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Nordic nations strengthen defences amid new threat

Nordic countries are raising their defence spending, amid fears of further Russian aggression in the region. State finances are generally sound but fiscal and monetary stimuli may also be needed, reports **Philip Moore**

The late Stanley Ross was seldom known for his diplomacy. One of the market's more colourful characters during the early years of the Eurobond movement, Ross was probably best known as the controversial architect of the so-called grey market.

He is also remembered for his highly outspoken political comments. In the mid-1970s, at the height of the Cold War, Ross used his entertaining weekly soap box-cum-gossip column, *The Week in Eurobonds*, as a platform to rail against what he regarded as the absurdity of Finland's newly assigned AAA rating from Moody's.

"We should ask ourselves when considering the new AAA status of this borrower, how many Kalashnikovs are pointed their way across the barbed wire border," wrote Ross. "As far as we are concerned, they can give it all the numbers they like, it will trade no higher in this marketplace than single-A."

Ross had to apologise for his insensitive comments, both to the Ministry of Finance in Helsinki and to Moody's. Rightly so. Finland was forced to cede 9% of its territory to the Soviet Union after the Winter War of 1939-1940. So, its proximity to an aggressive and potentially expansionary neighbour was no laughing matter in the 1970s.

Nor has it been a laughing matter since Russia's invasion of Ukraine in 2022. Finland shares an 830-mile border with Russia, and while the threat of any military confrontation is regarded as minimal, Helsinki has very legitimate concerns about the dangers of instrumentalised migration across its eastern border.

It was the immediacy of Russia's threat to the Nordic region that led Finland and Sweden to jettison decades of neutrality by joining Nato, in April 2023 and March 2024 respectively.

The seriousness of this threat was underlined in May, when the supreme commander of the Swedish Armed Forces, General Micael Bydén, issued a stark warning about Vladimir Putin's ambitions in the Baltic Sea.

Bydén told a German news service that he was especially uneasy about the security of the island of Gotland, which is part of Sweden and lies 90km from its mainland. "If Putin invades Gotland he can threaten the Nato countries from the sea," Bydén told the RND news site. "That would be the end of peace and stability in the Nordic and Baltic regions."

That was quite a statement, and it explains why Sweden is increasing its defence expenditure. It has already doubled its defence spending to around Skr120bn (\$11.3bn) in 2024 in line with its Nato commitment to allocate 2% of GDP to its military budget. It won't stop there. Sweden's cross-party Defence Commission has recommended an increase in its military spending to 2.6% of GDP by 2030.

Norway doubles up on defence

Norway's membership of Nato dates back much further than Finland's and Sweden's. It joined in 1949. But it is now committed to what prime minister Jonas Gahr Støre recently described as an "historic boost in defence spending." The Norwegian government said in early May that it plans to increase its military spending by Nkr600bn (\$57bn) over the next 12 years. This means that between now and 2036 its military budget will be almost doubled.

Finland has already seen sharp increases in its defence budget

since 2021, when it spent \$3.8bn, according to the Stockholm International Peace Research Institute. This rose to \$4.8bn in 2022 and \$6.3bn in 2023, with about \$6.6bn allocated for 2024.

Finland's increased military expenditure arising from Nato membership was regarded as sufficiently noteworthy from a financial perspective to warrant a section in the government's Debt Management Annual Review for 2023. This commented that "maintaining and developing a credible defence force will demand significant economic investments both now and in the future."

Denmark's parliament, meanwhile, recently agreed a proposal to fast-track investments in defence spending by Dkr35.2bn (\$5.1bn) in 2024-28.

It is not just governments that are focusing more intensively on the economic impact of geopolitics in northern Europe. Some of the leading regional private equity houses, well known for their financial firepower, are turning their attention for the first time to opportunities in the defence sector and related industries, according to Eirik Winter who, as well as being CEO for the Nordic region at BNP Paribas, is an officer in the Finnish Army reserve forces.

That makes sense, because the economic reverberations of Nato membership extend well beyond expenditure on armaments and military personnel, encompassing investment in infrastructure as well as technology.

"Finland and Sweden add enormous economic, as well as political, strength to Nato, not least because of the technological expertise that companies like Saab bring to it"

Eirik Winter, BNP Paribas

Norway's finance minister Trygve Slagsvold Vedum spoke for much of the region when he was recently quoted on the government's website as saying that the country's proposed defence investments will benefit the whole country in several ways. "When we spend so much on defence, it must be in a way which creates Norwegian jobs and investments," he said.

Tax hikes and spending cuts

A recent Swedbank report observes that this increased regionwide expenditure will be funded largely by tax hikes or lower non-defence expenditures. It adds that the direct economic effects of increased local defence spending will "nevertheless depend on exactly which tax hikes and reductions in other expenditures are carried out."

"However, other potentially more important economic effects also need to be considered," Swedbank notes. "Sweden's accession as a member of Nato has raised questions relating to military requirements for better infrastructure and healthcare capacity. Additional buildings and facilities are needed to host more military personnel, but better railroads, harbours and roads are also required for transportation of troops from the Norwegian west coast to Sweden and further on to Finland and the Baltic states."

Regional bankers agree that the economic impact of Nato membership should not be underestimated. "Finland and Sweden add enormous economic, as well as political, strength to Nato, not least because of the technological expertise that companies like Saab bring to it," says Winter at BNP Paribas.

From a sovereign credit perspective, there is for the moment negligible risk of the threat from Russia impacting the rock-solid ratings of the Nordic economies. "An invasion is not part of our base case assumptions for any of the Nordics," says Christian Esters, managing director at Standard & Poor's.

The fiscal implications of Russian aggression and Nato membership are more complicated to assess than the geopolitical ramifications.

"Norway clearly does not have any problem with deficits or external debt," says Jens Magnusson, chief economist at SEB in Stockholm. "So increased military spending won't

"An invasion is not part of our base case assumptions for any of the Nordics"

Christian Esters, S&P

create any risk of crowding out other investment there.

"In Sweden the risk may be slightly higher," he adds. "But the government has been very cautious about public spending in recent years, and with gross debt at about 32% of GDP there should be plenty of room for increased investment in our military capacity."

Maxim Rybnikov, a director at S&P in London, is not unduly concerned about the fiscal outlook in Sweden. "Given that net government debt is below 25% of GDP, we think there is ample scope for an increase in public spending from a ratings perspective," he says.

Denmark's government funding strategy, meanwhile, will be unaffected by its increased defence spending. According to research by Danske Bank, the government is already overfunded to the tune of Dkr35bn and has sufficient cash to fund any additional military expenditure.

Even in Denmark, however, Danske cautions that one implication of an expanding defence budget is less likelihood of buybacks and lower overall issuance in 2024.

Of all the economies in the region, Finland may be the most fiscally challenged by a sharp increase in expenditure to meet or exceed its Nato commitment. Its general government debt-to-GDP ratio reached 75.8% in 2023 and is projected by the EU to increase to 80.5% in 2024 and 82.4% in 2025 due to "persistent deficits and substantial stock-flow adjustments."

"Finland has weaker public finances than the rest of the Nordic region, with substantial annual budget deficits which are growing," says Magnusson at SEB. "So any programme that seriously ramps up public spending may risk crowding out other investments."

Pick-me-up required

Against the backdrop of pallid growth and weak labour markets, much of the Nordic region could certainly do with a pick-me-up from monetary or fiscal

policy. SEB forecast in early May that following feeble growth of 0.3% in 2023, GDP across the Nordic region would expand by 1.1% in 2024 and 2.5% in 2025.

Sweden looks as though it may benefit from both a monetary and a fiscal fillip. The recent interest rate cut by the Riksbank was regarded as a predictable but much needed opening salvo in a rate-cutting cycle expected to gather steam over the second half of 2024.

"We have three more rate cuts in our forecast for the rest of the year," says Magnusson. "Given that Sweden is a highly rates-sensitive economy, we think this will really help it to grow a little faster than the European average and probably faster than the United States in 2025."

SEB sees Swedish GDP growth of 2.8% in 2025, compared with 1.8% in the US and 1.7% in the euro area.

On the fiscal side, meanwhile, Magnusson is hopeful that a more expansionary public spending policy in the run-up to the election in 2026 will also help to stimulate Sweden's economic recovery.

Elsewhere in the region, Norway is in no hurry to follow the Riksbank's lead by going dovish on interest rates. The Norges Bank has raised its policy rate 14 times since late 2021 to its present level of 4.5%, and the Bank indicated in its most recent briefing that it expects the rate to be "held steady" for some time.

If that brings more pain for the Norwegian consumer, so be it. "We know that high interest payments are demanding for some people, and many people ask us when interest rates will be lowered again," the central bank advised in May. "Our assessment is that the policy rate is now sufficiently high to bring inflation down to target within a reasonable time horizon. But we still have a way to go before inflation is back to 2%, and the policy rate will likely remain at today's level for some time ahead."

At the same time, the central bank advised that the shackles are kept on the Norwegian banking sector, with the countercyclical capital buffer remaining unchanged at its upper limit of 2.5%.

"There is still a heightened risk of financial system vulnerabilities amplifying an economic downturn in the Norwegian economy, leading to bank losses," the Norges Bank cautioned. **GC**

Iceland seeks to exorcise its economic demons

In a bid to avoid a reprise of the economic trauma of the 1970s, Iceland is enduring its highest real interest rate in many years. Will the short term pain bring long term gain? **Philip Moore** reports

Few developed European countries seem to be more haunted by their recent economic history than Iceland.

It's not just memories of the traumatic banking crisis of 2008 that trouble Iceland's policymakers today. Their uncomfortable memories stretch much further back than that.

Ásgeir Jónsson, governor of the Central Bank of Iceland, was explicit about this in the speech he delivered at the Bank's annual general meeting in early April. This referred repeatedly to what Jónsson described as the "inflation demon" and its corrosive impact on Icelandic society in the 1970s.

Emergency legislation and other short-term measures were powerless then to prevent inflation ranging for most of the decade between 30% and 40% and peaking at 60% in 1979. With real interest rates reaching deeply negative territory, said Jónsson, many people who had worked hard all their lives saw their savings wiped out in a few years.

In some ways, Jónsson sees uncomfortable parallels between today and the 1970s. A decisive difference, however, is that since 2001 Iceland's Central Bank has been independent. This has allowed it to respond with unforgivingly restrictive monetary policy to inflationary pressures threatening the sort of economic trauma Iceland suffered in the 1970s.

The Bank has not hesitated to flex its monetary policy muscles whenever and however it sees fit, hiking its policy rate 14 times between May 2021 and August 2023 to a current rate of 9.25%. The result, as Íslandsbanki put it in a recent update, is that Iceland is now facing its highest real interest rate — about 4% — for "donkey's years".

High interest rates are nothing new in Iceland. William Symington, head of international funding at Íslandsbanki, says that when rates

plummeted to 0.75% during the Covid crisis it was the exception rather than the rule. "So Iceland as a society has never been accustomed to prolonged periods of low interest rates, as the rest of Europe and the US have been," he says.

Too tight

However accustomed to high rates they may be, many Icelanders think that enough is enough. Of the 29 bond market practitioners who responded to a survey published by the Central Bank at the start of May, 62% indicated that they thought the authorities' monetary stance to be too tight. This was up from the 42% who said the Central Bank was being too hawkish at the time of the previous survey in January. Just over a third of respondents to the most recent survey thought the Central Bank's monetary policy was appropriate.

That was hardly a vote of confidence from the market. But it's unlikely to cut much ice with Jónsson. "I can assure you that the repercussions would have been far worse if the Bank had not responded," the governor said in April, directing his remarks to those who have been critical of the authorities' hawkishness. "That would have been a journey back to the past, and one that few of us would have chosen to take."

He has a point. Inflation in the first quarter of this year reached 6.8% as measured by the 12 month rise in the consumer price index (CPI). This stubbornly high level, way above the Central Bank's target of 2.5%, is attributable to the overheating of the economy between 2021 and 2023. Last year, the only OECD countries to outgrow Iceland were Costa Rica and Turkey.

Some local economists argue that the reported economic growth of close to 20% over the post-pandemic period between 2021 and 2023 paints a false picture.

"CBI officials have repeatedly discussed — and, in our opinion, perhaps overemphasised — the strong accumulated GDP growth in 2021-2023," notes Íslandsbanki. "It is worth noting, though, that this growth is partly a manifestation of the recovery from the steep contraction in 2019."

Perhaps. The problem, says Arion Bank's chief economist, Erna Björg Sverrisdóttir, is that those same bond market participants who say interest rates are too high also believe inflation will remain significantly above target. Survey respondents expect inflation to edge down to 4.6% in one year and 4% in two years. Over the longer term, they expect it to average 3.8% over the next five years and 3.5% over the next 10.

These expectations are more or less in line with, or slightly below, those published by local banks. In an update in April, for example, Landsbankinn warned that inflation would remain persistent over the next few months, averaging 6% this year before falling to 4.4% in 2025 and 3.5% in 2026.

Sticky summer for inflation

The result is that Iceland will probably have to wait for rate cuts. Landsbankinn's head of economic research, Una Jónsdóttir, says the first rate cut is likely to come in October. "We think we'll see rates being cut repeatedly in 2025, but for the moment we think inflation

"Iceland as a society has never been accustomed to prolonged periods of low interest rates, as the rest of Europe and the US have been"

William Symington, Íslandsbanki

Íslandsbanki — a steady partner in capital markets



Íslandsbanki has been building a dependable presence in capital markets over the past 10 years through the issuance of various asset classes of debt in multiple currencies. With diversification as its watchword, it has established itself as a regular issuer, always aiming at a balance of consistency and choice of appropriate markets. It has a clear and considered funding policy, matching sources of funds to lending and in so doing minimising currency and refinancing risk.

Íslandsbanki has worked hard to achieve a strong set of credit ratings. Currently rated A3 (stable outlook) by Moody's Investors Service and BBB+ (stable outlook) by S&P Global Ratings, the bank's funding exercises are supported by extremely strong capitalisation, high levels of liquidity and solid earnings. The bank is committed to preserving the strongest ratings possible.

As one of the pillars of the Icelandic banking market, Íslandsbanki's deposit base remains the principal — and a growing — source of funding. Representing 53% of total funding, the deposit base is well diversified and granular, with only 26% of deposits belonging to the 100 biggest depositors.

Covered pioneer

In 2011, the bank became Iceland's pioneer for covered bonds, issuing the first such transaction domestically. The country's market for covered bonds has developed strongly over the past 10 years with ISK554bn (\$4bn) outstanding, and Íslandsbanki's share standing at 31%. The investor base encompasses all the biggest asset managers in the country, whether pension funds, mutual funds or insurance companies.

“The Treasury team at Íslandsbanki wants to ensure that it continues to be responsive to the needs of investors and the market in general”

Íslandsbanki is one of the leading players in Icelandic banking and is an innovator in the country's capital markets, notably being the first issuer of covered bonds. It has cultivated a broad investor base across the capital spectrum and across Europe.

More recently domestic markets have also opened up to the issuance of senior preferred and subordinate transactions. This provides the bank with opportunities that were previously unavailable to reduce dependence on foreign markets for these asset classes.

In overseas markets, the bank has a wide footprint as it has issued across a diverse range of asset classes and currencies. It typically issues one euro-denominated senior transaction each year.

In March 2024, Íslandsbanki issued a heavily oversubscribed €300m four year senior preferred, fixed rate bond. Launched with initial price talk of 230bp over mid-swaps, a more than five-times oversubscription meant that the bank was able to print the eventual transaction at 185bp over mid-swaps — a notable endorsement of the strength of appetite for Icelandic risk.

Íslandsbanki remains an energetic supporter of Scandinavian currency markets, having issued multiple times in Swedish kronor (SEK) and Norwegian kroner (NOK) variously in senior preferred, subordinated and additional tier 1 formats. Most recently, the bank issued dual-currency NOK 500m/SEK 500m three year senior bonds in green format — its first green transactions in those markets.

Indeed, the bank has issued in green or sustainable formats several times since 2020, when it signed its Sustainable Financing Framework (SFF) — the first Icelandic bank to do so. Íslandsbanki is committed to ESG principles across its

“As one of the pillars of the Icelandic banking market, Íslandsbanki's deposit base remains the principal — and a growing — source of funding”

entire business, not least in funding. In January 2024, it updated its framework, now renamed to become a Sustainable Funding Framework, incorporating all the latest changes to EU taxonomy and in alignment with ICMA Green, Social and Sustainable Bond Principles. Íslandsbanki will make judicious use of the framework to allow it to access the growing requirement for asset managers to invest in sustainable assets.

In the summer of 2022, the bank issued its inaugural euro-denominated covered bond. Rated A+ by S&P Global Ratings, the €300m 3% fixed rate five year was placed with a range of European investors that was almost entirely new to the bank. Although this was in itself a good diversification trade, the bank expects to be only an occasional issuer of foreign currency covered bonds.

The Treasury team at Íslandsbanki wants to ensure that it continues to be responsive to the needs of investors and the market in general. As Íslandsbanki looks to the opportunities that lie ahead, including its first issues of senior non-preferred bonds, we would welcome a dialogue with investors and other market participants looking across the capital spectrum.

To get in touch, email us at treasury@islandsbanki.is

will remain sticky throughout the summer,” she says.

“High rates have caused a slowdown in some ways,” Jónsdóttir adds. “For example, credit card turnover is decelerating. But at the same time, many people are benefiting from higher interest rates because households’ interest income exceeds their interest expenses as a percentage of their disposable income. So there is still scope for people to go out and spend money.”

