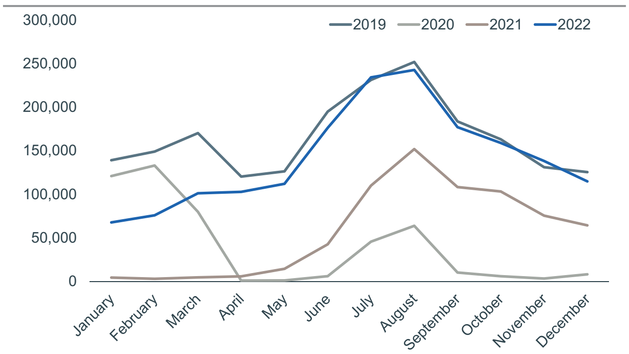
Diversification of the nation

That may be. But it has been recognised for several years that economic diversification will be essential if Iceland is to address the long-term threat of slowing growth. As the government acknowledged in a fiscal policy statement released in 2021, "owing to slow natural population growth combined with weaker productivity, the outlook is for the economy's growth potential to decline, all else being equal." This is reflected in Statistics Iceland's recent revision of its estimate of the economy's annual growth potential from 2.7% to 2.3%.

External economists have long been advising of the urgent need for Iceland to intensify its diversification efforts. In its most recent report, the IMF observes that "the multiple external shocks that have affected Iceland since 2019 underscore the need for further efforts to diversify the Icelandic economy. Iceland's high reliance on the tourism sector made it vulnerable to external shocks, resulting in high growth volatility."

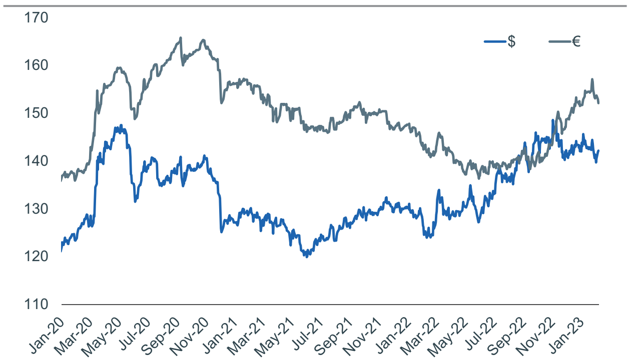
The IMF says that Iceland has already come a long way towards rebalancing the economy. But it suggests more needs to be done. Specifically, the Fund advises that "the focus should be on reducing burdens on start-ups, easing business regulations, promoting R&D investment, easing access to finance for small firms, and furthering education reforms; structural reforms should facilitate economic diversification and make the economy more resilient to

Tourist arrivals via Keflavik International Airport



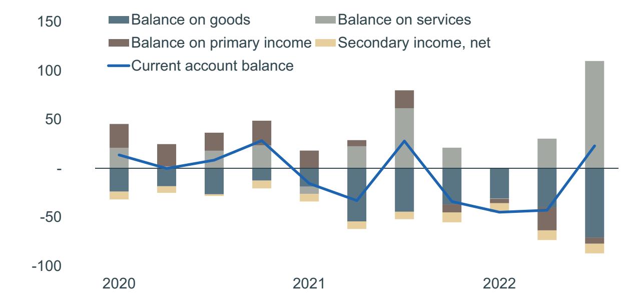
Source: Arion banki

Icelandic króna against major trade currencies



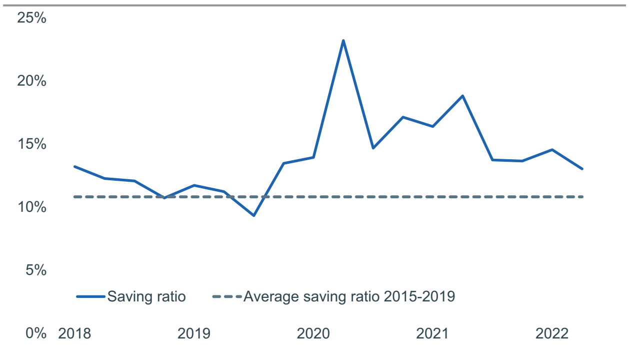
Source: Arion banki

Current account balance
Icelandic króna (bn) at constant exchange rate



Source: Arion banki

Household saving
% of disposable income



Source: Arion banki

shocks. Diversification efforts should focus on… spurring innovation by leveraging Iceland's human capital and advanced digital infrastructure."

Local bankers and economists endorse the view that economic diversification is essential. But they also argue that Iceland has already made commendable progress towards building a more balanced economy, which has changed beyond recognition over the last decade.

"The economy is now built on many more pillars of export revenues than it was a few years ago," says Fridbertsson at Arion. "As well as tourism, green energy and fisheries, we have seen a lot of investment flowing into aquaculture, food processing, infrastructure, the IP sector, and pharmaceuticals."

Arion's CEO, Benedikt Gíslason, adds that several relatively new Icelandic companies are already making their mark on the global economy. He points to the example of the biosimilars company, Alvotech, which was set up in 2013 and is already producing blockbuster drugs like Humira, which helped the group bolster its 2022 revenue by 114%.

"Imported inflation is actually on the decline, with most of the pressure coming from services, housing and wages"

Jón Bjarki Bentsson, Íslandsbanki

Elsewhere in the pharmaceuticals technology sector, Controlant has been a similarly eye-catching success story. A year before the Icelandic financial crisis, Controlant was an unheard-of start-up. A little over a decade later, its technology helped secure the global distribution of more than 5 billion doses of the Pfizer vaccine that played a pivotal role in countering the Covid-19 pandemic.

Strong outlook

Beyond the challenges associated with addressing inflation and promoting deeper diversification, Iceland's economy is robust and its prospects benign. Its trade has been relatively unaffected by Russia's invasion of Ukraine. Indeed, as Arion's Sverrisdóttir points out, Icelandic exports may paradoxically even have been a beneficiary of the war. "Of course we've been affected, as all of Europe has been, by higher inflation and interest rates," she says. "But the direct effect has been mainly concentrated in the seafood industry where prices have risen significantly. So we have been only one of a few European countries to have seen our terms of trade improve."

This will help strengthen foreign exchange reserves that are ample, which Fitch mentions alongside Iceland's comfortable fiscal cash buffer as a factor underpinning its single-A rating. "Strong credit fundamentals also include the country's sizeable pension fund assets, sound banking sector, and strong private sector balance sheets," Fitch adds.

The same is true of most households' finances. Fears of a housing bubble have receded over the last year, with economists confident that the slowdown in prices that has already begun does not herald a crash.

The CBI noted in March that "given how modest the vast majority of household debt is and how relatively brief the period of an excessively tight housing market proved to be, conditions overall do not suggest that the drop in prices will be excessive. In other words, the outlook is for the decline in house prices to be ultimately a sign of diminishing cyclical systemic risk rather than a harmful, disorderly realisation of it."

Icelandic homeowners appear to be equally relaxed about the outlook for the market, which perhaps reflects their confidence in their own finances. "Households as well as companies did not use the last upswing to increase leverage," says Sverrisdóttir. "Instead, they used it to pay down debt. So they are coming into this challenging monetary policy environment in a relatively strong position."

This may explain why there has been no stampede (yet) towards index-linked mortgages in response to rising inflationary pressures.

"According to the Central Bank's data around 36% of Icelandic mortgages are now CPI-linked," says Fridbertsson. "Given the rising rate environment, we were expecting to see more people refinancing into CPI-linked mortgages at least partially, but we haven't yet seen a material pick-up in demand. We view this is as one indication of how strong household finances are, but we still expect this to occur to some degree with continued hikes in interest rates." GC

Iceland's robust banking sector passes crisis test, pushes into international markets

To many Icelanders, the crises engulfing US banks such as SVB, Signature and First Republic, as well as the dramatic takeover of Swiss banking giant Credit Suisse by its domestic rival UBS will have triggered painful memories of their own banking and economic disaster 14 years ago, in December 2008.

However, that they are mere bystanders this time is testament to the strength of Iceland's economic recovery and the rebuilding of its banking sector since those dark days of the great financial crisis.

The major banks have all returned to core international capital markets, including the euro covered bond market, with Landsbankinn, in early March, getting its timing spot on with the country's first 'premium' covered bond after Iceland signed up to the European Covered Bond Directive in February.

In late February, *GlobalCapital* sat down with Iceland's leading banks and the Central Bank of Iceland to discuss the country's burgeoning economy, the pressure the resulting immigration is putting on the housing sector and how the central bank is fighting inflation. Interest rates began rising much earlier than in most countries, while the pandemic was still going on, so the banks are quite used to it, and loan books are growing. They are therefore looking for new sources of funding, above all in the international capital markets.

Participants in the roundtable were:

Benedikt Gíslason, chief executive, Arion banki

Hreiðar Bjarnason, chief financial officer, Landsbankinn

Elena Bortolotti, global head of covered bonds structuring, Barclays

Jón Guðni Ómarsson, chief financial officer, Íslandsbanki

Sturla Pálsson, head of markets, Central Bank of Iceland

Moderator: **Toby Fildes**, *GlobalCapital*

ICELAND'S ECONOMY AND THE HOUSING SECTOR

GlobalCapital: **It's a year since Russia's invasion of Ukraine, an action that changed capital markets around the world. And although inflationary pressures were being felt before then, with the world emerging from Covid lockdowns and catching up, the last 12 months have brought extraordinary changes. Amidst all this, how is Iceland's economy performing?**

Sturla Pálsson, Central Bank of Iceland: What we are dealing with, and have been for a while now, is an overheating of the economy. The central bank has been raising rates at 11 or 12 consecutive meetings.

The economy of course rebounded very well after the Covid crisis. Tourism rebounded well and the terms of trade for our most important export have probably never in Iceland's history been so favourable. So inflation or overheating is what we are dealing with.

Having said that, the Ukraine conflict and the Covid pandemic have demonstrated in a way the strengths of the Icelandic economy. Our exports are a low beta product — these are commodities that are sought after when we have a crisis — and we are more or less self-sufficient in energy. House heating in Iceland comes from domestic energy sources, hydro and geothermal. So we are less impacted by what happened in the European and US gas markets last year.

The challenges we face in global markets are because of the fact that we are a small nation. But it's very difficult if you look inwards — at both the economy and in a more narrow sense the financial sector — to see any obvious weaknesses in the system.

We probably need to maintain a strict monetary stance. Fiscal consolidation is another issue that would help to fight the inflation problem. Meanwhile, the bulk of the labour market has reached an agreement, though there is a certain segment that is still in dispute — but hopefully that will be resolved soon. So in the context of the global economy, Iceland is doing fairly well.

Benedikt Gíslason, Arion banki: It's a very tight labour market, and the supply side of the housing market has been an issue for some time. Land is obviously not a scarcity here but the municipalities underestimated the population growth we've enjoyed in the last few years. Our biggest challenge is to get new building permits across because the construction industry as a whole is operating at decent profitability and has the capacity to deliver more units.

If you look at the CPI on a harmonised basis, last year it was one of the lowest in Europe, although we see a bit of a lag when it comes to imported goods. Prices rises are coming in and this probably explains why on a harmonised basis we're moving up.

But if we get the supply side of the housing market in order, I'm sure that we will be able to tackle inflation, as housing is part of the CPI, which is not common in Europe.

Hreiðar Bjarnason, Landsbankinn: Iceland was faster out of Covid than many economies and tourism has played a big role in the positive economy turnaround.

So as a result, the central bank started raising rates earlier and faster than most other central banks. We are further along in dealing with the demand bosst — it's a more positive thing to deal with than many other economies are dealing with. It can be as difficult, but it's quite different in many ways.

The outlook continues to be quite good and the population growth is quite high. It's above most expectations for the last few years, partly because people are migrating to Iceland in bigger numbers than before.

It's a young population, so the organic population growth is still quite high as well. That is why the demand for housing has been the biggest driver of inflation, or the early driver.

Jón Ómarsson, Íslandsbanki: The savings rate increased quite substantially during Covid and therefore small companies and especially individuals had ample savings. So we have seen a fairly large increase in private consumption. That's part of the driver as well, heating up the economy. Across the board we are seeing some signs of that, in the housing market and the price increases are still coming in.

So that's a main challenge for the central bank — to raise rates to cool down the market. But that can take some time and it can feedback into salaries now. The wage agreements have only partly been finalised and obviously they can have an impact on inflation again. So we could have a bit of a spiral.

Gíslason, Arion: One thing which led to the strong recovery out of Covid was a measure the Icelandic authorities took during lockdown of raising a cap on reimbursements for R&D. That led to some of our leading companies in knowledge-based industries investing more. We've seen faster export growth coming out of that sector now — it constitutes around 15% of the export value of Iceland already. With the same trajectory, it will become even larger and more important.

GlobalCapital: Where are those exports going — to North America? Europe?

Gíslason, Arion: Around the globe.

Pálsson, Central Bank of Iceland: Over recent years the share of exports to dollar-based customers has increased, both with tourism and with these new industries.

Sturla Pálsson
Central Bank of Iceland

Corporate Iceland produces excess dollars but everything we import — durable and consumable goods — are more or less European or from the euro area. So last year the economy benefited from a stronger dollar: we are long dollar, short euros.

With regard to inflation, what we are seeing now is a very different landscape from a decade ago, because inflation pass-through is much better now.

There is much more lending to corporates and households in variable and non-indexed interest rates. Before, you could amortise inflation over the lifetime of your mortgage but that is much less an issue today.

Meanwhile, foreign currency exposure in household and corporate lending is at very low, manageable levels. In fact it's almost impossible under the new regime to take on such risk. So inflation, or the interest rate pass-through, is more efficient and the banking system is less risky as a consequence of this change in the lending stock.

Ómarsson, Íslandsbanki: One favourable development over the past two decades is that we have seen much more diversification in the economy. Looking 40, 50 years back, Iceland was mainly just exporting seafood. Then came exports of energy in the form of aluminium. In the past decade or so we've seen great growth in tourism. Now the intellectual property industry is growing quite substantially and becoming a fairly sizeable , the IT sector for example. Now aquaculture, both onshore and off as well. So we have many more pillars of exports than in the past.

Gíslason, Arion: Returning to the housing sector, it's a sign of strength in the economy that we have had policy rates at 6.5% without any big problems in the mortgage sector or society. This is testament to the fact that we are not going through a housing bubble.