This underscores a curious feature of Iceland’s economy, which is that many of its key macro indicators seldom respond as they should to restrictive measures, the most notable and orthodox of which is a restrictive monetary policy.

Maxim Rybnikov, director at S&P Global Ratings, says that Iceland’s monetary policy framework is the weakest in the Nordic region. He says that while on S&P’s scale of one to six (where one is the strongest), Iceland scores four for its monetary policy framework, compared with one for Sweden and Norway, and two for Finland.

“Part of the reason for this is that as so many goods are imported, monetary conditions and pricing levels are determined more by what’s going on internationally than by the Central Bank itself,” he says.

In other words, volatile imported inflation may be an inevitable function of Iceland’s size and the fact that it has one of the smallest free-floating currencies in the world.

Another reason for the failure of macroeconomic policy to curb inflation, says Íslandsbanki’s Symington, is the preponderance of inflation-related products. “The whole system is shot through with inflation-linked lending,” he says. “That blunts the effect of monetary policy because when rates are raised, it has little effect on the króna in people’s pockets.”

Whatever the ailment, the Icelandic patient seems obdurately resistant to its monetary policy medicine. “The Central Bank’s policy is warranted in the sense that the usual metrics of a slowdown, such as defaults, payment postponements and layoffs simply aren’t there,” says Íslandsbanki’s chief economist, Jón Bjarki Bentsson. “While there has been a slight slowdown in some industrial sectors, the problem for the Central Bank is that this has not yet fed through into the labour or the real estate markets.”

Bentsson says that this is still visible in the strength of demand for new employees in the labour-intensive tourism and construction sectors. This demand, he says, is generally met by imported labour, which in itself is another driver of upward inflationary pressure.

In the housing sector, meanwhile, Jónsdóttir at Landsbankinn says recent indicators suggest the market is heating up in spite of high interest rates. “Twice as many homes were sold in the capital region in April 2024 compared to April 2023,” she says.

That, Jónsdóttir adds, may be due to the loss of about 1% of Iceland’s housing stock as a result of the recent volcanic eruptions in the Reykjanes peninsula, which has prompted the wholesale evacuation of the town of Grindavik.

To date, says Sverrisdóttir at Arion, there has been little evidence that a restrictive monetary policy has stifled growth opportunities in Iceland. The performance of the stock market has inevitably been impacted by the relative appeal of bank deposits, coupled with disappointing company results in the first quarter, many of which were at or below consensus forecasts. By late May, the main Icelandic equity index (the ICEX) was down a little over 2% year-to-date.

But beyond that, the ripple effect of rates close to double digits has been muted. “Loan default rates have risen slightly but are still at pre-Covid levels, so we have yet to see any tangible indication that high rates are having a negative effect on investment,” she says.

The risk to investment levels of restrictive monetary policy is, however, a variable that the Central Bank is monitoring watchfully. “There is a real possibility that with rates at these levels for a longer period of time, investment will be hurt,” says Sverrisdóttir.

That will be a concern if it discourages the development of sectors such as IT and pharmaceuticals that

“There is a real possibility that with rates at these levels for a longer period of time, investment will be hurt”

Erna Björg Sverrisdóttir, Arion Bank

Iceland needs to support its diversification away from tourism.

Seismic risk to tourism

Visitors from overseas played a decisive role in helping Iceland to recover from its devastating financial crisis in 2008 and the austerity measures that followed. But tourism can be a capricious source of income.

For obvious reasons, this dried up entirely during the pandemic. More specific to Iceland, tourism income is hostage to seismic risk. Paradoxically, the industry benefited extensively from the Eyjafjallajökull volcano in 2010, which acted as a powerful free advertisement throughout the world for Iceland’s unique natural beauty.

The effect of the Grindavik eruptions of 2023 and 2024 has been less benign. Reykjavik-based economists say that in part at least this is a byproduct of misrepresentation by overseas media, which overstated the impact of the volcano on tourists’ safety.

Nevertheless, the closure of one of Iceland’s foremost tourist attractions, the Blue Lagoon hot springs resort, due to its proximity to the eruptions, was inopportune for Iceland as it coincided with the time at which many tourists book their summer holidays.

That is bad news for an industry that has already seen some softening in 2024. “We published a forecast for tourism arrivals in January, and so far, this year arrivals have been below this forecast every month,” says Bentsson at Íslandsbanki. He adds that while he does not expect to see a year-on-year decline in tourist arrivals, growing competition from other Nordic countries is also squeezing tourism income.

The silver lining in a tourism slowdown is twofold. The first is that it may support the Central Bank’s battle against inflation by weakening the labour market. The second is that it may encourage more investment in other, higher value, added spheres of economic activity more suited to a workforce as educated and aspirational as Iceland’s. GC

“We think we’ll see rates being cut repeatedly in 2025, but for the moment we think inflation will remain sticky throughout the summer”

Una Jónsdóttir, Landsbankinn

DZ Bank sees huge potential for local ecosystems



The climate finance gap is immense. Annual capital flows are trillions of dollars short of where they need to be and must increase at least sixfold to keep global temperatures to within 1.5°C by the end of this century. The focus on top-down funding needs is understandable — but it often overlooks the critical importance of building local, bottom-up solutions. For banks eager to help retail customers make real progress lowering emissions and improving energy efficiency — funding is not the main hurdle.

“When we look at the challenge of implementing solutions at the local level it’s often not financing that’s the bottleneck,” says Friedrich Luithlen, head of debt capital markets at DZ Bank. “It’s generating viable projects in the first place.”

But many lenders are stuck in a mindset that views the energy transition as just another problem in need of a banking product. Too often the financial sector’s response to the climate challenge is to adapt an existing product and make it slightly cheaper. But a few basis points will not be enough to drive change.

Instead, says Luithlen, the banking sector needs to acknowledge the energy transition as a complex challenge in need of holistic solutions. “We as banks have to focus on building advisory capacity to empower entrepreneurs and retail clients across the board to make the right financial decisions for their specific transition projects,” he says.

One-stop shops

Luithlen points to Jyske Realkredit — a leader in the Danish mortgage market — as a firm that is well aware of the challenges homeowners face when trying to appraise all the options.

Leading lenders like DZ Bank are well placed to guide retail clients through challenging energy and renovation projects that are key to climate success.

“When we talk about housing, it quickly gets quite complex because each property is different,” says Christian Bech-Ravn, head of rating and IR at Jyske Realkredit. “There isn’t one simple solution that fits them all.”

Perhaps the key challenge for households is that there are too many unknowns. Clients need to know the renovation options, their potential cost, the financing available and — finally — which firms could actually take the contract. Luithlen highlights local co-op banks in Germany, some of which go beyond pure financial advisory. “They will build up a network of contractors so that they can connect retail clients that want to refit their homes with the right tradespeople, the right architects, the right energy advisors,” Luithlen says. “This is a really worthwhile approach.”

Jyske has formed partnerships with firms that specialise in energy advisory for renovations and shifting from fossil heat sources to renewable. “Banks can create a one stop shop that allows clients to get started with a project right away,” says Bech-Ravn.

Data key to success

This endeavour is not without challenges. Partnering with other companies — many of which can be relatively small — can expose banks to reputational risk. Lenders will have to train staff in ESG and sustainability analysis. But the biggest hurdle is data. In Denmark, EPC scores are so readily available that for buildings where they are not, it is possible to

estimate the score based on properties with similar characteristics. Combined with data on heating sources, this allows banks to identify where the buildings that would most benefit from refurbishment or a change in heat source.

“We will typically contact the homeowners and explain we have a partner company that can help,” says Bech-Ravn, adding that the partner company can then refer the client back to Jyske for financing. “We are starting to create an environment where you can provide everything the client needs from one platform.”

But without good data, it can be prohibitively expensive for banks to spend the time and money building relationships and identifying clients. In Germany, banks face a harder time acquiring the necessary information. This, says Luithlen, is an area where policymakers could have a real impact. “Making more data available would help banks provide better advice at the retail level and do a lot of the heavy lifting that’s needed to make the housing sector more energy efficient,” he says. “We need to acknowledge that there is a very strong causal relationship between individual local-level projects and the success of wider energy transition and financing targets.”

The potential benefits to lenders of this new approach is undeniable. Energy efficient renovations are only going to increase. Banks have a chance to get ahead of the curve in bolstering their balance sheets with high-quality sustainable loans. For leading firms like DZ Bank, their home markets already offer a tried and tested method for funding property renovation — the covered bond market.

“Those energy renovation projects are very good from a risk profile perspective, and that should justify attractive interest rates for borrowers,” says Luithlen. “There’s a huge opportunity here to make a real difference in the energy transition. We just need to motivate more banks to start building those local ecosystems.”

“When we look at the challenge of implementing solutions at the local level it’s often not financing that’s the bottleneck. It’s generating viable projects in the first place”

Fast-growing Iceland looks forward

What is the future for Iceland's capital markets and economy? *GlobalCapital* convened a group of bankers in Reykjavik in May to discuss key themes, including inflation, the banking industry, green energy and the impact of recent volcanic activity



Toby Fildes, *GlobalCapital*: Let's start with inflation. How is Iceland's Central Bank's fight against inflation going?

Hreiðar Bjarnason, *Landsbankinn*: It's improving. Inflation is still somewhat elevated at around 6% and the Central Bank of Iceland is dealing with high inflation expectations going forward. So it seems the Central Bank wants or needs to have real interest rates much higher than you would expect in western countries. So they seem to be looking at 3% real interest rates, which is obviously significantly higher than you would want to be needed to cool down the economy. So that's the big challenge that the Central Bank is facing.

Ólafur Hrafn Höskuldsson, *Arion*: It's good to see that in the last decision we saw that most of the drivers of inflation are moving in the right direction and inflation is down to 6% from the highs of 10s at the end of last year. One of the challenges is the real estate driver and that goes into what Hreiðar was saying. The economy is growing fast. We had a huge population growth over the past couple of years.

The housing market maybe hasn't caught up and then, on top of that, 1% of the population, due to the volcanic activity near Grindavík resulted in people needing to evacuate their homes and reallocate. So this is the key challenge now.

Ellert Hlöðversson, *Íslandsbanki*: I agree. If you look at the composition of inflation, domestically versus internationally, internationally it tended to go hand in hand with energy prices. Obviously, that's not the case here, where the housing market has been driving inflation. Unfortunately the Central Bank discovered that GDP was being under-reported over the last two years which eventually led to a revision — the consequence of that was that monetary policy had been if anything too lax in hindsight. That doesn't help. So we have high interest rates but we haven't been looking at correct figures in controlling monetary policy as well.

Fildes, GC: The Central Bank is not alone in underestimating inflation. We've seen it in a lot of places in the world, with maybe the exception of Saudi Arabia.

Friedrich Luithlen, *DZ Bank*: But you had real estate included in the inflation numbers.

Hlöðversson, *Íslandsbanki*: That was not actually the difference in the measurement. The difference was primarily in investment and it had to do with new sectors domestically, which the stats of Iceland don't have any good data points to get into. So, they were underestimating investments into corporates, more or less.

Höskuldsson, *Arion*: All that means is that we are probably going to see these rates till the autumn at least. People were hoping to get the first drop in May but that's not going to happen so it's most likely it's going to occur in the autumn. But the good thing, apart from the housing market, one of the biggest uncertainties at the beginning of the year was the collective union wage negotiations. That's at least partly now out of the way with long-term agreements, which is a big step. And hopefully the other unions are now following one by one.

Fildes, GC: I mentioned that many countries have had inflation

Roundtable participants



Hreiðar Bjarnason , chief financial officer, Landsbankinn	Ólafur Hrafn Höskuldsson , chief financial officer, Arion Bank	Jens Hellerup , senior director, head of funding and investor relations, Nordic Investment Bank	Ellert Hlökkversson , chief financial officer, Íslandsbanki	Toby Fildes , managing director, <i>GlobalCapital</i> (moderator)	Friedrich Luithlen , head of debt capital markets and syndication, DZ Bank	Frank Jackman , covered bond editor, <i>GlobalCapital</i> (moderator)
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Photography by Silla Páls

shock, I wonder if the causes of Iceland's inflation were perhaps different from other countries? You mentioned, Fritz, real estate being part of the bucket. Was there anything special about Iceland's inflation, and is it under control now?

Bjarnason, Landsbankinn: Post-Covid, it was built-up demand for travel and obviously savings had built up, as they did in many other countries. We are now two or three years into that, so that's fading out as a factor.

For us it's getting into a more modest area and that is key to moderate the inflation. So, if we get there in the coming months, then we should be able to see inflation coming down closer to target in the next two years or so. But it's something that the market needs to see before believing. That's the difference between Iceland and many other countries.

Luithlen, DZ: I can contribute a view from some of the more entrenched Nordic investors, how they see the economy and the danger from inflation. There are two elements to mention. Firstly, investors broadly agree with the view put forward in the latest S&P reports: look we don't think there's going to be a housing crisis. Even on the elevated rates level, Iceland is well insulated from that type of shock.

Secondly, there are healthy underlying economic dynamics in Iceland: a young population, low dependency rates, high participation

of women in the workforce or a high GDP-per-capita ratio.

Those are the underlying factors that create an environment where people are happy to buy Icelandic debt. That holds also in the face of nominally high interest rate and current inflation levels around 6%.

Fildes, GC: So are the expectations for inflation to come down quite quickly now, like in certain other countries, or is it going to take a bit longer?

Höskuldsson, Arion: We're hoping it will come down quickly. At least for Arion Bank, there's a bit more pessimism it won't happen quickly, and probably rates will be a bit more stubborn than we were hoping for.

Luithlen, DZ: Yes, I agree with that. We are seeing different measurements of inflation trickling down. That said, as we're seeing in many other countries, inflation tends to be more sticky than anyone wants.

INTERNATIONAL BOND MARKETS

Fildes, GC: First of all it's invisible and then it's sticky. We can come back to various economic points but why don't we quickly talk about Iceland issues in international markets? Hreiðar, the last roundtable in March was just before or just after you accessed the covered bond market for the first time and I think you got your timing

to absolute perfection didn't you? Something happened immediately afterwards.

Bjarnason, Landsbankinn: Yes, we did at the time. It's been interesting. In the last few years, 2022 was quite difficult in foreign capital markets for sure... periphery countries with smaller issuers... 2023 we came back quite strongly. And this year has started very well for all the banks.

Fildes, GC: With the rates background helping?

Bjarnason, Landsbankinn: I don't think that that's been a big factor. But it's often difficult for us to understand what drives spreads, in particular. Obviously the rates are one thing but the spreads that we have to deal with is another. It's often difficult to see why it gets elevated and then as quickly comes down.

Höskuldsson, Arion: Like you said, we are a periphery country, it's a smaller investor pool than in other countries, other banks. It means that the risks are a bit more volatile than for some of the more stable countries. It's still great to see a recovery but it's a bit puzzling. I'm mainly puzzled by how high the spreads went in 2022. Not much changed. Obviously the guys that bought into those transactions that we issued at that point have made very good returns on their investment.

Bjarnason, Landsbankinn: Tensions were high in the market

and small issuers in those scales tend to be pressured more.

Höskuldsson, Arion: During this time as well, S&P was the key rating agency for the Icelandic banks; it's changing a bit now. They downgraded the economic risk assessment of Iceland during this period. It's difficult to say. It's one part of it. It doesn't help. And recently they upgraded it again. They published a positive report on the Icelandic economy, and especially the real estate sector, which they were worried about. That was a signal of confidence for the issuance.

Luithlen, DZ: We are in an extremely benign issuers' market at the moment, with a rate trajectory that is much less ambiguous in the euro space than in US dollars. And that's the overarching backdrop against which you issue. This is a good time to use that momentum, both in senior and in covered, to broaden the investor base and get more people involved across the EUR space.

Once you have new investors in your books and they do credit work for you, on the back of, "hey we need to invest anyway and look we can get a good pickup here", then this will stabilise your market access over time.

Jens Hellerup, NIB: I think that is clearly what has happened over the last one and a half years, there has been spread compression both within the SSA sector but also between the SSA sector and covered bonds. Investors have been looking for a pick-up.

You can say that typically happens when there is no crisis, so of course it's the exception now because a lot of things are happening around the world from a geopolitical point of view, so why is that happening now? Maybe the economy is better globally than expected and that's the reason.

Luithlen, DZ: Not necessarily from a German perspective. [Laughter]

Hellerup, NIB: Well, maybe there is a lot of liquidity and investors need to invest.

Fildes, GC: Jens, it's been five months since January that we've had a really strong bid for all kinds of bonds, without much let-up.

Hellerup, NIB: At least in our sector it has been very active in the first five months of the year. Then there is money around from bank treasuries and the central banks, but also from the asset manager and pension sector. We as an issuer are conservative, after the summer starts in September and with a US election in November the Autumn can be short.

Luithlen, DZ: We also see, especially on the covered side, the investment managers coming back to the market. Now that's an interesting point, well, we have a bit of a weird situation.

We have seen new issue premia have come down, sometimes even pricing through the curves. But we are still at elevated spread levels historically in the rates space, both on the SSA side as well as on the covered side.

One explanation for that is everyone knows SSAs are issuing a lot; investors think about the relative value between SSA and covered as two rates products. So, the €30bn more from the EU this year, KfW, EIB, all issuing at high capacity, and historically elevated levels, is preventing the spreads from tightening in the secondary markets. Additionally we have that disjunction between secondary and primary markets, which was extreme at the beginning of the year with everybody selling covered. Why? Because they wanted to get the high

new issue premia in the primary markets. You got to read that right.

But then there's also all the liquidity that's been building up in the eurozone because people are investing less in real estate. In Germany, as savings rates go up, at the end of the third quarter I think the number was €7.7tr in funds available for German retail, which is cash they have in the bank, investments with asset managers, their pension plans, etc. That's a record volume and that money is available and needs a home.

Fildes, GC: They're avoiding real estate?

Luithlen, DZ: Yes, because houses are still very expensive, rates are historically high, even though a lot lower than in Iceland. And if you want to refurbish your house, that's still very costly because raw materials, wood, concrete, whatever you need, are also historically at high levels. So, what are people going to do? They're going to save money and go to the asset managers and the pension funds. That's one of the reasons why we have this benign issuers' market at the moment.

Fildes, GC: Also maybe more liquidity, as the ECB is no longer buying everything and therefore it's returning to a proper market and you're beginning to see investors who were there pre-ECB coming back, or is that too much of a generalisation?

Luithlen, DZ: I'm not sure whether the ECB stepping out of the market is the main driver for the higher spreads. I think it's the overall issuance volume that we see in SSA that anchors people's expectations around where spreads should be. And the ECB is less of a general topic in the market now.

Frank Jackman, GC: Do you think the new investors, the tourist money, will stick around in the asset classes for a longer time?

Luithlen, DZ: Financial flows are going to flow where they think the best opportunities are. At the moment this isn't real estate; this is actually financial products. And if you can, like Iceland, offer a pick-up, then you can attract significant new flows of capital. On the flip side and by the same token, not all of them



"We are seeing different measurements of inflation trickling down. That said, as we're seeing in many other countries, inflation tends to be more sticky than anyone wants"

Friedrich Luithlen, DZ Bank

are going to stick around, to answer your question.

Hellerup, NIB: I am not sure the Bank treasuries are tourist money. I think the banks had a huge deposit inflow during the years with negative yields as most banks offered 0% return during the time with negative central bank rates. You would expect when yields have gone up that retail money would have got an alternative investment opportunity to the bank deposits. This has not happened, so banks are still very liquid due to their retail deposits. So it's still bank treasuries that are amongst the biggest investors in our bonds.

Bjarnason, Landsbankinn:

Deposits have grown significantly in Iceland since the start of Covid. But surprisingly they have continued to grow quite well post covid, even though economic growth is strong and people are travelling and spending. It's an interesting exchange because deposit beta is high in Iceland so people are not necessarily investing in other financial products, they're fine with their deposits in cash. Obviously high interest rates are difficult for the stock market in many ways, so we've seen a lot of reduction in leverage exposures in the stock market as well.

THE INVESTOR BASE

Fildes, GC: Have you noticed any change in the make-up of your investor base and where the interest is coming from?

Höskuldsson, Arion: We had a €300m senior issue on Tuesday [May 14] where we saw huge increase in demand.

Fildes, GC: And it went brilliantly, I hear.

Höskuldsson, Arion: Yes, we had a record book of €2.6bn (8.5 times book) and where the number of investors were around 190, which is a significantly larger number than we have seen in previous years. We saw increased interest across the board, including from the US, DACH and Apac regions as an example. Again, it's much broader than we've seen in the last few years, which is very pleasing, because we are small and infrequent issuer in the Euro market.

"Apart from the housing market, one of the biggest uncertainties at the beginning of the year was the collective union wage negotiations. That's at least partly now out of the way with long-term agreements, which is a big step"

Ólafur Hrafn Höskuldsson, Arion Bank



Like you were saying before, when you've done the analysis on Iceland, you're more likely to do the future issues, you're not doing the research just for one deal. So it's very good to broaden the investor pool.

Luithlen, DZ: That is the main challenge when you look at euros or other currencies: What do we offer to investors? Do we go €500m but not very regularly? Or do we do €300m and then tap? How do we design continuous investor engagement both on granular and bulk level? Given the glass ceiling that the Icelandic banks face in terms of balance sheet growth, these are not trivial questions.

Höskuldsson, Arion: Especially in the covered space because we each have one benchmark. €500m is big for us, we are small banks. So doing a benchmark is a big decision. And then if you do one and you only need to have one outstanding, you're waiting few years for the next one. You have to time it very well and you have to keep investors engaged without issuing more frequently.

INVESTOR RELATIONS

Fildes, GC: Investor relations, post-Covid, is a really interesting topic because people are having to think again about how they do it. People are bored with video calls now — do we need to get back out travelling again? How are IR habits and techniques changing? What are you doing about it?

Hlöðversson, Íslandsbanki: We're definitely using roadshows more than before. But we remain active in travelling and meeting people in person as well. It has to be said that obviously we are on the road for a potential sell-down by the Icelandic

government, so there are some synergies related to those. So we tend to do maybe ECM and DCM in the same trip.

Höskuldsson, Arion: At least from my perspective, we're still doing roadshows, we still feel we have to meet people. And do the virtuals in between. So it's good that we have more frequent interactions. That's my experience.

Fildes, GC: And not just because there's a deal coming?

Höskuldsson, Arion: No, we try to do it regularly.

Luithlen, DZ: You mentioned the shift to Moody's — what was your experience? Could you also speak a bit towards targeting investors' LCR pockets with a €500m trade and your considerations between having one or two ratings in senior and/or covered?

Höskuldsson, Arion: All the Iceland banks used to be S&P-only for years post the financial crisis. A couple of years ago, Arion Bank added Moody's. And that was very important. It is important to have more than one voice, more than one analyst looking at the country and a second opinion. Interestingly, at least from our perspective, we've been much higher rated by Moody's than by S&P. So obviously there isn't one true story, Moody's has a different perspective which is fine.

It's good to have two but also — we talked about our size, the difficulty of doing €500m, it's also very complicated for a company of our size effectively having, with the regulator, three capital ratings, three liquidity ratings. It adds operational complexity for us.

So we had to measure that against the benefit of investors having two ratings and whether there was any

impact on liquidity, on spreads. Our conclusion was that, for our issuance needs, having one credit rating was the conclusion. In the covered bond space, we had recently gotten a rating of AA2, which was quite supportive. And then, as mentioned before we did the deal this week, which was a testament of, at least on the senior side, that it is not negative from an investor perspective for us having one credit rating.

So yes, we want to have a very detailed discussion about this.

But we also need to regularly second guess that. That's part of management's responsibility. Having Moody's now is not a decision forever, although it's not a decision we make every year. We need to always consider should we now add another one, has our ratings requirement changed? Do we need to issue more and differently? It might be we need to have two ratings later on, but currently we think this was the right decision for us.

Luithlen, DZ: And to add to that, ratings are not cheap. So there needs to be a benefit to the costs.

Höskuldsson, Arion: Both in terms of direct but also indirect. There are a lot of indirect costs around this. So yes.

Bjarnason, Landsbankinn: I think it's helpful that we now have two. Landsbankinn still has S&P and we will stick with that. But we might consider doing Moody's also but again that's doing two times the work and two times the costs without necessarily any direct benefit in terms of pricing etc. But even though we remain with S&P and not rely on Moody's, it's helped us that Moody's is involved in rating our peers as it puts both S&P and Moody's framework and ratings methodologies into perspective.

And we've seen that already; S&P has improved the underlying rating for Iceland, for the banking industry in Iceland, and we see opportunities for further improving the S&P ratings on par with Moody's over the next year or two. So it's important because it affects investor pockets for LCR and size is one thing but that's difficult to get to on a regular basis because of the balance sheet limits that we have being purely domestically focused. So it's been helpful and we saw an improvement from S&P earlier than we expected.

Hlöðversson, Íslandsbanki: It also brings management discipline, to go through this and engage with the rating agencies.

Höskuldsson, Arion: It was helpful for us to go through the Moody's process, having to go through everything again and bring the case, starting from scratch. It was a very good process to go through.

Especially for Icelandic banks because relatively few asset managers have analysts that actually cover Iceland in depth. So it's even more important that the credit rating gives a broader view than we would have with just one.

GREEN BONDS

Fildes, GC: You mentioned that it brings management discipline. There's a similar argument around green bond issuance as well. When an institution like a bank or a corporate does a green bond, that comes from the very top and everyone has to be involved and it brings a discipline. Green debt is emerging as an important part of Iceland bank and sovereign funding. The question is, has the launch of the debut Icelandic green sovereign bond affected bank issuance plans for

labelled debt? Is this something you're contemplating more or has it brought more liquidity?

Bjarnason, Landsbankinn: What we've done at Landsbankinn is: our euro senior preferred issuance has been exclusively in green format for the four benchmark issues. So we've built up an outstanding pool of €1.1bn in green bonds. For us it's been an important factor, especially to increase the investor pool. And it has helped with pricing through the size of the order book and the possibilities to tighten in the process of issuing.

Hlöðversson, Íslandsbanki: I agree with that. To some extent it can be viewed as an investment. It doesn't really make a huge difference in terms of pricing but it makes a difference in terms of size of order book both internationally and domestically. We've done it in both markets and when times are tougher, that's the thing that will help us.

Fildes, GC: Did you notice that when times are tough the green format tended to perform slightly better?

Höskuldsson, Arion: Our record transaction this week wasn't green. I wonder how much bigger record it would have been if it had been green. So it's marginal I think, it does help, it does bring slightly broader pool of investors.

Bjarnason, Landsbankinn: Especially in difficult markets it's more important.

Luithlen, DZ: It adds a lot of execution certainty. We've done the Green debut deal for the Republic of Iceland. It was nine times oversubscribed. In a great market, of course people are going to flock to an issue like that. But in a difficult market, especially when you do sub benchmark and that's what you are strategically committed to be doing, then an ESG format can be really helpful.

Bjarnason, Landsbankinn: It allows us in these types of market that we are in currently to broaden the investor base and as Ólafur was saying before, to have a more recognised name when times are tougher – which they tend to be every few years.

Luithlen, DZ: Would you have the scope to also issue covereds under a framework?

"Iceland has huge potential in this area because we are all green energy. The challenge is trying to get it through the keyhole of the Taxonomy. But in the long run, Iceland has huge potential there. And to demonstrate that, it was great to see the sovereign issue a green bond"

Hreiðar Bjarnason, Landsbankinn



Bjarnason, Landsbankinn: It's possible, yes.

Luithlen, DZ: So, you're not following the paradigm, that cover pool has to be in green mortgages?

Bjarnason, Landsbankinn: We issue green under our sustainable finance framework. So it's still not fully EU taxonomy aligned, that will take a few years. Especially for Iceland where the major industries in Iceland haven't been fully described in the taxonomy. So that's one of the challenges and that relates to the housing market as well.

Iceland has huge potential in this area because we are all green energy. The challenge is trying to get it through the keyhole of the taxonomy. But in the long run, Iceland has huge potential there. And to demonstrate that it was great to see the sovereign issue a green bond.

Fildes, GC: Although leading the way in green came from the supras really. So Jens, what about you and NIB's green ESG activities?

Hellerup, NIB: We have issued green bonds since 2011 and more than €8bn has been issued over the years. It's still only a small part like 10%-15% of our annual issuance which has been in green format. We have the environmental mandate but it's still like we are only taking the best of the green assets and finance with a green bond. Investors appreciate it.

There is a lot happening with how investors are looking at green investments. In the beginning, some 10 years ago, it was very much focusing on the green programme and the green bonds. But now it's much more about the issuers. Green investors are looking into the issuers' ESG approach.

So, it doesn't help that you come with a green bond that finances 10% of your assets and then you do the 90% of your lending in a non-sustainable way. That doesn't work for the investors.

And this is maybe also why the greenium to some extent has disappeared, because if you go some years back there has probably been a couple of basis points or 3bp greenium. That has over the years disappeared. I know the last trade KFW did, two or three weeks ago,

"One factor, which all the banks are working on, is building the unsecured market domestically. That is a relatively new debt space . . . so that is something we have all been spending quite a bit of time on to get the investor base educated"

Ellert Hlööversson, Íslandsbanki



they were discussing that there was maybe 1bp greenium. It's true that in a difficult market the green label helps the execution.

You see it more in the secondary market where green bonds can trade 2bp-3bp tighter than a conventional bond, as green bonds are more stable than other bonds because this is the last bond that an investor will sell.

Fildes, GC: Did the sovereign get any spread tightening because of the green sovereign issuance?

Luithlen, DC: I think they have four issues outstanding with a curve that could be more liquid. So, to answer the question in basis points is not entirely straightforward. We certainly saw additional demand because of the format.

Fildes, GC: *GlobalCapital* is launching a new product that actually captures things like this. Jens, tell us about the role of NIB in Iceland and what have you done, what are you doing, what are plans, including from a funding perspective?

Hellerup, NIB: We've been doing lending in Iceland since 1977 and we have financed more than 220 projects, for more than the equivalent of €3bn. Of course, we have the environmental mandate and with the importance of the renewable sector with geothermal energy in Iceland, it has been obvious for NIB to finance. We are also trying to support the SME sector in Iceland and that's where the banks are helping us here. We can lend to them and then they can distribute it to the SME sector. So this is also an important segment for NIB.

That lending has basically been in euros and dollars but now we see more demand and we get the question if we can lend in ISK, which is also why I'm coming here

to see if I can get ISK for lending, for example by issuing bonds in ISK.

For the investors we believe it is a good opportunity. They get good diversification, the investors get an AAA rated name, and they get a small spread over the government. I would also like to mention that the investors get a green investment opportunity as we are happy to issue a green bond in ISK. We would probably pay a spread over the government, of course the question is what should that spread be?

Fildes, GC: Are you going to swap it or are you going to keep it?

Hellerup, NIB: We would basically lend the proceeds from a ISK bond to the Icelandic clients. We have that demand for ISK from investors and from our lending clients, but we have not agreed on the level with the investors — where we see it and where the investors see it. We are probably about 10bp or 15bp away from each other.

Fildes, GC: Does the fact that you don't have to swap it mean that you could probably?

Hellerup, NIB: We will keep it in ISK and lend it straight to clients here. The question is if that's not working with the investors, we will also speak with the banks here about doing a swap. I understand there is not really a good cross-currency basis swap market, but I guess the banks have access to cheaper ISK from the retail market, and we have access to the dollar or euro market cheaper than the Icelandic banks. Why don't we try to exchange this cash flow? I know we cannot call the banks and get a price tomorrow, but we have time to work out the swap opportunity.

Luithlen, DZ: By the way, that aspect of insulating the Icelandic

economy from cross-currency risk — the classic scenario that we had back in the day of lending in FX to the housing market or retail clients in any way, shape or form — the way you manage that in Iceland now is definitely a positive.

To understand that EUR issuance does not create a potential macro balance of payments risk creates comfort in investing in euro-denominated Icelandic debt. EUR lending is limited to those industries, companies and agents that also have euros in their foreign exchange revenues. That's definitely a positive that's been mentioned to us from international investors.

Bjarnason, Landsbankinn: The local banks are quite restricted in terms of maintaining some foreign currency imbalances. Actually they have always been. But pre-2008, a lot of foreign currency was lent to borrowers in Iceland that didn't have revenue in foreign currency. That was the kind of risk that doesn't play well through the cycle.

So I guess from the Central Bank's point of view, it would be fine if issuers like NIB would issue moderate amounts in ISK where they would swap it or do direct ISK lending in relation to that, especially if it's not hot money investing in those ISK products, just for the AAA name. Because that could increase macro prudential risks if seen as hot money carry trades in significant amounts.

Hellerup, NIB: We have a very good dialogue with the Central Bank and Iceland is an owner of and represented on our Board, so there is an ongoing dialogue.

BANKING SECTOR

Fildes, GC: Let's switch our focus to the Icelandic banking sector. How have the recent increase, which I think was in March 2024, to the counter-cyclical capital buffer, from 2% to 2.5%, and the introduction of an EU-aligned resolution directive, which was June 2023, impacted the Icelandic banking system?

Bjarnason, Landsbankinn: I would say that the latter one is a bigger factor than the counter-cyclical buffer, which was already expected to be taken up to the 2.5%. The BRRD II implementation is important in many ways, as it disciplines the funding plans and maintains the need for senior unsecured issuance being a significant part of bank funding. So a topic I guess for all of us and obviously not just in Iceland. Subordination requirement is also coming later this year so that again is something that is a constraint that we need to have a close look at when it comes to our capital planning.

Hlöðversson, Íslandsbanki: I would say one factor, which all the banks are working on, is building the unsecured market domestically. That is a relatively new debt space domestically so that is something that I know we have all been spending quite a bit of time on to get the investor base educated for these things.

Höskuldsson, Arion: It is quite unique actually. Even in our FX senior preferred, we don't see Icelandic investors as part of the investor base. It is unique. Most issuers in Europe have a base domestic demand that

they can count on. The Icelandic pension funds are the largest investors in Iceland. They [don't] really have a large appetite for this as of yet; they buy the covereds in Iceland, they buy the equity but they haven't been buying any large scale in the seniors. And this is, especially important now for an example because of the MREL requirements, we have a real requirement for this senior. It's important for the domestic investors to understand this product.

Luithlen, DZ: The European asset managers like to hear that. When they look at your debt, they will go through a relative value analysis. They will consider the senior / covered differential and invest, where they see the better value. And then if you add senior non-preferred in EUR to the basket of choice for AMs, covering Icelandic banks looks more interesting. Hence, if the domestic pension funds are in no hurry to find senior non-preferred from the banks, international investors from the Asset Management Community will definitely like to take a closer look.