Loan to value ratios have been on the conservative side — the Central Bank has used macroprudential measures well to make sure people do not over-borrow when investing in housing. And in the historical and international context the leverage of households is relatively low.

Bjarnason, Landsbankinn: The Central Bank has managed to cool down the housing market, which has two sides to it. There is still a lot of demand for housing but more and more people, because of the high interest rates, are not able to buy and pass the stringent rules regarding payment affordability. That can only be corrected through the supply side, so more housing is needed to solve that issue.

Pálsson, Central Bank: At the same time the immigration flow is creating excess demand for housing. The cause of immigration is of course high disposable incomes, the strong labour market. We will at least throughout this year and maybe next year see a very strong labour market still. This will apply some further pressures on inflation.

In some ways it is a good problem to have. But it would be nice to see a relatively quick transition closer to the Central Bank target level. We will come down to maybe the 4%-5% area quite quickly, but it might be more stubborn after that because we are seeing inflation filtering into a broader range of the products that make up the CPI, indicating that core inflation may be more stubborn than we hoped.

Ómarsson, Íslandsbanki: Quite an unusual feature of the Icelandic housing market is having CPI-linked loans. They lessen the impact from Central Bank policy rates and the effectiveness of those changes.

But at the same time, it helps with financial stability. People who have problems with the monthly payments can move over partly or fully into CPI-linked loans, thereby reducing their monthly payments. But at the same time, they will not see as rapid growth in their equity stake in the house.

THE BANKING SECTOR

GlobalCapital: Is the banking sector reflecting the generally positive economic picture you have all been painting?

Gíslason, Arion: Absolutely — well capitalised, profitable and loan growth at healthy levels, reflecting the robust performance of the economy.

Hreiðar Bjarnason
Landsbankinn

Bjarnason, Landsbankinn: Iceland is a small, open economy so we are going to be on average more volatile than larger, more diverse economies. But the banking sector fully compensates for that through very strong capital requirements. It has been a key feature of the Icelandic banks for the last decade, not least today. They are very well capitalised.

Ómarsson, Íslandsbanki: The banking industry showed considerable strength in navigating through the Covid crisis, with the banks being quite conservative in preparing quite heavily against the early impact. We have since then recovered to a large degree and taken those impairments back through our earnings, leaving the banks in an extremely healthy and good shape.

Pálsson, Central Bank: The external environment for the banks is not what it used to be. The economy as a whole has a very strong external position. Our international investment position is positive to the extent of 25% of GDP, whereas historically, it used to be deep in negative territory.

The Central Bank is holding high reserves, mostly illiquid assets and central bank cash — the reserves are around 25%, 26% of GDP. So in the context of how the banks are structured, it's very difficult to see anything of concern.

Historically of course, GDP and balance of payments volatility have been problematic for the economy, because of its small size and openness. But today we have so many things in order that maybe weren't 10, 20 years ago, it creates a more stable environment for the banks to focus on supporting the local economy.

GlobalCapital: So crisis has made you stronger?

Pálsson, Central Bank: Definitely. It showed very clearly during the Covid crisis and the Ukraine conflict how resilient we were.

Gíslason, Arion: We haven't really seen the Central Bank apply any QE here in Iceland during Covid. And if you look at the repo windows which were widely used in Europe by banks, again Iceland's banks did not use them. So the banking system is not exposed to any tapering efforts or vulnerable to weaning themselves off long-term repo facilities.

Bjarnason, Landsbankinn: We had during Covid for a couple of years very low interest rates, when the Central Bank rate went down to below 1%. But that only lasted halfway through Covid before the Central Bank started increasing again.

So, unlike most economies in Europe, Icelandic borrowers never got used to their domestic interest rates being at or below zero. Therefore, even though interest rates are now quite high, it's not unusual for borrowers in Iceland. And even today, asset quality has never been better and loans in default have never been lower.

GlobalCapital: The financial industry outside Iceland spends a lot of time worrying about that adjustment to higher interest rates and how the banks and leveraged companies will fare. But as you've pointed out, it's quite different here. How is that difference manifested in economic performance and the banking sector?

Gíslason, Arion: It's reflected in the fact that last year we had one of the highest GDP growths of any country in Europe. Usually when there is economic turmoil around the globe Iceland feels it strongly. But this time it's different. All the elements we mentioned as strengths are playing into our hands.

Pálsson, Central Bank: It was mentioned earlier that savings rates increased sharply during the Covid crisis. But in the last decade or so real disposable incomes have also been rising quite fast. So even though we've seen housing prices increase significantly, while they are probably high as a percentage of disposable income, they are not excessively high.

Of course house prices will always rise in such a tight labour market, when there is high disposable income and lower interest rates. But now interest rates are doing their job and cooling things down.

We saw that recently in the most recent inflation numbers. It's not the housing component driving inflation, as it used to, it's more on the other side. If you compare household indebtedness in Iceland to Scandinavia, we are much lower. Corporate indebtedness is also very manageable and low, especially in a historical context.

INTERNATIONAL CAPITAL MARKETS

GlobalCapital: Capital markets have had a tremendous start to 2023, with great funding conditions reflected in — in some sectors at least — record bond issuance. Elena, what have been your experiences been so far this year?

Elena Bortolotti, Barclays: It has been a very positive start to the year. Obviously the Icelandic economy and its banks are in a good position and access to international markets is very strong. This has been the case for a while of course, including the inaugural covered bond for Arion in 2021 and then Íslandsbanki following last year with its first internationally placed covered bond.

Elena Bortolotti
Barclays

It has been a long way back of course, since the financial crisis. When we are on the road speaking with investors, we feel the rating of the Icelandic banks is probably not where it should be — in a sense it should be higher. And consequently the covered bond instrument, which is now rated single-A, should be, at least from where I see it and looking at the fundamentals, at least at a double-A, if we didn't have the country ceiling set by the rating agency.

We have had an exceptional January — in the covered bond space, it was the busiest in 10 years.

At the same time, there is a bit of uncertainty and this has been shown in the shift of tenors. Covereds tend to be a product where we look to do longer dated seven or ten years plus deals, maturities that suit better given that the underlying cover pools tend to include long dated assets. Now for investors the sweet spot is unfortunately more at the shorter part of the curve: three or five years. We are seeing books three or four time oversubscribed for these maturities.

There has been an adjustment, however, in pricing, mainly driven by the fact that the European Central Bank is stepping back. We were accustomed to opening books and having a 50% order from the ECB. That has been tapered down. It was 20% in January and it's gone to zero in March.

Not having that lead order means it is more of an investor's market — there has been a bit of widening on spreads. But investors say they're happy because now the price actually reflects where covereds should be pricing, rather than being as tight as they were in the past.

Overall we are hopeful that these conditions and volumes remain strong, even though [mortgage] origination volumes are down. This obviously affects covered bonds because you have less collateral to issue against. But as interest rates stabilise, hopefully banks will start to originate more mortgages.

And we have the end of the TLTRO, which should see more banks returning to market-based funding. And elsewhere in Europe, the TLAC and MREL requirements have been satisfied, so banks can switch to a funding product rather than a regulatory product.

For the Icelandic banks, there are still some MREL and TLAC needs, but definitely covered bonds is available and it's a cheap funding tool.

Gíslason, Arion: It opened up new alternative ways of funding the mortgage portfolio. This is something Norway did in 2004 when they opened up the covered bond to different currencies beyond Norwegian kroner. They now have 60% of their mortgages funded by these means. For a small economy like Iceland, this greatly helps with investor diversification, so pension funds are able to invest more abroad and have a lesser role in financing the mortgage market here, which is healthy diversification for the economy overall.

Ómarsson, Íslandsbanki: It's a natural step. We started the covered bond market here domestically in 2011. It is a relatively young market compared to many European countries but has been building up since then and is a very mature product now and very popular with domestic investors. So it's a natural step to go abroad and diversify the funding base.

Pálsson, Central Bank: The Central Bank is the funding agent for the Republic of Iceland so we manage all the financing locally and globally. The sole objective of us being visible in the market is to diversify the investor base. I don't know if there is much overlap in the investor base between the republic and the banks, but there is probably more in the covered bond space than in senior unsecured.

We are also trying to set a benchmark for other domestic issuers, in the hope that that will help the economy to access global capital markets. And of course there are export industries who are in constant need of foreign currency financing.

So the republic is trying to do its bit. It's been two years since we last issued and we cover all our fiscal needs in the local Icelandic króna market. We of course want to see more global investors taking a look at that, but as long as there is no change in our foreign currency issuance policy, it should be expected that we will take a hard look at the market some time soon and try to do something.

But for some, it's difficult to digest the repricing that has taken place. Our outstanding bonds have coupons of 0%, 0.1%, 0.5%. We are not going there any time soon. There has been a permanent shift in yields. Both for investors and issuers, this is a new environment.

Bjarnason, Landsbankinn: We had a good start to 2023 but it was also a very difficult year last year in foreign capital markets. I'm talking generally here, but not least for smaller peripheral issuers. As an Icelandic bank we definitely felt that.

Especially for senior paper last year it was quite difficult for smaller issuers and pricing was at elevated levels.

It shows strength to have that flexibility of issuing covered bonds versus senior for funding needs. Then you need to manage available MREL funds in a way that gives you that flexibility.

GlobalCapital: You mentioned that Iceland is a small issuer and the banks are small issuers, but you've done something genuinely innovative and exciting in covered bonds. Elena and Benedikt, why don't you tell us more?

Bortolotti, Barclays: We started working with Arion on their programme and set it up in 2011. At the time, we had set up the skeleton and the pillars to allow for international issuance but we had no rating. So it wasn't really something we could contemplate — it was used just for domestic issuance.

When the economy and banking sector started improving, but also Standard & Poor's (S&P) rated the bank, we restructured the programme to cater for international issuance, working closely with S&P.

The tricky part was the hedging. We have an innovative structure based on some of the higher-rated programmes where you have this concept of contingent or forward-starting swaps. It's entered on day one, but there's no exchange of cashflows. However, you still have a commitment to post collateral and replace the swapcounterparty.

In the Icelandic covered bond programmes, we don't have a hedging agreement signed on day one but under the deed of covenants the issuing bank has an obligation to post collateral. Any FX mismatch is mitigated via the posting of additional collateral upon certain triggers being met.

S&P doesn't give any credit to the collateral posting amount but we wouldn't be able anyway to pierce the country ceiling, as we already have reached the maximum achievable rating.

We did want to discuss it with some investors and they were happy with the structure — hence why we made this change to the programme, and in fact the other two programmes [for Íslandsbanki and Landsbankinn] have the same hedging structure.

The other thing we did, which I think was really smart, was to introduce some structural features that would be introduced by the EU Covered Bond Directive when transposed into Icelandic Law for example a minimum over-collateralisation requirement and a liquidity buffer. At the time under Icelandic law that wasn't a requirement. These were all elements investors were asking for and they appreciated.

These are contractual obligations which now we're in the process of taking out because Iceland has actually transposed the Directive into its own law on February 21. It is going to be effective from March 1 so we are in the process of updating some of the programmes.

This is another milestone, because now, touch wood, in the next few weeks we might see the first premium Icelandic covered bond, which means it will be ECB-eligible and liquidity coverage ratio-eligible as well.

Gíslason, Arion: Let's hope so! For Arion this was an innovative structure and it was even nominated for some awards. What also helped us make the move was that obviously we are funding Icelandic króna mortgages and there has to be the ability to convert some of this financing into króna financing. With the increased depth of the FX and FX swap markets, we felt this was the right time, following the liberalisation of capital controls, to start funding ourselves in euros.

Bortolotti, Barclays: Iceland is one of the few countries where covered bonds price tighter than the sovereign. I think it's Iceland and Italy. I was looking at some numbers for Arion — the senior to sovereign differential is 200bps and the senior to covereds differential is 211bps. The saving is there and it's a tool that gives you flexibility. Everyone knows in difficult times it is the product to have in the range of your funding tools.

Also it allows you to diversify your investor base. I've been on the road with all of you and we saw this, right? It is a different investor base. Even though you might have the large investors and asset managers that might hold your senior, a covered bond goes into a different pocket. And now with the regulatory status, that is crucial because we will start seeing even more banks buying it and holding it for LCR.

Another trend we've seen is not only have the Icelandic banks been issuing domestic currency senior unsecured bonds, but also retained covered bonds, which they can use to repo with investment banks. So it's a valuable security that opens an array of options for the issuers.

Ómarsson, Íslandsbanki: Firstly the European covered bond market offers favourable pricing compared to senior unsecured. It also opens up a new, larger investor base for us and helps diversify our funding. But maybe most importantly the covered bond market is a more stable market than that for senior unsecured. We saw that quite clearly last year in turbulent times. It's good to have access to those more stable markets.

Bjarnason, Landsbankinn: Landsbankinn has been a frequent issuer of covered bonds domestically in ISK, but our inaugural €300m Premium Covered Bond issuance in euros was successfully priced on March 9, 2023. We had been working with Barclays for some time, planning to follow in the footsteps of our domestic peers for covered bond issuance in euros. The legislative framework for covered bonds out of Iceland needed updating to comply with EU regulations and that process delayed our issuance plans for some months, but was finalised as of March 1, 2023. So we were quite effective in capitalizing on the favourable market conditions, doing the necessary investor work and pricing a successful transaction in a relatively short period of time.

GlobalCapital: Benedikt, how has your investor base evolved?

Gíslason, Arion: We saw with our inaugural covered bond a totally different type of investor participate. We saw German banks that had until then limited interest in the Icelandic credit since 2008.

Bortolotti, Barclays: I don't know if anybody picked it up but Íslandsbanki issued its bond post-July 1, meaning that it wasn't eligible for LCR or for ECB. So in this instance the investor base was more skewed to asset managers.

While with Arion, which was issued before the implementation of the Directive, there was strong participation from the German investor base and more banks buying it because it was LCR-eligible. So it's going to be interesting to see the next one, especially if it has the premium label, to see how the investor base shifts.

But typically we're seeing interest from some of the official institutions as well as some banks, maybe smaller tickets because it's not triple-A obviously — it's only a single-A — and then we always have the asset managers, lots of support from the Nordic investor base and also from the UK.

GlobalCapital: You made the interesting point earlier about the ECB backing out of buying covered bonds. While issuers may miss seeing the central bank take down 50% of each deal, a lot of people are seeing this as a positive for covered bonds, because it's allowing investors who were squeezed out of the market to come back in.