Hellerup, NIB: I think that's education. You have seen in other Nordic countries they've had this senior non-preferred requirement for some years and the investor base has not been developed at all. That's a role that NIB has taken as well; we are happy to go in and help these transactions and be an investor and try to crowd in money when we buy in to these trades. So this is another role we have had. I'm not sure we can call it developing capital markets but supporting a new product, which banks need to issue due to regulations, is a role NIB has taken on because we see the importance of a well-functioning financial market, especially in the role of supporting the SME sector. We have bought senior non preferred bonds from banks from most of the Nordic and Baltic countries and we will be able to do that in Iceland also.

Luithlen, DZ: In the local currency?

Hellerup, NIB: Yes, if I get the ISK (laughter). It is our role with NIB now, like with Iceland but also in the Baltic, to try to help local markets and it has been with the senior non-preferred requirements in the Nordic countries where we are helping that market and also banks in the Baltics.



Jens Hellerup, NIB

Hlöðversson, Íslandsbanki:

It's a transition. It takes time to educate the market. And there is another point to this, a nuance if you will. The current legislation framework for the pension funds doesn't segregate covered bonds from the counterparty risk, as in most European jurisdictions. So when the pension funds are viewing their counterparty risk, they have to count the covered bonds, in addition to the equities, in addition to the senior, everything. That's something I know at least I, and hopefully my colleagues, are pushing this. It's a nuance.

Bjarnason, Landsbankinn: It's very important to get that covered bond classification changed for the pension funds, because it's been well established that covered bonds are a different risk, a completely different thing.

Höskuldsson, Arion: But on the capital point, it's probably worthwhile for the record, the counter-cyclical buffer, of course the Iceland banks are extremely well capitalised. We're 20% covered equity ratios and then we are standardised so leverage ratios is 12% plus, probably the highest you will see in Europe. It's an important point from the credit risk perspective because there's a lot of equity there.

Luithlen, DZ: It's a factor of two roughly.

Höskuldsson, Arion: Two or even three.

Luithlen, DZ: Investors also mentioned that Iceland manages its volatility as a small open economy very well. There may be criticism around some aspects of the regulatory regime like the one that you mentioned just now. But on the whole, international investors appreciate the very steep and well executed learning curve from the global financial crisis fallout here in Iceland. That is a super-important aspect of the debt placeability in the long term.

VOLCANIC WORRIES?

Fildes, GC: There's been renewed volcanic activity on the Reykjanes Peninsula. Has it affected things, are you worried about it?

"The local banks are quite restricted in terms of maintaining some foreign currency imbalances. Actually they have always been. But pre-2008, a lot of foreign currency was lent to borrowers in Iceland that didn't have revenue in foreign currency. That was the kind of risk that doesn't play well through the cycle"

Hreiðar Bjarnason, Landsbankinn



Bjarnason, Landsbankinn: It has. It continues. It's an ongoing event and could last for decades as an ongoing event. It's interesting because in Iceland we have a natural catastrophe insurance, which is mandatory for every real estate owner in Iceland. So when such a thing happens, it is a fully-funded vehicle that should compensate. And this happens when we get avalanches etc, people are compensated financially.

Luithlen, DZ: Who is underwriting that risk?

Bjarnason, Landsbankinn: It's a fund, it's basically an SPV within the government that collects fees from every real estate owner in Iceland every year and builds up funds and has done for a long time. And then they have a reinsurance from London to top it up five times. So it's very well-funded.

The tricky thing, and even for Iceland this is unusual, is what is happening in Reykjanes. We have a town which has been evacuated and is uninhabitable. So people are not allowed to live there and haven't been able to for six months and probably will not be allowed to live there for the coming years. However, only a small part of them have been compensated from the natural catastrophe insurance scheme, as most of the houses in the affected area are not directly. But you might have a 30m deep crack right next door.

Luithlen, DZ: It has to be direct damage?

Bjarnason, Landsbankinn: Yes. And that's why the government set up this vehicle to buy up those assets from the individuals in the area funded partly by mortgage lenders in the area. So that has meant some credit risk for the banks as well. But

it's a nuance and in similar cases in Iceland, that should not be necessary because of the insurance scheme.

Hlöðversson, Íslandsbanki: If you look at it from a macro economic standpoint, the impact is limited. There is some impact on the housing market but the Central Bank has made this publication, was measuring it at 0.1% or 0.15% of GDP divergence. So it's a limited effect. Obviously, there is a lot of uncertainty for the inhabitants of Grindavík and this government initiative has relieved them of the uncertainty.

Fildes, GC: Even if they might be still waiting for the money?

Hlöðversson, Íslandsbanki: Yes, that's just time. I think that will be completed probably in the next few weeks. But it's still very uncertain what will take place in Grindavík, and there are many potential scenarios. If there were to be an eruption within Grindavík and the volcano will ruin everything, then we have very clear lines on what will happen. But the most likely scenario is that nothing further will happen so, at some point, we will have to make decisions on what are we going to do with this town.

Luithlen, DC: From a human perspective it's super-important that, especially in a community like Iceland, you have a sense of "everybody is in the same boat", "on the same island". This element of social cohesion and mutual solidarity can even be seen as credit positive.

Fildes, GC: Jens, I know the NIB was there supporting during Covid. I presume the NIB stands ready to help if required?

Hellerup, NIB: Of course we have a mandate for the environment and

productivity. This would be outside the mandate but, as you said, during Covid the three Baltic countries got loans from us. I'm pretty sure the government can manage but of course it's definitely something we would look at if we get the request. So there is the will within the Nordics to help if there is anything we can do. That's at least what we did in the Baltics during Covid.

Bjarnason, Landsbankinn: Again, the magnitude of this is quite limited so it's not on the Covid scale in terms of the effects on the overall economy as it is relatively contained within the affected area.

Hlöðversson, Íslandsbanki: And also, after Reykjanes, the volcanic systems at Reykjavik, everyone is probably a geologist in Iceland now. The volcanic systems, I'm told, are quite complicated and it may move elsewhere from the current fissure but we have made some risk assessments. For example, we believe that the capital area is not at risk currently.

Fildes, GC: I don't know whether you would agree with this but I would say that it was actually the volcano that prompted the tourism burst in 2011. So, I presume for Iceland's tourism economy at least, you need a volcano every few years or so, don't you?

Hlöðversson, Íslandsbanki: And we need to keep in mind also one of our biggest national assets is a lot of pure green energy. And this is the counteract to that.

Bjarnason, Landsbankinn: That's a good point because we have learnt to live with those things. Usually, we have such volcanic activity up in the highlands and/or in unpopulated areas. This time it's closer. But geothermal energy for us is hugely important. The Blue Lagoon stems from it in this area

but that also means that every few hundred years you get this activity where we see it now.

Hlöðversson, Íslandsbanki: Aside from a few back-up generators, we produce all our energy in a green manner from hydro plants or geothermal. District heating is widely spread, for example every house in Reykjavik has district heating from geothermal sources. And it's obvious, you can't really build geothermal plants outside of active volcanic fields if you will; that's where the heat comes from. So these things are counteracts.

Fildes, GC: Are you any closer to exporting that energy?

Höskuldsson, Arion: Of course we export it mostly through aluminium smelters through local production. But no ammonium plants where you liquefy ammonium and you send it to the Germans to help, that doesn't need to be — [laughter].

Also new industries — fish farming on land is utilising this energy. We're seeing data centres coming up as a big industry here, based on the same energy source. So we're exporting energy in various shapes or forms indirectly.

Hellerup, NIB: I guess the "storing of energy" [power trades] everyone would probably like to develop. I know it's probably going slower than initially thought but that could be quite a big thing in Iceland with all the geothermal energy.

Fildes, GC: Icelink? Is that what it's called?

Hellerup, NIB: Power-to-X where you use your renewable energy to split the water into oxygen and hydrogen.

Bjarnason, Landsbankinn: What's been debated in Iceland for decades is

the possibility of building a connector to Europe to export energy. But it's controversial, for many reasons.

It's a massively capital-intensive project but it's doable. It has been done and absolutely, the Scandinavian countries have such connectors to Europe. So it's definitely possible. It's still on the political agenda to answer that question. Do we want to use the energy that we produce in Iceland to do something in Iceland? Or do we just want to export the raw material through a cable? That's one of the questions. The national power company has looked into this, very detailed, and is very much for it if the politics get some consensus on it.

The project finance has got to be good if done and obviously it can work both ways so we can also import energy through such connectors. We can manage it day and night, etc.

Höskuldsson, Arion: This was discussed a lot, probably five or 10 years ago. There was a big discussion and analysis done on it and the politicians basically decided not to do it. So that discussion died down.

Fildes, GC: With Europe having had to shed itself, or trying to shed itself, of dependency on Russian gas, it might make a lot of sense.

Luthlen, DZ: I'm certainly no expert on any of this but I would imagine that should the Germans get around to building a gas transmission system which is usable for nitrogen, then we get the infrastructure that would allow new and other forms of energy exports.

Hlöðversson, Íslandsbanki: There are plans on both ammonia and nitrogen plants in the eastern part of Iceland, next to some wind farming. But who knows?

Hellerup, NIB: But wind is not big on Iceland is it?

Hlöðversson, Íslandsbanki: No, we have some development project but nothing really commercial. Someone told me but I'm also no expert that the problem is that we do not have stable wind — and usually too much.

Hellerup, NIB: And then if you cannot store the wind or the electricity and you have the geothermal energy for free anyway. **GC**

"Aside from a few back-up generators, we produce all our energy in a green manner from hydro plants or geothermal. District heating is widely spread, for example every house in Reykjavik has district heating from geothermal sources"

Ellert Hlöðversson, Íslandsbanki



Iceland's rarity is a blessing and a curse

The sovereign's scarcity in the market compromises its pricing power and has a knock-on effect for the country's banks, causing frustration for their bankers. Can they find a solution? **Philip Moore** reports

Iceland's long-awaited sovereign green bond appeared at first to tick every box an issuer could have hoped for.

Four years in the making, the €750m 10 year transaction generated a final order book of €7bn, allowing for it to be priced comfortably inside initial guidance at 95bp over mid-swaps. Almost 280 accounts participated in the 4.5% March 2034 green debut, led by BNP Paribas, DZ Bank, JP Morgan and Nomura.

As it was under no funding pressure, Iceland enjoyed the luxury of being able to choose its timing, launching in mid-March in a benign market environment. This, coupled with Iceland's scarcity value and the strength of its green credentials, made the deal's success a virtual certainty.

What was more surprising was the performance of Iceland's issue in the secondary market, where the bonds tightened by between 25bp and 30bp within a couple of months.

A harshly critical view would be that this suggests the bonds were mispriced. A fairer interpretation is that it illustrates how challenging it is to find fair value for a credit issuing into a virtual vacuum in terms of immediate comparables.

Myriam Zapata, SSA DCM ESG specialist at BNP Paribas, says that the right price is — by definition — the level at which investors are prepared to buy. "Investor feedback suggested that fair value was around 105bp, which is why we started at 110bp," she says.

"We don't have much to compare Iceland to," says Zapata. "The Nordics are the obvious benchmarks. But they issue in their own currencies. For euro issuance, the closest comparables are some of the central and eastern European sovereigns."

That's an imperfect comparison at best. The liquidity profile of some of the CEE issuers might be similar

to Iceland's. But there the similarities end. Economically, politically, socially and ecologically, Iceland and central Europe have very little in common.

Nor was Iceland's own curve much help as a pricing guide. This year's green trade was its first euro issue since early 2021, when it had priced a €750m 0% April 2028 note at 48bp over mid-swaps.

Banker frustration

Reykjavik-based bankers are understandably frustrated that the irregularity of the sovereign's presence in the market, an inevitable by-product of the size of the economy, compromises its pricing power.

"Iceland's government, corporate and household debt are all low by international standards, and we have been consistently out-growing other Nordic economies for the last 20 years," says Sturla Pálsson, director of markets at the Central Bank of Iceland. "So, on the basis of all our economic fundamentals, fair value on our bonds is much tighter. In these markets, a 10-year benchmark for the Republic of Iceland at 95bp over swaps is clearly an extremely good deal for the investor."

Pálsson adds: "If we could make a soft commitment to be in the new issue market every year, it would

be much easier for us to come out with IPTs [initial price thoughts] that would tighten less in the bookbuilding process and improve our bargaining power with the investor base."

However, he says: "This is an unavoidable trade-off, because as a small economy we don't want to accumulate too much government debt in foreign currencies."

Another reason why Iceland's green bond presented an unusual pricing challenge is that its sustainability profile is very different from virtually every other country in the world. As Zapata says, Iceland is regarded very highly from an environmental and social perspective. It has no fossil fuels to speak of and is a recognised leader in renewable energy, which is used to heat every home on the island.

Iceland has no scope for deforestation, because the Vikings chopped down all its trees a thousand years ago. It can't spend money on weapons because it has no army.

And although female workers staged their first strike since 1975 last year, Iceland has topped the World Economic Forum's global gender gap rankings for well over a decade.

Global role model

All this makes Iceland a global role model for environmental and social standards. This raises the question, posed by a number of investors on the roadshow, why Iceland needed to step down the green bond route at all.

Pálsson agrees that if you strip out the aviation and fisheries sectors, which can give a distorted impression of Iceland's environmental profile, it probably produces fewer emissions than virtually any other economy. This makes Iceland one of the last countries in the world that could be accused of greenwashing.



But Pálsson says that while Iceland is clearly some way ahead of many other countries from the perspective of sustainability, it still has plenty to do, which meant there was a long list of use of proceeds from this year's green issue.

"There are multiple ways in which we can improve on our environmental performance," he says. "One example we are looking at is strengthening the [electrical] links to our harbours to allow trawlers, cargo ships and cruise liners to connect to the local grid rather than use diesel."

With no shortage of sustainable infrastructure projects to be financed, says Pálsson, the benefits of issuing in green format comfortably outweighed the costs associated with the pre- and post-issuance documentation and reporting.

"The fact that we decided to issue a green bond underlined how serious the government is about meeting the commitments we have made on sustainable development," says Pálsson.

"In terms of placement, I think we achieved the best of both worlds," he adds. "We had about 277 names in the book, and although we were only able to allocate bonds to less than half of them, having our debt held by about 150 investors globally is very healthy for an economy the size of Iceland."

The success of the sovereign's green bond reflects a more general strengthening of demand for scarce Icelandic credits.

Among the three banks that aim to maintain as regular a presence in the market as their modest financing requirements allow, Landsbankinn was first out of the traps with a deal this year, in early March. Its €300m 5% May 2028 green senior preferred transaction via ABN Amro, Barclays, Bank of America and Goldman Sachs was priced 40bp inside initial price thoughts, at 225bp over swaps.

Later the same month, Íslandsbanki completed its first euro issue of 2024, with a €300m 4.625% March 2028 senior preferred transaction via ABN Amro, Bank of America, Morgan Stanley and Nomura. Pricing was tightened to 185bp, compared with initial guidance of 230bp over swaps.

In May, Arion Bank benefited by being the last of the trio of Icelandic banks to access the senior market in euros, issuing its slightly longer deal at a tighter spread than either

"Iceland's government, corporate and household debt are all low by international standards, and we have been consistently out-growing other Nordic economies for the last 20 years"

Sturla Pálsson, Central Bank of Iceland

of its compatriots. Arion priced the €300m 4.625% November 2028 senior preferred issue via ABN Amro, Barclays, Morgan Stanley and JP Morgan at 175bp over mid-swaps.

"I believe it was the strongest book for any Icelandic issue for more than a decade," says Theódór Friðbertsson, head of investor relations at Arion. "The deal was more than eight times oversubscribed, and the number of investors surpassed our expectations. So did the geographical diversity of demand, which came from more than 25 countries."

"Only a year ago we were issuing at around 400bp," Friðbertsson adds. "When rates were at their lowest, the best pricing we achieved was around 65bp over for a senior preferred issuance."

Others agree that the pricing levels commanded by Icelandic banks have been almost absurdly volatile in recent years, with wild gyrations in secondary market spreads entirely uncorrelated with economic fundamentals.

William Symington, head of international funding at Íslandsbanki, points to the example of the €300m three year green senior preferred bond his bank launched at the beginning of 2022.

"We priced at a spread of 83bp, and by the end of 2022 the bond was marked at 500bp over," he says. "During that time, the Icelandic economy and banking sector prospered. But it was a very bearish rate environment, and investors were running scared from financial assets and being highly prescriptive about what they wanted to buy and at what level."

No wonder funding officials at Iceland's three banks watch their pricing levels with a mixture of bemusement and exasperation.

"Of course we get somewhat frustrated by the volatility of our spreads, which are mostly unrelated to Iceland's economy or to the credit quality of the banks," says Hreiðar Bjarnason, CFO at Landsbankinn.

For the foreseeable future, it is hard to see how Iceland's banks can free themselves from paying a surcharge for their relative illiquidity by increasing their supply in international markets.

"Since 2008 the Icelandic banks have had a purely domestic focus, which means that our loan growth is significantly linked to expansion of the domestic economy," says Bjarnason.

This inevitably restricts the banks' scope for increasing their presence in the euro covered bond market. "Our mortgage portfolio is exclusively in Icelandic krónur, so there is a regulatory as well as a risk appetite-related limit to the volume of covered bonds we can issue in euros," says Bjarnason.

Among other options for diversifying their international funding strategies, the green bond market is one that the Icelandic banks are monitoring closely.

Better to wait

Symington says that Íslandsbanki contemplated issuing its most recent euro transaction in green format. "But the market was so hot we took the view it would be better to save our green allocations for a rainier day," he says. "In any case, we were able to tighten pricing from initial price thoughts to such a degree that any potential greenium would have been irrelevant."

Besides, Symington says that the green label probably provides more of a pricing advantage for issuance in Scandinavian currencies than in euros. This is an important consideration for a bank like Íslandsbanki that regards currencies such as the Swedish krona and Norwegian krone as important sources of funding.

Friðbertsson says that Arion plans to build on its existing green framework with an updated version that will also include social categories. "When it comes to eligible assets we had more or less utilised most of them in our existing senior green bonds, although we did [hold a tender offer for] one of our green bonds in parallel to our recent issuance," he says. "Some of our other green bonds are also approaching maturity which will further free up eligible assets. Our intention is that the share of sustainable assets will continue to grow as a percentage of our total loan book, but that will obviously take time." GC

Growth despite high interest rates



Following a period of robust economic growth in the post-pandemic era, a turning point has now been reached. We forecast very limited economic growth in the coming years, or 0.9% this year, 2.2% in 2025 and finally 2.6% in 2026. High interest rates will dampen growth through diminished consumer consumption and the delay of various investments in wait of lower rates. We expect capital formation to increase by a mere 0.1% this year and private consumption by 0.9%.

Sticky inflation at around 6%

The Monetary Policy Committee of the Central Bank of Iceland has maintained unchanged policy rates since August 2023. The MPC has stated that the rate-cutting cycle should begin at a “credible point in time” and not before there are “clear indications” of receding inflation. We expect inflation to remain sticky at around 6% in coming months. Most recent CPI figures showed a slight uptick in May, with inflation rising from 6% to 6.2%. As a result, we do not expect any rate cuts until this fall at the earliest.

Inflation is currently quite broadly based. While housing has been its main driver in the recent past, imported goods as well as services have recently increasingly put pressure on inflation. The fact that services are causing more inflationary pressure than before could be traced to recent collective bargaining agreements in the workforce. Despite providing for quite modest wage growth, the agreements may have enhanced demand and thereby increased inflationary pressure.

Demand pressure appears notable on the residential housing market despite high interest rates and housing prices have risen in recent months. A possible driver of increased demand is the housing crisis caused by recent seismic and volcanic activity on the Reykjanes peninsula which has affected an entire 1% of the Icelandic population. Up to 1,200 homes were evacuated, forcing entire households to relocate, which naturally put a pressure on housing prices in other areas.

Interest rates are expected to remain high most of this year due to persistent inflation. Landsbankinn’s Economic Research department nevertheless expects the economy to show resilience and grow. The department recently published an outlook on the subject, leading up to 2026.



Una Jónsdóttir, Landsbankinn Economic Research

Contraction in the first quarter of 2024

Preliminary figures show that GDP is estimated to have decreased by 4% in the first quarter of 2024. The contraction is mainly due to a failure in the capelin catch, which led to less growth in the stock of marine products compared to the same period last year. Private consumption increased slightly, and capital formation grew by 2.4%. The contraction in GDP is not necessarily a result of high interest rates, as we experienced a slight growth in domestic demand. We expect domestic demand to grow at slower pace in coming quarters, as interest rates remain high.

Slower export growth

We expect export growth to slow down this year compared to previous years. The travel industry shows clear signs of a slowdown. While we expect the number of tourists visiting Iceland to continue to grow, we see a slight decline

in factors such as the length of stay. Tourism grew fast in the post-pandemic era — we now expect that a turning point has been reached, leading to much slower growth.

As for the other main export sectors, we expect to see growth in marine products this year as higher catch quotas for demersal fish were issued, counteracting the capelin catch failure. Aluminium exports are expected to increase less this year than in recent years, not least due to a reduction in energy allocation to large users earlier this year.

Other export sectors, i.e. other than the travel sector, aluminium and fisheries, have grown handsomely in recent years; a trend we expect to continue going forward. The outlook is for significant growth in the export of pharmaceuticals and medical equipment, which doubled between years last year. Export of farmed fish is also likely to increase.

High inflation the main challenge

In general, our outlook for the next couple of years is for very little economic growth. Inflation is the main economic challenge we face and while inflation expectations remain high, the battle won’t be won. The MPC has signalled that a rate-cutting cycle is on the horizon, just as soon as inflation and inflation expectations decline.

As always, uncertainty remains a factor in our forecast, most notably represented by international war efforts that may impact the economies of our business partner countries and thereby Iceland. In addition, the seismic and volcanic activity on the Reykjanes peninsula is on-going and could pose a threat to local infrastructure and tourism in the area.

Una Jónsdóttir, Head of Landsbankinn Economic Research

Iceland takes tough line on regulating banks

Iceland has implemented one of the strongest financial regulatory frameworks globally as it looks to shake off the spectre of the 2008 crisis. But are these stringent requirements too restrictive?

Philip Moore investigates

Just as Icelandic monetary policy is shaped by memories of corrosive inflationary cycles, large sections of its banking regulation are a legacy of the financial crisis of 2008.

It is the Central Bank's unshakeable commitment to ensuring that none of the mistakes of the early 2000s are repeated that underpins one of the strongest banking regulatory frameworks in the world, let alone in Europe.

"For the banking industry, we tend to adopt EU regulations and then take them one step further," says Arion Bank's chief economist, Erna Björg Sverrisdóttir.

One of the most striking recent examples of the so-called 'gold plating' of the Icelandic banking system — perhaps more accurately, its 'armour plating' — has been the Central Bank's use of the countercyclical capital buffer. Originally introduced after the 2008 crisis, the countercyclical buffer was suspended during the pandemic and reinstated in September 2022, at 2%.

In March 2023, in response to concerns about growing inflationary pressures, the Central Bank announced that this buffer would rise to 2.5%, the upper end of its range, from March 2024.

This made Iceland one of only three European banking systems — the others are Denmark and Norway — with a countercyclical buffer of 2.5%. Theódór Friðbertsson, head of investor relations at Arion Bank, says that as this comes on top of a systemic risk buffer of 3%, a systemically important institutions buffer of 2% and a capital conservation buffer of 2.5%, Iceland's banks are faced with "significant buffer requirements".

The Central Bank's Financial Stability Committee (FSN) said

at the time of the increase in the countercyclical buffer that this was "conducive to bolstering resilience still further in the face of the risks that have accumulated and could materialise in the coming term".

Mark Naur, senior analyst in the research department at Danske Bank in Copenhagen, says that Iceland's Central Bank has compelling reasons for its highly conservative regulation of the three banks that emerged from the smouldering wreckage of the 2008 crisis.

"The Central Bank is very aware that there are still plenty of international investors whose fingers have been burnt in the past in Iceland," he says. "So the Bank believes it needs to be more vigilant than some other regulators and signal very clearly that it is on top of any inflationary threat to the system."

Highest quality

The result today is that, thanks in part to its uncompromising regulation, the credit quality of the three banks that emerged from the crisis has reached an all-time high. "Never in Iceland's history have our banks been as strong as they are today," says Sturla Pálsson, director of markets at the Central Bank of Iceland.

To the frustration of Reykjavik-based bankers, rating agencies have been hesitant to give the banks full credit for this strength. "One of the challenges we face is that the

ratings agencies continue to classify both the Icelandic economy and the banking system as being riskier than we consider them to be," says Hreiðar Bjarnason, CFO at Landsbankinn. "Our ratings have been improving in recent years, but we still have some way to go to persuade them that we have a regulatory environment that is on a par with those in other Nordic countries."

The most recent recognition of the strengthening of the banks' credit profiles was the upgrade of Arion Bank, Íslandsbanki and Landsbankinn by S&P Global Ratings in early April.

Noting that the economic risks facing Icelandic banks have abated thanks to a stabilising housing market and significant private sector deleveraging, S&P upgraded the long- and short-term ratings on each of the banks to BBB+ and A-2 respectively.

A notable barometer of the strength of Iceland's banks is their capital ratios, which are all well above their regulatory minima. At the end of the first quarter of 2024, total reported capital ratios reached 23.2% at Arion Bank, 23.6% at Íslandsbanki and 24.9% at Landsbankinn, with common equity tier one (CET1) ratios standing at 18.8%, 19.9% and 22.2% respectively.

At Íslandsbanki, head of international funding William Symington says that even these

"The [Central] Bank believes it needs to be more vigilant than some other regulators and signal very clearly that it is on top of any inflationary threat to the system"

Mark Naur, Danske Bank

Arion shines in Iceland and across the Arctic



First, it is wholly publicly owned. Second, it has a highly successful asset management arm — easily the largest in the country — with assets under management of ISK1.3tr (\$9.36bn), which is similar to the bank’s own balance sheet. A third feature that sets the firm apart is its own universal insurance company — Vördur. This combination of unrivalled breadth and a state-of-the-art digital platform has created an offering for clients that is second to none.

“We have been spearheading digital development in Iceland for several years,” says Theódór Friðbertsson, head of investor relations at Arion, noting that online platforms are now the firm’s key distribution channels.

The benefits in terms of productivity and efficiency across Arion’s operations have been impressive. Around 75% of the bank’s core products are sold digitally, which has allowed it to reduce its physical footprint by around 45% since 2018. Integrating Vördur’s operations with those of the bank has helped support growth in insurance across retail and corporate clients. In 2023, Arion more than doubled insurance sales through the banking teams and saw a steady rise in bancassurance premiums.

“We’ve been very successful at utilising the strength of the bank’s various divisions and our digital expertise in order to scale the businesses,” says Friðbertsson.

The centrepiece of Arion Bank’s digital service is its world class app — voted the best banking app in Iceland for eight consecutive years. The many features available to customers include starting and managing pensions, opening banking accounts, making real time payments, arranging overdrafts, investing in stocks and funds and managing insurance needs — all in a single application. Speed and simplicity are touchstones across the firm’s operations. Processes that can be onerous for customers at other lenders — credit assessments for mortgage applications for instance — take only minutes at Arion. This all has supported the lowering of the bank’s cost-to-core income by almost 20% in the last five years.

A growth market

Identifying and meeting customer needs is a strategic priority for the bank. “Last

As one of the country’s systemically important banks, Arion Bank has long been a leading force in the Icelandic market and in recent years has extended its focus to the wider Arctic region. In the retail segment, it serves half the entire Icelandic population through a diverse product offering. Its cutting-edge corporate and investment banking operation also boasts more than half the country’s companies as clients. But Arion differentiates itself from peers on several other fronts.

year we took a deep dive to identify the main pain points for our clients,” Friðbertsson says. “We are always asking ourselves what are their key requirements and how we can improve our ability to meet those requirements.” The digital roadmap guiding Arion’s investment in technology will continue to centre on the priorities of customers and clients.

The fact that Arion’s client base continues to grow is due not only to the breadth and quality of the bank’s service — Iceland’s population is also growing. In addition to being one of the most educated, innovative and developed countries in the world, with the highest gender equality ranking, it is also one of Europe’s fastest growing. A prospering economy is attracting global talent and creating substantial growth opportunities for the bank.

Iceland has made a name for itself in tourism, sustainable energy and fisheries, but new export sectors are thriving. The country boasts world-class pharmaceutical and biopharmaceutical firms producing biosimilars for the global market, with Alvotech being the largest. Since being listed on Nasdaq Iceland in 2022, Alvotech has become the largest company on the Icelandic stock exchange. This milestone underscores its significant impact on the Icelandic economy.

The ICT [information and communication technology] sector is booming and the biotechnology sector is also flourishing, with Kerecis, a company that develops, manufactures, and markets regenerative graft from Omega-3-rich fish skin, becoming Iceland’s first unicorn in 2023. Fish farming plays a significant role in export growth, now accounting for 2.5% of total exports. Several major investment projects related to land-based fish farming have also become crucial

to business investment growth in the coming years.

“The knowledge sector base has been growing steadily and that’s incredibly important for us,” says Friðbertsson, noting that Arion’s exceptional corporate advisory business has been involved in a large majority of Iceland’s listings over the last decade.

Arctic opportunities

Arion’s ambitions extend to the wider Arctic region. Replete with sustainable fisheries, transportation, rare earth metals, sustainable energy resources and tourism potential, the region holds huge promise.

“We have strong and longstanding relationships with other countries in the Arctic region across different sectors from fisheries to energy,” Friðbertsson says, noting that developing the region will require a bank with the requisite relationships and expertise — but also one dedicated to sustainability.

Morningstar Sustainalytics ranks Arion in the top 4% of banks globally, and the top 2% among 550 regional banks. A member of the net-zero banking alliance and a signatory of the Business Ambition for 1.5°C campaign, the firm’s ESG credentials are world class. For three years in a row, rating agency Reitun has assigned the bank an “outstanding” ESG rating. Within the next two years, Arion plans to have the Science Based Targets initiative (SBTi) validate its targets on financed emissions.

“Looking to the future, we have the expertise, the infrastructure and the connection to the investor community,” says Friðbertsson. “Arion is uniquely placed in a dynamic and fast growing economy and with potential to support future development in the Arctic region.”

relatively high levels understate the true capital ratios of Iceland's banks. This is because all three banks continue to use a standardised rather than an internal ratings-based (IRB) method for calculating their regulatory capital. "This means that although our headline ratios look high, on a like-for-like basis they would be stratospheric compared with other Nordic banks," says Symington. "If we expressed them the same way the Swedish banks do, our total capital ratios would be 40%-plus."

Evening out those distortions by migrating across to IRB is something that the Icelandic banking industry has been studying for a long time, according to Bjarnason at Landsbankinn. "The problem we face is that the requirements of the IRB approach are very strict," he says. "For example, they call for a long history of data loss reporting. This would mean that the effects of the 2008 crisis would need to be included in the historical data, which would give a distorted picture of our true credit profile."

He adds: "It would be beneficial for us to apply an IRB approach, which would improve our capital ratios. But I don't think it would do so as significantly as you might expect."

Besides, says Bjarnason, an equally important measure of stability among Iceland's banks is their leverage ratios. "Leverage ratios were around 13% or 14% in 2023, which compares to an average closer to 5% for the large Nordic banks," he says.

Neither their capital and liquidity ratios, nor the profitability of the Icelandic banks, is likely to be affected in any meaningful way by the volcanic activity in the Reykjanes peninsula, which recurred at the end of May.

Decisive move

The government moved decisively to meet the needs of households and business directly affected by the eruptions when they began in late 2023. Most of these are concentrated in the town of Grindavik, which in November 2023 accounted for about 0.9% of Iceland's population.

Residents whose homes have been damaged or destroyed by seismic activity in the region have been invited to sell their

properties to a state-owned special purpose vehicle — Fasteignafélagið Thórkatla — with the right to buy them back after three years.

Those buying new houses, meanwhile, benefit from a relaxation of the Central Bank's rules on debt service-to-income (DSTI) and loan to value (LTV) ratios. Until March 2027, the maximum DSTI for these borrowers rises from 35% to 40% while the maximum LTV is increased from 35% to 40%.

The impact on the banks has been minimal. Bjarnason says that Landsbankinn is by far the most exposed of the three Icelandic banks, with a share of close to 60% of mortgage loans in the Grindavik area. "Although we are the most affected bank, the area accounts for only about 1.8% of our mortgage portfolio and for 0.8% of our total loan book," he says.

Nor have there been any signs that Iceland's restrictive monetary policy is having a discernible impact on non-performing loans at any of the banks. Having reached a high of 8.9% for the banking system as the pandemic tightened its grip in mid-2020, problem loans had declined to 1.9% at Arion and Íslandsbanki, and to 1% at Landsbankinn, by the first quarter of 2024.

One of the reasons for this decline is the high share of inflation-linked mortgages in Iceland, which has neutralised much of the impact of high nominal interest rates. "Our cost of risk has barely changed over the last year, in part because people have been free to transfer their nominal rate loans into inflation-linked mortgages," says Íslandsbanki's Symington.

Another explanation for falling levels of bad loans is the legacy of the financial crisis. "One of the main reasons impaired loans are low is that since the financial crisis we have seen the overall leverage positions of the household, as

"Never in Iceland's history have our banks been as strong as they are today"

Sturla Pálsson, Central Bank of Iceland

well as the corporate, sector drop quite significantly," says Theódór Friðbertsson, head of investor relations at Arion Bank. "People are much more aware of the dangers of over-leverage, which is helping the economy through this point in the rates cycle."

This is echoed by S&P, which notes that leverage in Iceland's private sector has fallen "markedly" relative to GDP. It forecasts that GDP will continue to outpace loans in 2024, with private sector debt stabilising at around 145% of GDP over the next two years, significantly below S&P's 152% four-year (2021-24) rolling average forecast.

Conservative calculation

As with their capital ratios, Icelandic banks' reported return on equity is calculated conservatively, according to Symington. "We're all generating ROEs of about 10%," he says. "But if we were to calculate them on the same basis as the main Nordic banks, they would be more like 20%."

Given their exclusively domestic focus, the scope for Iceland's banks to raise their ROEs will remain limited. "Our target ROE will remain above 10%," says Bjarnason at Landsbankinn. "I think that will be comfortably achievable in the current interest rate environment, but obviously with high capital and leverage ratios it will be hard for any of the Icelandic banks to increase ROEs to the mid to high teens that we see in some European countries."