Bortolotti, Barclays: It has caused a widening of pricing but Icelandic covered bonds are not eligible for the purchase programme so we would never have had an order from the central bank. They are, though, ECB repo-eligible.

But definitely you're right. Sometimes investors I speak to say 'look, it's a Covered Bond Purchase Programme deal, I'm not interested because the price is not where it's supposed to be'.

That's changing and that's why we've seen a bit of a widening in covered bonds, yet the books have been significantly oversubscribed. It is more reflective of the fair and real value of the instrument now, rather than supply and demand.

GlobalCapital: **Your investor bases have developed in covered bonds, but are you seeing any of that development, diversification, cross over into your other forms of financing, senior unsecured, for example?**

Jón Guðni Ómarsson
Íslandsbanki

Ómarsson, Íslandsbanki: Those are on the whole quite separate accounts, really. So we have seen, I would say, limited impact so far.

Gíslason, Arion: There are more investors that hear the story and eventually it will lead to a broadening of the investor base across our financing lines.

In recent months and years the Icelandic banks have realised that they are quite reliant on the European investor base. They should try to market more broadly to the US and Asia as well. Up until now the liquidity has been there, but the widening of spreads — and even widening further than our peers in comparable banking systems in Europe — means looking further afield is something banks should consider doing.

Bortolotti, Barclays: As Benedikt said, the investor base for senior and covered bonds are different. But the fact that the banks are coming to the market more regularly is important.

We saw this with the first covered bond issuance from Arion. Some investors said: 'It's a small name, it's a small region, we don't want to put in the time.' But then when they saw the second deal coming and then the tap, they're like: 'Oh, this is becoming quite interesting, maybe we should be doing our homework.'

We're getting a lot of traction and interest from investors. When we were on the road, some were asking if Arion was going to be the only one. They see it as a systemic product and it's very important to have all the banks accessing the market, not all three necessarily once a year, but this gets investor engagement, they start doing the work.

I'm sure some of the larger accounts could have pockets for both. Once you've done the work, if you've done it for covereds, you've done it for senior.

Gíslason, Barclays: You're absolutely right — the combined issuance of all three banks makes for a decent size in the international market.

GlobalCapital: **What about non-covered bond issuance? How are you finding markets? Is there something you're eyeing up this year?**

Ómarsson, Íslandsbanki: The turmoil was substantial in the capital markets last year. But the impact it had on the pricing of Icelandic bonds was very surprising, especially when we speak to investors and hear that they don't have concerns about Iceland, the economy or the banking system. It's more to do with the size of the issuance and technicalities on that front. We are a bit disappointed we're not seeing more depth in the capital markets for Icelandic bonds.

But obviously now we're seeing a very rapid tightening. So we are optimistic that we will continue to see development on that front throughout this year.

GlobalCapital: **Did you feel Iceland was being punished more than others?**

Ómarsson, Íslandsbanki: I would not use the word punished. I think it had more to do with the fact that fear was dominating the capital markets. A lot of asset managers had their own problems to deal with, they were experiencing outflows in some cases and they needed to have as much liquid paper as possible. Our size and ratings counted against us.

GlobalCapital: **Is this a problem Iceland will always have? What can you do about it?**

Ómarsson, Íslandsbanki: To some extent I think we will always have this problem. We also learnt quite a bit from this. During these kinds of times, we need to be even more open in meeting investors and telling our story.

GlobalCapital: **More roundtables…**

Ómarsson, Íslandsbanki: Exactly. And then with the MREL rules, we have to be even more thinking far ahead about pre-funding and having longer-dated funding to some degree.

Bjarnason, Landsbankinn: We plan to issue both covered bonds and senior bonds this year in the international markets. But we will be somewhat opportunistic in terms of timing.

Gíslason, Arion: We completed our funding needs for this year late last year but MREL requirements mean we might issue at some stage this year.

Ómarsson, Íslandsbanki: It's quite interesting thinking about upcoming maturities in 2025. We've started to think about those now. It's a bit of a change in the environment.

THE OUTLOOK

GlobalCapital: So there will be quite a difference in the terms available now. Deep breaths — what are your views on how the rest of the year will shape up? Fingers crossed, they're as good as the first two months.

Pálsson, Central Bank: The market this year has been much better than anyone anticipated. But no one knows what the future holds. The best thing we can do, from the republic's perspective and the banks', is just go out and tell the story. It's a good story, it's a strong story. Usually those who take the time and effort to dig into the story, they get more confident.

If you look at Iceland and all our developments in the post-crisis years, I think we compare very well with the triple-A countries of the world. To me it is obvious that the rating agencies are not too generous when it comes to Iceland.

We maybe have to revisit that issue — frankly speaking we are stronger than our ratings would indicate. The most recent episodes of crisis that have come over the world have demonstrated that very well.

The outlook for the economy is good. Even though we are forecasting 2.5% growth next year, we are seeing the return of Chinese tourists, so the outlook for tourism is very good.

Our terms of trade are coming off the peak a bit, but up to a 2.5% growth rate is healthy and more manageable from the central bank perspective than 7%. So hopefully we will see a soft transition to a healthy and stable environment.

Gíslason, Arion: I mentioned earlier about the importance of diversifying the investor base. There is one very good development, which is the opening up of the local market for Icelandic banks, in particular for Tier 2 and other capital instruments. And I'm sure the senior and secured markets here will also develop this year.

Benedikt Gíslason
Arion banki

There's been a lot of education of the investor base around MREL requirements and how they play into the funding needs of banks. We have seen considerably better Tier 2 spreads in the local secondary market in the last four to six months.

GlobalCapital: When you say develop you mean get a bit bigger?

Gíslason, Arion: Yes, it's getting bigger. There was some understandable conservatism from the pension funds who took some losses in 2008. They're now trying to get more comfortable around the regulatory framework for the banks and the different instruments.

Bjarnason, Landsbankinn: In the domestic market also one consequence of the Central Bank's monetary policy tightening is that loan originations, especially on the retail side, are slow this year. That means funding needs will be more on a refinancing front rather than to meet new originations and loan book growth. I agree with Benedikt, we will probably get a more versatile product offering in the domestic market than we have in the last few years.

Ómarsson, Íslandsbanki: The outlook in general is quite favourable. The main challenge is obviously inflation and how much interest rates need to rise to bring that down, and whether we will see more impact here, especially on the investment level.

However, leverage is quite low across the board — government, businesses and households — so they are in a good position to tackle these fluctuations. Therefore we are not seeing a pick-up in delinquencies in our mortgage book or other lending books.

We have less than 2% of our loan book outside Iceland so the bulk of our operations are domestic and the outlook here is favourable across industries.

GlobalCapital: There have been a few mentions of ratings and rating agencies. How can you persuade the agencies to see you for who you really are?

Bortolotti, Barclays: A lot of it is really just about educating them and maybe broadening out to other agencies and teaching them and explaining the Icelandic story — and why they're wrong!

Gíslason, Arion: I hope the rating agencies are picking up that the historic lack of diversity and concentration of our export industries that led to a weaker rating than our neighbouring countries is being replaced by a real diversification in our export revenue.