The potential for extracting more efficiencies from declining cost-to-income ratios may also be limited. Although Íslandsbanki saw its cost-to-income ratio creep up from 42.1% in the first quarter of 2023 to 44.9% in the corresponding period this year, at Arion the ratio fell sharply from 46.9% to 35.7% over the same period. Landsbankinn, meanwhile, reported a continued fall to 33.6% compared with almost 47% at the end of 2022. GC

"People are much more aware of the dangers of over-leverage, which is helping the economy through this point in the rates cycle"

Theódór Friðbertsson, Arion Bank

ESG a natural fit for Nordic banks

The Nordic region has a long and proud history in social welfare, sustainability and related areas, so it is naturally well placed to play a prominent role in green finance too. *GlobalCapital* gathered a panel of prominent market participants together in June to discuss key themes and consider the next big developments



Atanas Dinov, *GlobalCapital*: Why has the Nordic market been such an incubator for green and labelled debt developments? Where did it all start and how did issuers and investors in capital markets start this drive? Jens, being a supranational, at the same time the Nordic Investment Bank also lends to a lot of the borrowers that the banks themselves face, could you say how it started from your viewpoint?

Jens Hellerup, Nordic Investment Bank: I think it comes back to the Nordic welfare model, which is very much linked to equality, sustainability, social welfare and transparency and this is linked to the business where you focus more on long term value creation than on short term goals. This also leads to ESG.

On the 'E' side, you have renewable energies: in Denmark you have the big wind farms onshore and offshore, in Norway you have hydropower, and in Iceland you have geothermal energy.

On the 'S' side, social security, equality again, and you read much about social responsibility from the corporate side. And on the 'G'

side, it's based on transparency, low corruption levels in the Nordics and the strong rule of law.

Where it started for NIB was in 2005, as we were the first supranational to get the mandate to finance environmental projects. I cannot say it was before there was any climate change or climate crisis but at least it was before there was the same awareness of it as today.

Institutions in the Nordic countries were among the first to issue green bonds, with NIB in 2011, Kommunalbanken in 2010. One of the first green bonds from the World Bank in 2008 was, to a large extent, bought by Nordic investors.

So ESG is rooted in more than 20 years in the region — this whole movement in green bonds, ESG and how it could be turned into sustainable finance. It's not only about risk and return but about impact, which is the third dimension in the current investor equation. And investors were very open about that.

Dinov, GC: After starting from the SSA market, how did ESG transition through to the banking side? What are investors looking for in bank debt products?

Petra Mellor, Nordea: Nordea started issuing green bonds in 2017 and the SSA market set a very good precedent here. I think it was the European Investment Bank that issued the first green bond back in 2007 and Nordea was one of the investors. And just to add to what Jens said, the Nordic market is very well advanced in terms of sustainability, both the banking and the corporate sector. Given that many large investors are government-owned or cooperatives, there was also strong interest early to invest in sustainable bonds. Consequently, there's been a big demand for green and other labelled bonds in the Nordics from the investors from the very start.

Banks saw this and started to analyse how we could also contribute to a climate change and transition. We started to investigate which assets we had that were potentially eligible for green funding.

Kerstin Ahlqvist, Swedbank: I believe it has been an iterative process. I agree with what Petra mentioned regarding the demand for the product itself. We have, in Sweden for example, state-owned funds with investment mandates

Roundtable participants



Christian Bech-Ravn, director, head of rating and investor relations, Jyske Realkredit

Kerstin Ahlqvist, head of long-term funding and sustainability, Swedbank

Johannes Trautwein, ESG origination, DZ Bank

Petra Mellor, head of bank debt, long-term funding, Nordea

Jens Hellerup, senior director, head of funding and investor relations, Nordic Investment Bank

Patrik Götzinger, executive director, DZ Bank

Atanas Dinov, bank finance editor, *GlobalCapital*, (moderator)

Eivind Hegelstad, chief financial officer, SpareBank 1 Boligkreditt

and criteria from the outset being long-term-driven with an aim to be sustainable over time. And, as also mentioned, there is the aspect of social welfare and long-term contribution of pension money managed by Swedish investors, which I guess is also the case in Denmark and in Norway.

So, the demand has been there from the start because of these mandates and then the private sector has followed suit. While there are certainly other drivers as well, this is one of the more important ones.

Dinov, GC: How has this investor demand been transitioning into another part of the banking sector — covered bonds and mortgages?

Eivind Hegelstad, SpareBank 1 Boligkreditt: First let me just add to Kerstin’s point. There’s a lot of pension money in Norway looking to do the right thing. But the huge fund, the sovereign wealth fund of Norway, cannot invest in Norwegian assets at all, it can only buy non-Norwegian assets. But it is looking to buy green and it has been an innovator in that field around the world but not inside Norway because it’s not allowed to.

But there are three things that I would highlight that spring to my mind when we started planning the first green covered bond issue back in 2017.

We’re very digitalised societies in the Nordics. We have a lot of data and we like to use the data. And that

went hand in glove with the green question.

There’s also, as people have been saying around the table already, a great deal of wanting to quickly do the right thing regarding the environment and the green transition in the Nordics. I’ll just say it like that. But it would be amiss to not say that we also want to do the right thing for our investors around the world.

We are a relatively small capital market in Norway. We are — I wouldn’t say necessarily dependent — but we’re keen to bring on board as many European investors as we possibly can. This was an important point as well when it came to offering green bonds. Demand for green grew and we wanted to satisfy that demand by offering green bonds, and thereby be relevant to covered bond investors around Europe.

Christian Bech-Ravn, Jyske Realkredit: The Danish covered bond system is different from the rest here in the Nordics. We have a match funding principle where we need to match cash flows on the loan and on the bond. This makes it more difficult for us to issue green bonds.

Basically, if we were to finance all our green lending with green bonds, we would have to double the number of ISINs that we issue; that would of course affect the liquidity. So, from the Danish perspective we have a lot of focus on transparency, at the cover pool level, and are really

trying to be ahead of the curve when it comes to this transparency.

We have been publishing different data on ESG for our covered bonds. We started publishing EPC scores, not only showing lending to the top 15% most energy-efficient buildings, which we could actually finance with green bonds, but also showing the rest of the loan book. By doing this we also show the tail risk. And we think that’s important for investors, when they’re looking at the cover pool, not only to look at what is green, but they also need to look at the amount of non-green activities that are being financed out of the cover pool. Investors need to look at what the bank is doing to change this. If the bank over time is able to finance a transition of the non-green activities. And by showing the entire cover pool, that is something that we are able to show.

We have been working on publishing this data since 2017-2018. We were the first financial institution to start publishing ESG data for covered bonds. And now all Danish mortgage institutions are publishing this data, and we’re starting to see, that especially for Danish covered bonds, investors are using this data in their investment decision — looking more at a cover pool level instead of each individual bond.

We’re still working on ESG transparency. In the European market there’s still very much a focus on whether the bond is green or not. But we can see now in Denmark, the investors are slowly

looking more at the cover pool and we think within the next couple of years we will see the same for many European covered bond investors.

MORE SIMILARITIES THAN DIFFERENCES

Dinov, GC: This sounds like there are also divisions between different markets within the Nordics. Johannes, from your perspective as an originator, have you encountered these differences?

Johannes Trautwein, DZ Bank: Of course, there are some specialities in different countries and different approaches that have been used by the various issuers. When you look for example at DNB Bank, which issued its first green bond in a covered bond format in 2015, they made use of the energy efficiency regulations that were in place in Norway and became stricter over the course of the last years. This approach has been used by other banks and got translated into other countries with their own energy efficiency regulations.

There are also differences across the issuers, but they have a very similar approach based on a common understanding. In terms of types of sustainable bonds, they are all very much looking into the green bond market rather than the social or sustainability bond market. To summarise, there are more similarities than differences.

Mellor, Nordea: I can add that from Nordea Bank Abp, we issue senior preferred, senior non-preferred and capital instruments and from here we have issued more than 10 green bonds in different formats across five currencies. Nordea also owns a mortgage credit institution in each of the four Nordic countries where we operate and we have issued green covered bonds from each of these different subsidiaries as well, where the use of proceeds is intended to finance the green assets in the mortgage covered bond pools.

We issued our first green covered bond in Denmark, where we opened a green ISIN in 2019. Subsequently, we have issued green covered bonds across the different countries. We have five different green portfolios where we have assets. From the

bank, we have green assets from large corporate institutions and business banking, while we have green mortgage portfolios in the four Nordic countries and currencies in which we operate.

Dinov, GC: How do the European Union's Green Bond Standard compare with different practices within the region? And how is this affecting your issuance?

Ahlqvist, Swedbank: I believe that the EU Green Bond Standard will likely be somewhat of a gold star standard going forward due to it being so strict. However, it will capture only a very small part of the balance sheets of banks at least in some of the Nordic countries. As long as there is no harmonisation of energy class systems in between countries, I think there is a difficulty in comparability.

If we just look at the Nordics, Sweden is one example where approximately 1% of the national stock of EPCs is A label, whereas for example in the Netherlands it's more like 15% or even higher.

Bech-Ravn, Jyske Realkredit: In Denmark it's also closer to 15%.

Ahlqvist, Swedbank: So it is clear that the starting points really differ between countries.

I like the approach that you are taking at Jyske Bank and we have the same kind of approach. In Swedbank, when we look at the balance sheet and the funding, we see it more holistically and we believe that more and more investors do as well. Green bonds have been a catalyst for putting focus on greenifying the balance

sheet but at the end of the day, the most important is how we manage to transition the total balance sheet. Green Asset Ratio is a bit limited in terms of reporting and comparability as it is not taking into account the different starting points between countries.

Trautwein, DZ Bank: That's an experience I can totally share. At the beginning of the green bond market, investors really looked into the project itself, whether there was any kind of positive impact. But then the discussions shifted really fast towards the ESG strategy of the issuer and how it matched to the projects it was financing.

Now it is shifting again towards the projects itself but more on the risk mitigation — investors now want to make sure the financed projects are not harming any other environmental and social objectives.

That underlines that discussions have become quite broad, focusing not only on the projects but also on the overall ESG strategy of the issuer. For some years now, an increasing number of issuers are incorporating the new Taxonomy into their frameworks and also starting to look at the European Green Bond Standard.

Bech-Ravn, Jyske Realkredit: On the EU Green Bond Standard, it's very much a data exercise. It's really about getting the data for the activities that you're financing and especially when we talk about covered bonds where we need to get the data for many different buildings.

I believe that we have many buildings that are actually complying with the Taxonomy but we still





“We found the Taxonomy to be overall very helpful, very formative. To get a standardisation of what a green bond is, is very helpful for investors and would make it much easier for people to understand what they’re buying”

Eivind Hegelstad, SpareBank 1

need the data. Especially when we talk about SMEs we still need the data for each individual company, to make sure they are also living up to the ‘do no significant harm’ and they are living up to the minimum social safeguards.

For companies in the Nordics, the minimum social safeguards are already included in the legislation, so I think most of them will live up to these requirements. But we still need to get the data from them. This is going to be a data exercise that we will be working on over the next years.

Ahlqvist, Swedbank: Yes, the best banks in disclosure, reporting and standardisation will most likely benefit.

Hellerup, NIB: It’s the same with buildings because if you look at LEED and BREEAM certification for buildings, NIB will only finance green buildings with the highest certification (LEED Platinum or BREEAM Excellent or Outstanding) and these are not even eligible under EU Taxonomy. That’s quite interesting that you have the best rating and they’re not eligible within the EU Taxonomy.

Dinov, GC: Would you say that the EU Taxonomy and the Green Bond Standard are making your issuance easier?

Hellerup, NIB: I don’t think they make it easier but we have tried to look into the projects we have financed with our green bonds (NIB Environmental Bonds). What we have done is to see how eligible are they with the EU Taxonomy. And we take the whole portfolio

into account — it’s about 80%. But if you then start thinking about ‘do no significant harm’ part, it’s about 50% of the 80%.

I agree about the minimum safeguards. We really do the ESG work and we go out and speak to people on the project and look at them. We believe we are covered on that one but we probably need data if somebody came in and audited it. Maybe a pure player is able to issue a bond which is aligned with the EU Green Bond Standard, but if you are a bank where you have a big portfolio of different things, it would be very difficult to issue a bond in the near future that is aligned to the EU Green Bond Standard.

HARD REQUIREMENTS

Trautwein, DZ Bank: We also observed this in the market with an increasing number of issuers mandating external parties to review their frameworks and whether they are aligned with the EU Taxonomy. But for many of them, they at least aren’t fully aligned because they often missed some of the DNSH (do no significant harm) criteria, which are partially very difficult to fulfil, like for green buildings. For the adaptation requirements, say if you have a single building in an area which has a high flood risk, what are you going to do? How do you want to adapt to that as a single person or institution? It’s similar with other requirements like the famous toilets and the flush volume you cannot exceed — it’s a similar issue with very strict requirements. Some of these DNSH criteria are very difficult to achieve.

Bech-Ravn, Jyske Realkredit:

I really support that we get standardisation of what is green but the EU Taxonomy’s requirements are too hard at the moment, as you’re saying, for new buildings. It’s difficult with the ‘do no significant harm’ actually to get the data.

Jyske Bank is financing electric cars where we need to know what type of tyres are on the car to be aligned with the do no significant harm criteria. But we don’t have that information. If a private owner buys a car and finances it with us he is free to change the tyres the next day if he wants to. We are not able to follow what type of tyres are actually on the car. We need the government to step in and start adopting the Taxonomy into the legislation.

Dinov, GC: Eivind, what is your opinion being in a country outside the EU. How is that Taxonomy affecting your issuance of covered bonds?

Hegelstad, SpareBank 1: I’m glad you asked that question. We’re not really outside the EU, we’re part of the European Economic Area. Most regulations pertaining to banks have EEA relevance. So we would have to transpose those into Norwegian law. Part of being in the inner market, but not being an EU member state is we follow all the rules but have no political say in Brussels.

We found the Taxonomy to be overall very helpful, very formative. And to get a standardisation of what a green bond is, is very helpful for investors and would make it much easier for people to understand what they’re buying.

I do agree with the complexity; there’s too much complexity in the Taxonomy. And I absolutely agree also with Christian that it’s up to governments to look at that complexity and think about the regulation, to make the process more straightforward. But that’s probably very far down the list of all the to-do things that a government has to look at.

Nevertheless, we issue green bonds solely based on residential Norwegian mortgages and we were able to let the national building regulations solve the ‘do no significant harm’ questions for us. So I do have full alignment with the EU Taxonomy for my green bond issues going forward.

Financing resilience on all fronts: Q&A with NIB's André Küüsvek



What has NIB recently been up to?

“Our net interest income hit a historic high. The record is not only attributable to high interest rates and the economic climate, but also to a number of strategic decisions we have taken.

NIB is focused on financing climate and nature, productivity, and innovation, as well as looking at ways to support regional resilience. Our Board of Directors recently approved NIB's updated Sustainability Policy for public consultation, opening for financing defence while excluding weapons and ammunition.

Importantly, we remain dedicated to financing the transformation towards a climate and nature resilient economy. NIB has put in place a Climate Strategy with interim decarbonisation targets for 2030 to better support our member countries in their transition. Our own long-term target is to become a net-zero bank by 2050.

Maximising our added value by providing sustainable long-term financing in the Nordic-Baltic region is at the heart of it all.”

How can NIB maximise its impact as an IFI?

“Achieving a climate and nature-resilient economy requires substantial additional investments and NIB is committed to bridge this financing gap by mobilising resources and attracting private investment.

We are financing Nordic and Baltic companies in transformative industries, including renewable energy, battery value chains, the hydrogen economy, carbon capture and storage, carbon-neutral steel production and electrification of transport.

As a bank striving for net-zero, completely divesting from hard-to-abate companies might make our portfolio look good, but it wouldn't help the planet.

This is why NIB focuses on financing both ‘fast-lane’ sectors with green solutions and ‘slow-lane’ sectors that face challenges in reducing carbon emissions, provided the companies commit to and follow a 1.5°C pathway.

Beyond the environmental impact, NIB plays a crucial role in supporting member countries by financing investments that enhance productivity improvements and economic resilience.”

In turbulent times finance can be a guiding force. According to **André Küüsvek**, President and CEO of the Nordic Investment Bank, the bank has a growing appetite for investing in climate and nature, while securing regional resilience. In this Q&A, Küüsvek outlines his vision for the triple-A rated international financial institution based in Helsinki, detailing how NIB makes impact-driven investments to foster resilience.



André Küüsvek, Nordic Investment Bank

What are the most important types of projects that NIB finances?

“NIB prioritises high-impact projects where we can add value in the financing structure through our long-term lending.

We focus on the entire value chain — e.g. from energy production to battery cells, to car and truck manufacturers using these cells, and to customers electrifying their fleets. This approach supports not only individual projects but the broader transition of entire industries.

NIB has also started extending tailor-made sustainability-linked loans (SLLs) to companies. We have had very good dialogue with leading Nordic and Baltic corporates about their transition strategies.

Looking at these SLLs on our books, we are now discussing with investors how to possibly use them in our funding mix.”

How is NIB's funding strategy outlook ahead of the mid-year?

“We will continue to serve the evolving needs of our investors.

Key elements to our funding this year include US dollar global benchmark transactions, along with diverse public and private issues, ensuring a varied currency portfolio and broad investor base.

We have also raised money in currencies such as Australian Dollars and New Zealand Dollars. Earlier this year, we also issued bonds in Pounds Sterling.

Importantly, NIB continues to issue its own green bonds, known as NIB

Environmental Bonds (NEBs), to finance projects with measurable positive environmental impacts. NEB proceeds have financed projects such as wind parks in Estonia, green building developments in Norway and rail electrification in Denmark.”

What drives you on the sustainable capital markets?

“NIB actively supports the development of the sustainable capital markets in our home region, and we have a long-standing investor base in Nordic currencies. NIB is also looking to issuing NEB bonds in Icelandic Krónur.

By issuing green bonds in major Nordic currencies, NIB enables local investors to fund projects ‘in their backyard’, fostering direct community impact and supporting the growth of regional green fixed income markets.

The issuance of NEB in the Nordic currencies come in addition to established NEB issuance in EUR.”

NIB recently reviewed its Sustainability Policy, allowing security and resilience investments. How big a change is this for NIB?

“Building a green economy is futile without security. We see that green transition, innovation and security are mutually and virtuously reinforcing.

NIB can now finance defence sector for military goods, excluding weapons and ammunition, and dual-use equipment—those with both military and civilian applications—that support the security of the Nordic-Baltic region.

These policy changes send an important signal, allowing us to adapt to new geopolitical realities while maintaining the core mission of the Bank.

NIB's continued focus is on financing for a better, greener future.”

Dinov, GC: Considering what you have just said, that the EU Taxonomy is somewhat restrictive, are you ready to report the upcoming Green Asset Ratios that the European Banking Authority will require banks to report? Has that been a constraint on your funding or has that helped by adding transparency to your bonds and are investors looking with new interest to buy those?

Hegelstad, SpareBank 1: It absolutely adds transparency. That is part and parcel of what the system should be. Banks should report the level of EU Taxonomy-aligned assets as a share of all lending. Partially going back to my previous answer, there are more complexities involved with lending categories outside mortgages. If I put on my SpareBank 1 hat, for the whole of our group of 13 banks, we do a lot of other sustainable categories in the lending programme so there are more complexities there, and we struggle with easily finding the Green Asset Ratio in certain aspects amongst some of those categories.

But the GAR within mortgages is pretty straightforward. You just calculate if something aligns fully. However, there are going to be some discrepancies in what are my green assets and my GAR ratio is because I'm going to have grandfathered green mortgage assets, which are outside the Taxonomy. I'm going to have assets that were green a while ago, even before the Taxonomy came into existence, and I'm going to continue to report those as green because I have green bonds outstanding. That's an explanatory situation that we obviously need to engage in and look at, as part of the reporting.

It's the same way with the green assets that are outside residential

and commercial properties, which are seen as green or classed as green but they don't fully align with all the 'do no significant harm' criteria. And you have to explain that as well because your GAR is going to look small versus your overall green portfolio in those cases.

Dinov, GC: What does this mean for the unsecured issuance from banks, in senior and capital deals? Would the GAR or the EU Taxonomy help and assist with future issuance?

Trautwein, DZ Bank: The basic idea of the GAR is quite good and I understand what they are trying to achieve. However, you have to be very careful when using this figure and comparing banks because there are so many exceptions within the GAR that make it very difficult to compare one bank with another.

Green lending towards SMEs or a company outside the EU will not contribute to increasing the GAR — in contrast, it would decrease the ratio. The same applies to activities or sectors that are not covered by the EU Taxonomy.

There are so many exceptions out there, that it makes it very hard for people outside to see what this number actually means. You really need to have a description of why that GAR is at that point. It's a good idea, but it's really difficult to use that number to compare banks.

Mellor, Nordea: I think that many banks will continue to issue under the ICMA Green Bond Principles and thus will have to continue to report on and maintain those portfolios as long as we have the green bonds outstanding under those Principles. We would probably see new issuance under the EU Green Bond Standard as well in 2025.

The first issuers under the EU GBS will likely be monoline banks — banks that have one product to offer, for example real estate — and also corporate [lenders] that operate in categories where the EU Taxonomy is relatively easier to assess, for example an energy or a utility company.

For a well-diversified bank, it can be a little bit harder to define EU Taxonomy alignment, especially on the SME side. For the retail mortgages business, it may be a little bit easier to define the EU Taxonomy alignment.

Hellerup, NIB: Now with the Taxonomy you have the concept of what is green and what is not green. With the EU Taxonomy available now, this is what will help the ESG market going forward. NIB has had the environmental mandate for 20 years based on its own taxonomy.

There are a few categories where we don't agree with the EU Taxonomy or we had some differences, where something was outside it, or we had something where we are stricter. But now there is something which is defined as green, which we can agree whether it is good or bad. We all know about nuclear, we all know about natural gas, and we can discuss whether these should be included or not. But at least it's up to the issuers when they issue their green bonds and take these categories into their green bonds.

Dinov, GC: When you issue as an EU bank, how would that compare to a non-EU bank, say one based in the UK or North America? Are these clearly defined standards helping you with your unsecured issuance?

Ahlqvist, Swedbank: We have touched on this earlier but of course guidance generally is good. GAR, as discussed, has several limitations because for example of what data is available.

What we will see is probably two developments going forward: EU GBS being one path where we have very high standard green assets — and then another path of transition frameworks being developed. And I think we won't be able to achieve any of the climate targets from us banks nor the overall targets for the EU if we don't manage to align these two and focus on developing both.

"We're still working on ESG transparency. In the European market there's still very much focus on whether the bond is green or not green. But we can see now in Denmark, the investors are slowly looking more at the cover pool"

Christian Bech-Ravn, Jyske Realkredit



What we have seen outside the EU is that there is already progress in this area. We have UK banks, Canadian banks and Asian banks that are not bound by the EU Taxonomy regulations, allowing them to take a more holistic approach.

HOLISTIC APPROACH

Dinov, GC: Do you think this is better for them?

Ahlqvist, Swedbank: They can look at it a bit more holistically than EU banks and, as we have said earlier, the GAR ratio is impacted by the composition of a bank's balance sheet. The starting point and outcome will naturally differ between a mortgage bank and banks with more diversified balance sheets with a higher degree of corporate lending. Banks with a lot of SME lending will be at a disadvantage because these smaller corporates might not report on EU Taxonomy and therefore only the denominator is impacted, indicating a lower GAR ratio.

All this is interesting because non-EU banks can be more creative by implementing financing frameworks with a broader approach to transition planning. In the EU, we will probably also land there but it will take a bit longer.

Dinov, GC: Although transition finance is a big topic, not much issuance linked to it is happening. How would a bank finance borrowers that are in transition? If sustainability-linked loans are extended, would you be able to issue sustainability-linked bonds?

Hellerup, NIB: It's hard to issue a sustainability-linked bond. For example, Nordea has financed their sustainability-linked loans with a bond and this might be a way to finance the transition. This is because the sustainability-linked loan is a super-good product for transition because that's where you look at the company and not a project, which typically is behind a use of proceeds bond.

And these two supplement each other very well as these are two different products. It's not one or the other being better. For transition finance we need to look at the

"The EU Green Bond Standard will likely be somewhat of a gold star standard going forward due to it being so strict. However, it will capture only a very small part of the balance sheets of banks, at least in some of the Nordic countries"

Kerstin Ahlqvist, Swedbank



whole company in its transition. Say, do we like a cement factory? You look at the company in its transition to produce cement in a more sustainable way. If it is a utility company there could be a wind farm to substitute some fossil fuel-based heating, then it will be a good project.

For a bank supporting the transition, the sustainability-linked loan is very good tool. However, a bank issuing a sustainability-linked bond is challenging because you need to look at the underlying project you are financing and get that audited. That would be very difficult. But I like the idea that you are financing the sustainability-linked loans. ICMA has a working group that is looking at how you can structure a bond which finances sustainability-linked loans. Four institutions, JP Morgan, Crédit Agricole, the Loan Market Association and NIB, are in the working group and we have created some guidelines.

Bech-Ravn, Jyske Realkredit: I definitely think we need to finance the transition. Right now, we are rewarding companies that are setting up targets. If we look a couple of years ahead, then we will start including target setting from companies much more into our credit processes.

We will see that the companies that we are rewarding now will become the standard. When we look at our credit process, we will say 'Do they have targets? If yes, good'. Then we can give them a loan. And when we say 'Do they have a target? No, they don't have any targets,' then potentially we will give them a higher price on a loan. It's also about transition risk; I think that many banks are still working on

how to deal with that. I believe in the future we will see sustainability-linked loans as a matter of transition risk rather than awarding some companies.

PROCESS NOT A PRODUCT

Trautwein, DZ Bank: There is one phrase that covers it quite well — transition is a process not a product.

Ahlqvist, Swedbank: Many banks are now working on transition loan definitions as well and I believe we will see these definitions becoming clearer in the near future. SLLs are part of it but there is likely a broader set of criteria that you can add to the transition loan definition as well.

Dinov, GC: In Nordea's case, why didn't you issue an SLB? Why did you choose the innovative approach to do it through a use of proceeds bond?

Mellor, Nordea: We realised that we had many assets on the balance sheet that were sustainable but not necessarily qualified for our green funding framework. So we created a new framework where we use sustainability-linked loans to allow our investors to invest in Nordea's SLL financing activity that tackles climate change where the use of proceeds of the bond is intended to be used to finance the SLLs. As the use of proceeds format in terms of green bonds was very well established and this new format contributes to climate change, we discussed whether we would call these bonds transition bonds. But there wasn't a market standard yet for transition bonds, while the Loan Market Association had already established principles for SLLs.

We then decided to issue SLL bonds where the use of proceeds are intended to be used for the sustainability-linked loans on our balance sheet. This way we offer investors another way to invest in Nordea sustainable assets with more information and transparency than a normal bond. The product also allows us to engage with our customers in the journey towards a better sustainable world. All assets in our SLL bond asset portfolio have climate targets that are quantifiable, ambitious and robust.

We choose not to issue a sustainability-linked bond as SLBs may not be regulatorily efficient for banks. Hence, we invented this new, more efficient SLL framework instead.

Dinov, GC: You first issued in local currencies and then in euros. If you were to repeat it, which currency would you choose?

Mellor, Nordea: We like the local currency markets and we know the local market investors well. We had a good dialogue with key investors and decided to test the new product in the local market first. Another advantage of starting in the local market is that the benchmark size here is smaller. This meant that we didn't have to build up a portfolio of €2bn in assets before issuing a benchmark size. Hence, in the Nordic countries, in SEK and NOK, we could issue smaller volumes still in benchmark formats.

We started with SEK and NOK in 2022 and then we came with the first SLL euro benchmark in 2023. And we hope to come back to the

local markets as well as the euro market in due course.

WHERE ARE THE SLBs?

Dinov, GC: On the subject of SLBs, there's been only one case of a bank issuing, when Berlin Hyp printed a senior preferred deal in April 2021. It came with a 25bp step-up coupon. Why are there no more SLBs and what is stopping their issuance?

Trautwein, DZ Bank: We worked on this transaction as bookrunner and it went very well. Berlin Hyp achieved a very tight pricing on the back of positive investor feedback. However, as you mentioned, the regulatory requirements are having a negative impact on the take-up from banks so far. When you issue an SLB as a bank you theoretically have an incentive to redeem if you do not meet your target and have to pay a higher coupon.

It is not MREL-eligible and therefore it doesn't really make economic sense for most banks to issue SLBs. Therefore, the innovative structure from Nordea is a very interesting development and I would hope for more issues to come.

I recently read that Crédit Agricole CIB is considering issuing an SLLB, which could give a further boost to this segment.

Hegelstad, SpareBank 1: We were fascinated by the Berlin Hyp sustainability-linked bond at the time and we had a discussion with them and looked into it. The incentives offered for the issuer to stay the course, well, that's a technical issue, but it is a bit difficult due to swaps

and cash flows and perhaps analytical and reporting requirements. It could probably be solved, but I'd first put that on hold in a "technical box".

The problematic thing was that you need to be able to control the environment. Essentially this goes back to what Christian was saying: it's about the whole covered bond pool or the whole balance sheet, how you green it, how you improve it over time, that's the sustainability-linked feature. That's the way it works with Berlin Hyp as well.

But if you don't control the environment then it's challenging. We try to control the environment, by saying to customers 'you get an interest rate discount if you green your house'. Here I'm just talking about residential mortgages, just to keep it simple. Some will greenify their houses but most won't. For single family house owners it may not be worth it. It's probably too little, it's too complicated, it costs a lot, it's a long process to renovate.

You aren't able to move people to greenifying their houses with a say 50bp discount, which our banks are offering to prospective mortgage holders in this country. And when you can't control the environment, how can you promise then that your overall balance sheet or your whole cover pool will move in a certain direction by a certain time? You really can't.

It's also a little bit disingenuous and almost to be taking a bet that you are able to. You are then reliant upon the government coming in and saying, we are going to have to have these energy efficiency measures implemented, and here is a new law to achieve that. This means that however you calculate the CO₂ emissions equivalent, which is complicated in its own right, you reach it just by being compliant with the new regulation.

That is what, at least to my understanding, Berlin Hyp has done as well. They've said this is the energy use or CO₂ reduction target of the German government moving in that direction and that is also our target for the SLB.

Johannes can correct me if I'm wrong, but now there is a discussion pertaining to the German government, whether they are going to make their goals in 2030, 2045 or not. And many people are saying they're not going to make them.

Just look at the resistance in Germany to the green change. In

"Discussions shifted really fast towards the ESG strategy of the issuer and how it matched to the projects it was financing. Now it is shifting again towards the projects itself but more on the risk mitigation — investors now want to make sure the financed projects are not harming any other environmental and social objectives"

Johannes Trautwein, DZ Bank



the EU election the Green Party lost nearly 9 percentage points of its overall vote tally in Germany compared to the last parliamentary election in the country; there's a shift in opinion and that is a big part of the reason why people are thinking that Germany is not going to make their commitments. And that then would imply that Berlin Hyp is not going to be able to make theirs either.

But you can of course do many other things as a specialised lender, like Berlin Hyp is, and they're very competent people and I have all the confidence in them. But this is the dilemma for banks looking to issue SLBs which are linked up with a government target.

Bech-Ravn, Jyske Realkredit: I fully agree with you Eivind, and it also introduces some risk of greenwashing. When you're setting a target where you're not really able to control it yourself, it's actually controlled by the environment. For Berlin Hyp, it's very much controlled by the government.

We have a target that's even more ambitious than Berlin Hyp's. We have a target to reduce carbon emissions for residential buildings by 85% within the next 10 years. It's very ambitious but the main driver for this is the transition of the energy supply in Denmark. We are financing renovations of buildings that we finance but the main driver is not going to be the banks, it's going to be the transition of society, which we are not as a bank driving.

So, when we are issuing these sustainability-linked loans and also bonds, we must be very aware that there is a chance of greenwashing.

Trautwein, DZ Bank: As we have discussed, Berlin Hyp used the carbon intensity target for the SLB. There are two key factors. First, the energy efficiency of the buildings they are financing, that's something they can somehow manage and mitigate. The second point is the energy mix in Germany. Due to geopolitical developments with Russia's war against Ukraine, the energy mix in Germany has deteriorated in terms of CO₂ emissions, at least temporarily. Instead of natural gas, coal is now increasingly used to generate energy. So, while Berlin Hyp was still well above its target



"I really support that we get standardisation of what is green but the EU Taxonomy's requirements are too hard at the moment"

Christian Bech-Ravn, Jyske Realkredit

achievement path in 2022, this gap narrowed in 2023.

Dinov, GC: With a lot of control being outside banks and lenders, and issuing SLBs not being the way forward, what is the best way to green a bank's balance sheet? Where is the best spot to do that in the capital structure?

Bech-Ravn, Jyske Realkredit: We are a bit special as a Danish bank so covered bonds are a big part of our business. It would have a big effect to do it with covered bonds, but again, our main focus is still on transparency. It's more on transparency than issuing green bonds. We can, and we have, issued green bonds, but our main focus is on transparency.

Ahlqvist, Swedbank: We see labelled bonds as tools to help incentivise green lending but most importantly it starts with the focus on our customer lending. What do we do in terms of customer business, sustainable product development and how do we get customers on board? We, on the funding side, are the residual of our green asset growth, meaning that if we manage well on the business side then we can issue green bonds. But it starts with the customers and it starts with the commitments we, banks, have in place in the green transition journey we are on.

The social aspect of "ESG" is also important to mention in this context. Swedbank added social lending criteria to our framework to support targeted groups in the communities in which we operate already two years ago. We are proud to have led the way in societal commitment to our customers and we were the first Nordic bank to issue a social bond in 2023.

Hegelstad, SpareBank 1: I totally agree with that. It starts with the lending and there are things that are easier and things that are more difficult in the lending. If you talk to companies, you can certainly set targets in their plans. You can do that on commercial buildings as well. But when it comes to the biggest part of our balance sheets, which is residential mortgages, at least it is for any bank in Norway, it's going to be very difficult and very unpopular and a big no-no to the 'S' in ESG if you tell customers they can't get a mortgage.

TIER TWO GREENIUM

Dinov, GC: Nordea recently issued its second green tier two in euros. What was the investor reception to adding an ESG label to the capital?