But we are also seeing diversification of our funding sources too — the opening up of the covered bond market being one, the increase in the number of international investors in our equity another, as well as inclusion in indices. This is all playing into a better functioning and open economy with more pillars to support it and I'm sure this will find its way to being recognised in our ratings. GC

Iceland's banks plunge into green funding, sovereign hangs back

Icelandic banks have become enthusiastic issuers of labelled bonds, sensing that they gain extra interest from investors. The government, however, has delayed joining them, partly because it does not need much funding. Meanwhile, as Philip Moore reports, the banks' focus has now shifted to accelerating the growth of their green lending, as they try to contribute to Iceland's ambitious decarbonisation targets

For a country with a modestly sized bond market, Iceland has shown a keen interest in green and sustainable finance.

Since the beginning of 2021, Iceland has produced five green, social or sustainable (GSS) bonds, according to Dealogic — all issued by the three biggest banks. They have totalled €1.49bn — perhaps not a vast haul, but 31% of all the syndicated bond issuance it records from the country.

Apply the same analysis to Europe as a whole, and GSS issuance — also throwing in sustainability-linked bonds — has been 20.5% of the total.

Green issuance began in Iceland with the City of Reykjavik, which brought a 30 year domestic deal in December 2018.

Since then, Orkuveita Reykjavíkur (Reykjavik Energy) has joined it, having launched its first green bond in 2019 and released its updated Green Financing Framework in 2021.

In October 2021, the seafood company Brim brought some diversity and innovation to the króna GSS bond market when it became the first Icelandic issuer to package a new issue of green and blue bonds, with an Ikr5bn five year transaction (€33m at today's exchange rates).

Among the banks, Íslandsbanki set the ball rolling in November 2020 with an Ikr5bn trade. Arion banki, which published its Green Financing Framework in 2021, has also issued green króna bonds.

But apart from a $150m private placement in 2020 by the national power company Landsvirkjun, international GSS issuance from Iceland has been confined to the major banks.

Íslandsbanki launched the first labelled sustainability bond for €300m in 2020. The following year, Landsbankinn issued two €300m senior unsecured transactions, and in the same year Arion launched its first green trade, a four year, also for €300m.

Arion returned to the green bond market in September 2022 with another €300m two year senior preferred deal.

Green edge

These international green bonds from Iceland have found no shortage of demand.

Íslandsbanki's curtain-raiser in 2020 generated a peak book of more than €1bn. Arion's first green bond had peak orders of over €600m, from more than 70 investors. That enabled it to achieve its tightest new issue pricing for several years.

Landsbankinn reports equally robust demand for its euro green bonds. "Our inaugural green issues were very well received," says Aðalheiður Snaebjarnardóttir, sustainability manager at Landsbankinn. "We achieved a greenium for each of the issues, and we were also able to access a broader investor base than we had ever reached before."

No government

Conspicuous by its absence in the international GSS market has been the government. As early as 2020, Iceland established a task force to study the potential for sovereign GSS issuance. This brought together representatives from the central bank, ministries of finance and environment and various sustainable finance experts and consultants.

The government followed up in September 2021 by publishing a Sustainable Financing Framework, identifying projects that met its sustainability criteria. Under the framework, rated Dark Green by Cicero, sovereign GSS bonds can be issued locally or overseas.

But to the frustration of local bankers, Iceland has yet to use the framework to establish an international GSS benchmark. "A green sovereign pricing benchmark would certainly help the asset class in Iceland," says Theódór Friðbertsson, head of investor relations at Arion. "It has been two years since the government's last international bond, so it will be interesting to see if its next issue is a green bond, or at least partially sustainability-linked."

"A GSS bond would likely broaden the investor base for Iceland and strengthen our position in global capital markets"

Sturla Pálsson, Central Bank of Iceland

Sturla Pálsson, director of markets at the Central Bank of Iceland (CBI), recognises that a benchmark from the sovereign would be warmly welcomed by borrowers eyeing up possible international issues.

"One of the main drivers behind global bond issuance by the Republic of Iceland is to provide a benchmark for other local issuers in foreign markets," he says. "A GSS bond would likely broaden the investor base for Iceland and strengthen our position in global capital markets, and therefore have a possible pricing benefit."

Pálsson adds that the sovereign has plenty of eligible assets. "The sovereign has already identified expenditures that would easily justify a benchmark-sized global bond under the framework," he says. "We have a selection

City of Reykjavik launched green bond issuance in Iceland with a 30 year domestic deal in December 2018

committee assessing the eligibility of individual projects and we might look at issuing a bond to finance a portfolio of different projects. For the inaugural Sustainable Financing Framework issuance we have been looking to issue a straight green bond but might however broaden the scope of projects to justify a larger issue size."

The CBI has yet to reach any decisions on the timing, size or currency of an inaugural green bond. "We have little need for issuing since all fiscal needs are met through the local currency treasury programme," Pálsson says. "Our next bond might be issued under the Sustainable Financing Framework we published in 2019, but markets are volatile, and we are in no hurry."

Clean as a whistle

There is another reason why Iceland feels no great urgency about leaping aboard the sovereign green bond bandwagon that has been trundling around much of the world since Poland opened the market in late 2016. Iceland has no need of it as a public relations exercise.

The 2022 Environmental Performance Index puts Iceland 10th out of 180 countries, well ahead of GSS-issuing sovereigns like Poland (46th) and Egypt (127th).

Cashed up

Iceland's banks can afford to be equally selective in their approach to international markets. Roughly half their funding comes from deposits, of which there has been no shortage recently. Total inflows rose by 10% — or Ikr237bn (€1.6bn) — in 2022, according to the Central Bank.

The banks' modest wholesale funding requirement means their international borrowing is defined principally by investor demand.

At Landsbankinn, Snaebjarnardóttir says that in today's environment, this demand is concentrated more strongly in covered bonds than the GSS bond market.

Friðbertsson at Arion says that although he is delighted by the investor response to the bank's brace of green bonds, there are no further transactions in the pipeline. "We probably won't be returning to the green bond market either until our current green bonds reach maturity, or until we have more green assets in our loan book," he says. "Today, eligible green assets account for 12.5% of our loan book, but for almost a quarter of our outstanding borrowings."

Ramping up lending

Arion wants to expand green loans to 20% of its portfolio by 2030, in line with its Green Financing Framework. That would require green lending to grow twice as fast as total loans.

Iceland's other banks are also committed to enlarging their green loan books. In 2022, Íslandsbanki released its carbon neutrality report, *On the Road to Net Zero*, setting out its objective of achieving a net zero loan portfolio by 2040.

More immediately, its sustainability goals for 2023 include raising sustainable loans to 15% of its corporate and motor portfolios. Íslandsbanki has also pledged that by the end of 2023 its sustainable assets "must have overtaken sustainable liabilities once again".

Íslandsbanki's sustainable lending exploded by 134% in 2021, from Ikr25bn to Ikr58bn.

But in 2022 this slowed to a 36% increase, to Ikr79bn (€530m). Of that, 53% was green loans, 33% blue loans and 14% social facilities. In absolute terms, this looks reasonable and well diversified enough. But Íslandsbanki concedes that the increase of Ikr21bn was well below its original target for the year of Ikr40bn.

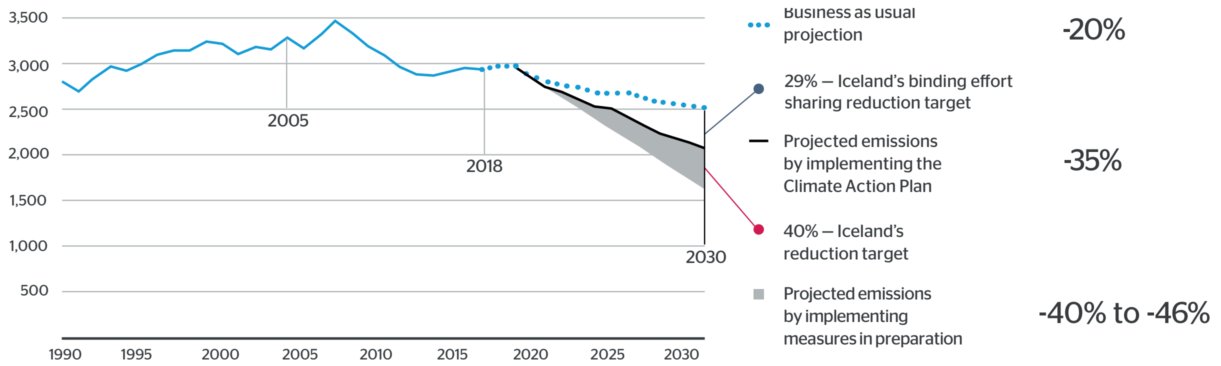
Given Iceland's image as a super-clean economy with abundant resources of clean renewable energy, it may seem curious that green assets make up a modest proportion of the banks' loan books.

After all, as Friðbertsson points out, Arion is in the top sixth percentile of banks for its ESG rating from Sustainalytics, ranking 55th out of 992 banks.

The problem for Iceland's banks, Friðbertsson says, is that their asset pools do not tick all the boxes required by international investors.

"If you look at housing, our focus

Iceland's effort sharing emissions 2005-2030 (1,000 tonnes CO_2 — equivalent)



Source: Government of Iceland, Ministry for the Environment and Natural Resources

has only partly been on energy efficiency," he says. "Buildings in Iceland generally do not have Energy Performance Certificates, nor is Primary Energy Data available."

Low emissions

Arion has been using the international green bond market to refinance part of its residential mortgages assessed as green. But since virtually all homes in Iceland use renewable energy, both hydroelectric and geothermal, the criteria for assessing the green credentials of mortgages in Iceland are quite different from the methodologies used in most of Europe.

In 2021, Arion commissioned Mannvit, the engineering firm, to analyse its mortgage book and identify the homes that could be categorised as green. Based on their carbon emissions, proximity to public transport and the environmental impact of their waste and recycling management, the study found that about 13% of Arion's residential loans conformed to Mannvit's definition of a green mortgage.

"Because we generally don't have energy efficiency labels in Iceland we instead identified the top 15% of houses in the methodology and in line with market standards," says Friðbertsson. "The reason why this is currently 13% is the exclusion thresholds put in place relating to proximity to public transportation and waste management."

Landsbankinn has a similar problem. Its two green bonds mainly refinance loans to the fisheries sector. As Snaebjarnardóttir says, this meant that the first of them could equally have been categorised as a blue bond. The assets backing it conformed to the Marine Stewardship Council Fisheries Standard.

But Snaebjarnardóttir says that as aquaculture is not yet covered by the EU Taxonomy of Sustainable Economic Activities, Icelandic banks are unlikely to be able to maximise funding benefits by issuing in blue format.

"At the moment, the EU Taxonomy has only finished two chapters, on [climate change] mitigation and adaptation, and almost nothing in those two chapters fits the Icelandic economy," she says. "For example, the EU Taxonomy has not yet started on marine aquaculture, which means that many of our assets aren't yet included in the Taxonomy. We hope that by the time we issue our next green bond more of our assets will be eligible under the EU Taxonomy, which is due to be completed before the end of this year."

Doing their bit

The Icelandic government has signed the Paris Agreement, and aims to reduce greenhouse gas emissions by 40% by 2030, from 1990 levels. It has also set a goal of carbon neutrality by 2040.

This may be a tall order. Surprisingly, Eurostat data released in 2021 shows Iceland as having Europe's highest greenhouse gas emissions per capita. But the figure is skewed by its tiny population and large tourism sector.

Iceland's leading banks believe their green bond issuance is already making a meaningful and measurable contribution to the country's net zero target.

Íslandsbanki, for example, reports that in 2021 its green bond proceeds resulted in the avoidance of almost 2,800 tonnes of CO_2 equivalent emissions. They led to the production of 4GWh of clean energy, it reckons, and over 3,000 square metres of eco-efficient buildings.

"It will be interesting to see if [the government's] next issue is a green bond, or at least partially sustainability-linked"

Theódór Friðbertsson, Arion banki

Arion, meanwhile, calculated at the end of 2021 that its green financing that year had prevented greenhouse gas emissions equivalent to those created by 36,228 return flights to Copenhagen.

Among other initiatives aimed at promoting sustainable finance in Iceland, in June 2020 Arion launched a new green deposit account, the first from an Icelandic bank.

The response from individual, NGO and corporate depositors has surpassed expectations. By the end of 2022, total deposits had reached Ikr21bn (€140m), up from Ikr8bn 12 months earlier. GC

Harnessing the Arctic

Iceland is uniquely placed to support the economic development of the Arctic region. But alongside the vast potential around transport, energy, tourism, mining and fishing are key concerns around its fragile ecosystem and geopolitics, following Russia's invasion of Ukraine.
Philip Moore reports

Benedikt Gíslason, CEO of Arion banki in Reykjavik, recalls that when Donald Trump announced in 2019 that he fancied buying Greenland, everybody laughed. It was not the first occasion on which a US president had floated the idea of absorbing Greenland. But it was probably the first time anybody had described the idea of acquiring 836,000 square miles of territory as "essentially a large real estate deal".

Trump's flippant comment caused offence as well as hilarity not just because of its neo-colonial undertones. It also belittled the importance of Greenland, economically, ecologically, politically and militarily.

The last person you would expect to make a similarly inappropriate remark about Greenland or the Arctic is Ólafur Grímsson, who served as president of Iceland between 1996 and 2016. In 2013 he was among the co-founders of the Arctic Council, an inter-governmental forum set up to promote co-operation, co-ordination and interaction among the states that have territories within the Arctic.

Cracks inevitably opened within the eight-nation group when Vladimir Putin sent his tanks into Ukraine in February 2022, at which time Russia held the chair of the Council. A week after the invasion, Iceland — along with Canada and the US — refused to attend meetings chaired by Russia.

This gave rise to misgivings that years of fruitful co-operation in the region would go to waste. As the Arctic Institute noted in March, "the Russia-Ukraine conflict has further impeded international scientific collaboration in the Arctic. While the Arctic Council continues its activities with a limited resumption, how collaboration may continue without Russia remains a critical concern."

But the end of what Norway's foreign minister Anniken Huitfeldt used to describe as "High North, low tension" has not blunted Grímsson's enthusiasm for the Council he co-founded a decade ago. "Last year a lot of people said to me that it would be pointless to continue the activities of the Arctic Council given the tragic military development in Ukraine," he tells *GlobalCapital*. "But we concluded otherwise. The forums we've held recently in Greenland, Iceland, Abu Dhabi and Tokyo demonstrate that the global desire to engage in the future of the Arctic has never been stronger."

Arion's Gíslason agrees. He says that of approximately 120 projects involving Arctic Council partners that were ongoing at the time of the invasion, about 90 have been unaffected by the Russia-Ukraine conflict.

Grímsson says that some 2,000 people from 70 countries attended the recent Arctic Council forums, which he believes should rank in importance alongside the Davos World Economic Forum and the annual Munich Security conference.

Norway's finance minister Anniken Huitfeldt used to talk of High North, low tension before Russia invaded Ukraine

Continental proportions

In part, this reflects the sheer size of the Arctic region. "Most people still regard the Arctic as a remote and almost peripheral area," he says. "But if you add up all the Arctic territories stretching from the US and Canada to Greenland, Iceland, Norway, Sweden and Finland and on to the vast Arctic part of Russia, you're talking about a part of the planet similar in size to Africa. It is of continental proportions."

More important than its size is the economic potential of the Arctic region, which Grímsson describes as the "new frontline of 21st Century multi-dimensional resource utilisation".

More specifically, Grímsson says there are five areas with far-reaching economic potential. The first is transportation, both by air and sea. Airlines like Icelandair and fast-growing airports such as Keflavik near Reykjavik are already leveraging their geographical location to shuttle air passengers from Europe to America. Shipping companies, meanwhile, are capitalising on the new lines passing through the North American and Russian waters of the Arctic to cut as much as 50% off the sailing times though the Suez Canal.

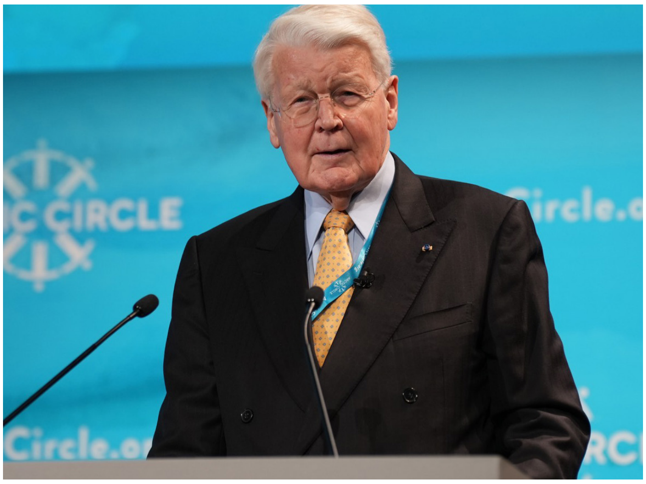
The second is the extensive reserves of natural resources buried beneath the Arctic. Fossil fuel exploration is increasingly being outlawed across the region. But it is rare earth metals used in the production of electric vehicle batteries and other sustainable technologies that are attracting the attention of investors. "The Arctic is extraordinarily rich in minerals and rare earth metals which are absolutely critical for technological and economic growth in the 21st

Century," says Grímsson.

Equally critical, Grímsson adds, is the Arctic's potential as a source of clean energy resources ranging from hydro and wind to geothermal power, all of which could be exported from the region to Europe.

"Then there are the fishing grounds of the northern and Arctic oceans, which are rich in wild fish stocks that are being diminished in other parts of the world," says Grímsson.

Finally, he points to young and relatively prosperous visitors from Europe, Asia and North America as a fast-growing source of demand for eco-tourism to the Arctic.



Arctic Council co-founder Olafur Grímsson says the region's economic potential puts it it at the frontline for resources

Well placed

Iceland's geographical location, its expertise in clean energy and aquaculture, and its recent experience of managing a tourism boom, mean it is ideally positioned to support the development of each of these sectors.

This explains why Arion, for one, has stepped up its lending to the Arctic region significantly in recent years. Its Arctic loan book has expanded at a compound annual growth rate (CAGR) of 48% since 2019, and grew by 62% in 2022 alone, accounting by year-end for 8.7% of the bank's total corporate loan portfolio.

In the corporate finance market, meanwhile, in November 2022 Arion led the first listing on Nasdaq Iceland of a Greenland-focused mining company, Amaroq Minerals, which holds the largest minerals portfolio in southern Greenland. More listings of this kind would endorse Iceland's credentials as a regional financial centre. "Iceland has a good opportunity to use its well advanced financial system and human capital to become a financial hub for the Arctic region," says Gíslason.

The potential of the Arctic also explains why Arion has joined forces with Arctic Circle, Guggenheim Partners and PT Capital to set up Arctic Investment Partners (AIP), the formation of which was announced at the 2022 Arctic Council Assembly in Reykjavik last October. Grímsson says that at this stage the AIP is neither a bank nor a fund, but a structure bringing together like-minded players from around the world to explore sustainable investment opportunities in the Arctic region.

Handle with care

There are potentially two formidable problems with Grímsson's vision of the Arctic of the future. The first is that what he describes as an economic and touristic "utopia" may be seen by many as a dystopian nightmare permanently scarring the fragile ecosystems of the far North.

Grímsson rejects the suggestion that rising inflows of tourists and businesses searching for investment opportunities need be unsustainable. He insists that if polar bears are at risk and if glaciers are melting this is not because of what is happening in the Arctic itself, but because of the energy policy of the major industrialised nations. Besides, he argues that regional governments are already acting as role models for sustainable development in the High North. "Look at the visionary decision by the government of Greenland announced at the Arctic Circle assembly in August that it will allow no more uranium mining," he says.

Greenland's moratorium on uranium mining and the bans on fossil fuel exploration imposed by several regional governments may leave many multinational companies feeling like schoolboys with their noses pressed against the sweetshop window, allowed to look but not touch. But this does not make it impossible to build up worthwhile loan portfolios in the region.

"We emphasise that when we talk about investment in the Arctic we're not talking about oil and gas, but about renewable energy, seafood and tourism," says Gíslason. This is self-evident from the structure of Arion's Arctic loan portfolio, 54% of which is accounted for by seafood, with 25% in industry, energy and manufacturing and 12% in tourism.

Nevertheless, Grímsson's suggestion that the economic boom he describes will cause little harm is unlikely to be shared by environmentalists. One recent research study concluded that over the last 40 years the Arctic has warmed nearly four times faster than the rest of the world. While emissions in the industrialised world may be the main driver of environmental damage in the Arctic, increased economic activity in the region is clearly a contributing factor. As the 2022 Arctic Report Card from the US National Oceanic and Atmospheric Administration (NOAA) noted in December, maritime ship traffic opens economic opportunities for new trade routes, but also poses "potential human-caused stresses on Arctic people and ecosystems".

A second source of potentially catastrophic risk for the Arctic area may, paradoxically, be the wealth of its natural resources. The potential for conflict in the region between superpowers coveting its resource base has been well understood by military strategists and regional politicians for years. In a speech in Washington in 2019, Iceland's foreign minister Guðlaugur Thor Thordarson was already cautioning that "the scope, speed and apparent ambition of the Russian military build-up in the Arctic does raise questions".

None of this has been lost on the US. It may no longer be contemplating buying Greenland lock, stock and barrel. But unease at the elevated security risk in the High North has prompted the US to channel increased investment into its Thule airbase in northern Greenland and to expand its consulate in Nuuk. GC