Mellor, Nordea: We issued our first green tier two in November last year and the new green tier two in May. Nordea is still the only Nordic bank that has issued green tier two in euros. We have issued green in all bond formats now but ATIs: we have issued green covered bonds in all our four different home currencies on the back of green mortgages in these currencies. From the bank we have issued green senior preferred, non-preferred and then tier two. We have looked at the market conditions, together with the investor appetite, to decide which bond format we would use our green assets for at the time. In 2017, we issued green senior preferred and then slightly later green senior non-preferred when the asset class became relevant, and then most recently we issued green in tier two format.

We'd like to be active across different bond formats but of course we also take into account the market conditions, the investor appetite and the potential greenium when deciding which format to issue green bonds in.

Dinov, GC: Did you achieve a greenium with your recent tier two?

Mellor, Nordea: Yes, we achieved about a 5bp greenium in our tier twos. We have achieved slightly different greeniums in different products and currencies in different times. For example in the euro covered bond market, there has tended to be a smaller greenium as spreads have been already tight historically compared to local and credit markets.

Meanwhile, in the green Swedish covered bond market, the investor interest has been significant. Both times we have issued green SEK covered bonds, we have had very well oversubscribed order books and investors have been more willing to accept a larger greenium than in the euro covered bond market.

Ahlqvist, Swedbank: There are different approaches to how to view the effectiveness of the instruments you choose to issue and there is no right or wrong. The approach that we have taken is that green senior and covered bonds are the most effective and relevant funding instruments for green assets, whether mortgage loans or corporate loans.

Then one can look at it from a market-driven approach, which is more driven by the greenium. We have been steered by the potential greenium achieved when choosing

the format of what we have issued in the past.

We look at two things there. Firstly, the greenium is important for us because we transfer over the entire funding cost discount back to the business areas to incentivise green lending provided to customers. From the start in 2017, when we launched our first green bond framework, we had 10bp transferred so we actually overpaid in the fund transfer pricing internally. Nowadays, we have a more market-driven, transaction-based tool. It means we now transfer back 3bp to 5bp, which is the discount to the funding cost we achieved in greenium over the last few years.

The other element is the derisking element a green label brings to the execution of a trade. In the MREL build-up to January 2024, we issued quite high volumes of senior bonds, and the market has not always been with us during these years. Hence, it has also been a very efficient tool to issue green or social bonds to derisk and to secure the funding we need in a certain instrument more cost-efficiently.

We have so far issued in senior preferred and senior non-preferred formats and we will also, to Petra's point, look at local markets as the greenium achieved in SEK and NOK domestic covered bonds are favourable because of the high demand from local investors.

Dinov, GC: Would you consider green tier two?

Ahlqvist, Swedbank: Our approach is a bit different there. We believe that green covered and senior instruments are more effective to fund green assets.

Dinov, GC: Where have you found the biggest greenium up to now — in what currency and in what format? And is it possible to pinpoint it precisely?

Ahlqvist, Swedbank: Issuance format and currency have been very market-dependent and the greenium differs at different points in time. Swedbank was the first Nordic bank issuing green senior non-preferred bonds in sterling and in US dollars. We have also been issuing in Swiss francs, euros and Swedish kronor. Our framework allows the flexibility to issue across the capital stack down to tier two, but not in AT1 format.

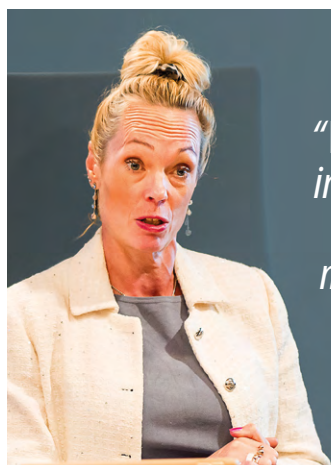
Dinov, GC: And in covered bonds, in which currency is it best to capture the greenium?

Bech-Ravn, Jyske Realkredit: It's close to zero, no matter where you go. At least in the euro market the greenium is relatively small. It's the same in the Danish market at least, I cannot say for the Norwegian or the Swedish ones. I know that the Swedish investor base in general have more focus on green investments. So I would imagine that there is a bigger greenium in Sweden.

Jyske Bank has issued senior bonds in the Swedish market and, especially when we look at the senior market, it's almost a necessity that you do it in a green format in the Swedish market.

Mellor, Nordea: We have seen a slightly smaller greenium in the euro and Danish krone markets of 1bp or 2bp or so. And in the Danish krone market, the greenium is passed on directly to the customer, given the match-funding principle. In the Swedish and Norwegian covered bond markets, we have received some 4bp to 5bp greenium due to the high demand from the local investor base. Like Swedbank, Nordea is passing on the greenium we get from bond issuance to the business areas.

Hegelstad, SpareBank 1: I agree with Christian, the greenium is rather small. Like I said earlier, we offer customers up to 50bp off the interest rates for greening their houses and we get nearly nothing back. This has been a question from equity analysts — what is the cost to the bank, as the volumes are so small



"We have achieved slightly different greeniums in different products and currencies in different times. In the green Swedish covered bond market... investors have been more willing to accept a larger greenium"

Petra Mellor, Nordea

in terms of successfully converting people to become green with their houses. There's not a cost issue. It should be bigger, it is generally zero to 2bp in covered.

Hellerup, NIB: I don't think — maybe I'm speaking on behalf of the SSA sector — that any of us are issuing green bonds because of the greenium. It is very small. It's more about making the awareness, doing the communication of what you're doing, signalling, these kinds of things.

You can claim that maybe at the beginning there was a couple of basis points, but it has gone close to zero. You might see it in the secondary market, if there is a crisis or if something happens in the market, then investors are more willing to stick to green bonds and you see more performance there. Where it is most helping is maybe in the execution. You see it with Germany, because there you have a bond that you can compare directly and the last green bond there was half a basis point of greenium or close to that.

That said, we would also like to issue in Swedish kronor because we have lending in Swedish kronor but here it is very difficult to issue if it is not a green bond.

If we want to get the diversification into the Swedish asset managers and pension funds, the green bond is the way forward.

Dinov, GC: There is a lot of talk about supras and their hybrid issuance. Some view their mandate itself as being ESG-compliant whereas banks are for-profit organisations. Is the next step for ESG capital markets to expand the greening of the economy and the lending by going down to perpetual capital?

Hellerup, NIB: There was the G20 report which basically said the supras should try to do more lending. Supras have equity and callable capital. However, it is only the equity they can leverage on. So if you don't increase your capital you can issue hybrid capital and you can use that to leverage on.

African Development Bank has been the first to issue hybrid capital. It was sold to a completely different investor base from the usual SSA bonds and they also made it green.

“Non-EU banks can be more creative by implementing financing frameworks with a broader approach to transition planning. In the EU, we will probably also land there but it will take a bit longer”

Kerstin Ahlqvist, Swedbank



They did a very good trade but one reason for it working was also due to the spread and maybe not because it was green.

At least within our sector this may be a strange concept if you call this a use of proceeds bond. You do some funding which is now hybrid capital, you pay more than normal funding, which is fine as you want to leverage three to seven times, but only the proceeds can be used as use of proceeds.

LIMITED IMPACT

Trautwein, DZ Bank: From a pricing perspective, I see limited impact to doing perpetual debt in a green format because the more subordinated you go, the less SRI investors tend to be in the order book. Therefore, the impact on the pricing will be rather limited in our view.

On the structuring side, it is possible. With regards to the discussion whether a perpetual instrument potentially requires you to have green assets for eternity — of course that can be an issue and it can be a risk. However, if we look at the banks, they all strive to become more green, to increase their green lending. So I don't see a big risk that there won't be enough green assets available for issuers.

From our point of view, the sweet spot for issuers in terms of getting most of the SRI investors in the order books but also achieving a significant greenium is in the senior unsecured space, be it in preferred or non-preferred format.

Dinov, GC: Do you think it is an option to do a labelled AT1? Has there been any resistance from regulators or from investors?

Mellor, Nordea: In our green funding framework we are open to any bond format, so we are not restricted from a funding framework point of view. We are following the market developments and we have not yet issued AT1s in green format. One of the reasons is that there seems to be a little bit of resistance from some investors for green AT1s, partly because capital is supposed to fund your whole balance sheet, not just the green assets.

Also, there is some scepticism from the regulator with regards to the fact that AT1 is by definition a perpetual bond and your green assets are not necessarily perpetual. That means it could be a mismatch of the maturity and thus a potential incentive for an issuer to redeem an AT1, which is not allowed from a regulatory point of view. Hence, we have not yet gone down that path.

Ahlqvist, Swedbank: I think we have the answers from the others here. Jens' point about how the capital efficiency is working and the perpetuity impact is a challenge and so is the mismatch. And the regulator has not really been pushing the development either.

Dinov, GC: It sounds like we are in a transitioning process and, in the Nordic markets, despite there being all these differences, it appears that local investors, in local currencies as well, are also demanding innovative products. How has your interaction changed over the years with these regional investors?

Ahlqvist, Swedbank: Our interaction has really evolved over the years along with the regulatory development. If green bonds have been a catalyst for issuers to

push green assets, now what we see and the approach we take is more of a holistic one. It is one where the investors — if they have enough relevant disclosures and data available in a standardised and comparable way by us banks — can take decisions on a much more holistic basis.

To go back to your question on whether we can we issue an SLB, some of us here today are diversified banks with mortgages and also corporate commitments on our balance sheets, making the starting point more difficult to issue an SLB. But I think an investor would, if they have a holistic view and are confident with the data that we as an issuer provide, be able to compare between the different banks how we score from an ESG perspective and buy our conventional bonds.

That is also why we at Swedbank have what we call a sustainable funding strategy. Our approach is that we as a treasury function have an important role to play within the bank to drive initiatives that contribute to the bank's transition and sustainability targets. If successful, that can bring down the funding cost and we can contribute positively to the ROE for the bank. That is the way we work and the reason why we are so involved with these topics internally.

MORE INTERACTION

Bech-Ravn, Jyske Realkredit: I very much agree. We are definitely having more interaction now with investors regarding ESG. We have really tried, especially when we talk

about transparency, to push this to the investors. At the start we didn't really get a need from the investors but we saw transparency as the best way to work with sustainability. We made a push to investors before they needed the data and now we can see that it's paying off that we originally made this push. Taking this data into consideration now, it's easier for them.

We have really tried to push our agenda to investors and now it is paying off, at least in the Danish market, which is our most important market.

Hegelstad, SpareBank 1: While I agree with what's been said so far, I feel that covered bond investors — and I am talking about the covered bond investor because that is the product I issue — have landed in two camps.

One is a very large camp and they have a tick-the-box exercise; they're not interested in the detail. They appreciate that you follow the EU Taxonomy for example but that's it. And then you have a very small group, which are very agile and detail-orientated.

Bech-Ravn, Jyske Realkredit: I think the small group is growing quite fast. The investors are getting more details and while five, six years ago, we only met with the portfolio manager, now, we often meet with the portfolio manager and the ESG manager. The focus on ESG is changing and investors are becoming more detail-orientated.

Dinov, GC: Investors being more sophisticated when it comes to

ESG, is there a particular region or type of investor that now stands out?

Trautwein, DZ Bank: I totally agree that the discussions with investors have changed quite a lot in the last few years. There are more ESG discussions, and ESG also plays an important role in conventional bond transactions. There are regions, particularly within Europe, that are more frontrunners than others. The Nordics, as we already mentioned, where ESG is strongly rooted, is one of them. But also in France and the Netherlands ESG is a major topic. Other regions are also picking up and increasingly incorporating ESG in their investment decision process. But the Nordics, France and the Netherlands are still the places to go if you want to market ESG transactions.

Hellerup, NIB: I agree that the Nordics has been ahead of other regions for years. And investors from this region have asked the questions. You need to bring your own environmental analyst to a lot of the meetings because the ESG theme is coming, so the questions can get quite technical. But that happens always in the Nordics but it is also true for the Netherlands and France where you have a dedicated investor base there as well.

Mellor, Nordea: Investors are engaged in this topic and we have a good dialogue with them. We also engage with our customers as we can't do this on our own. We have to do it together: investors, issuers and the issuers' clients — the customers.

Bech-Ravn, Jyske Realkredit: And there is a big focus on a green transition in the Nordics. It was quite interesting in the EU election, when most of Europe moved right, the Nordics moved left — moving to the green parties.

Mellor, Nordea: Indeed, but the support for the Greens fell in Germany and France.

Bech-Ravn, Jyske Realkredit: But we, the Nordics, actually went the other way. In Denmark, Sweden and Finland as well.

Ahlqvist, Swedbank: And the young generation is interested in the future of our climate. **GC**

"I don't think — maybe I'm speaking on behalf of the SSA sector — that any of us are issuing green bonds because of the greenium. It is very small. It's more about making the awareness, doing the communication of what you're doing, signalling, these kinds of things"

Jens Hellerup, NIB



Nordic lenders develop fresh ESG funding formats

The Nordic market has been a nursery for ESG debt innovation since the market's inception. Now banks in the region are working on new ways to fund the green transition, writes **Frank Jackman**

It is debatable who issued the first green bond. The European Investment Bank suggests its €600m Climate Awareness Bond in 2007 was the first, while the World Bank claims the crown for its Skr2.325bn (€205m) 3% November 2014 deal the following year.

But for Jens Hellerup, head of funding and investor relations at the Nordic Investment Bank in Helsinki, one thing is clear — Nordic investors nurtured both issues. In fact, the World Bank's first green bond was sold entirely to Scandinavian investors, through SEB.

"The Nordic investor base has been a part of this market since it started," says Hellerup. Environmental, social and governance investing has "historically, been more pronounced in the Nordics than anywhere else in the world."

These investors "have a clear sustainability focus," says Gustaf Winberg, head of financial institutions debt capital markets at Nordea in Stockholm. "For many funds, the highest return is not always the key objective, with investors instead having high ESG guidelines. This has fostered a great market for innovation — from [supranational, sovereign and agency issuers] to high yield, everyone wants to be green."

On the issuer side, the Nordic Investment Bank has "been active

in the green bond market since 2011 and has had an environmental mandate since 2005," Hellerup says.

It was also a Swedish borrower that issued the first green corporate bond in 2013 — a Skr1.3bn bond from real estate firm Vasakronan, again through SEB.

Since then, the Nordic labelled debt market has grown. Nordic borrowers in all asset classes have issued €28bn-equivalent of green, social and sustainable notes so far this year, according to Dealogic data.

As a result, 2024 is already the fourth busiest year for Nordic labelled issuance, and it is on track to come close to last year's €48.9bn-equivalent record high.

"By the end of the first half, close to half of all Nordic corporate bonds issued this year were in a sustainable format," says Lars Mac Key, global head of sustainable products at Danske Bank. "This is not a niche market anymore — more issuers are trying to raise a large part of their debt in a sustainable format."

Time to transition

But the focus is shifting away from straight labelled bonds to those that incentivise a transition. To this end, many companies are considering sustainability-linked loans and bonds.

These are used by borrowers that do not want to commit to



▲ Vasakronan, the Swedish property company, was the first corporate green bond issuer

using all the proceeds for green purposes, but are willing to tie their cost of funding to whether they achieve certain ESG performance targets. These instruments are therefore a way for companies to advertise the progress they are making in their transitions to becoming more sustainable.

The market has grown since the first Nordic sustainability-linked bond was issued in 2021. Nordic borrowers issued €3.5bn-equivalent of SLBs in 2021, rising to €5.2bn-equivalent last year, according to Dealogic. Supply has slowed slightly in 2024, with only €1.5bn issued so far.

The bulk of this has come to the euro market: €11.5bn of the €15.2bn-equivalent of Nordic SLBs outstanding. These deals range from small privately placed notes to large dual tranche benchmarks like those issued by Vestas, the Danish wind turbine maker, in March 2022.

"We see a trend in Nordic corporate issuers complementing their green bond frameworks with the SLB format, to cater for only

"ESG has, historically, been more pronounced in the Nordics than anywhere else in the world"

Jens Hellerup, head of funding and investor relations at the Nordic Investment Bank



sustainable debt, as green assets are limited,” says Mac Key. “To this, we see a shift in a few names that now believe the SLB format is a better fit.”

Of course, sustainability-linked bonds are not suitable for every issuer. Banks, for instance, find it very hard to issue them, for regulatory reasons.

“SLBs are complex for banks — banks have a broad set of assets, which are difficult to report on,” says Winberg. “Issuing SLBs is a lot easier for corporates.”

What to do with SLLs

However, banks own large quantities of sustainability-linked debt — in particular loans to corporate borrowers — that need financing. “Nordic banks have slightly larger portfolios of SLLs compared to European banks, as more Nordic corporates are looking for the product,” says Winberg.

These are sustainable assets — but can they be used to back sustainable finance bonds? Sustainability-linked loans do not themselves have a green use of proceeds, so it would be difficult to argue bonds referencing them were green bonds.

One Nordic lender, Nordea, came up with a novel approach to this — issue a bond with its use of proceeds earmarked for funding sustainability-linked loans. The issuer did not call it a green bond, but an SLL financing bond.

Nordea debuted this structure with a €400m-equivalent dual tranche senior preferred deal in

“For many funds, the highest return is not always the key objective, with investors instead having high ESG guidelines. This has fostered a great market for innovation — from SSA issuers to high yield, everyone wants to be green”

Gustaf Winberg, head of FIG DCM at Nordea

Swedish kronor and Norwegian kroner in late 2022.

But the debate over the viability of the product did not take off until it launched its first euro deal in the format — a €1bn 4.375% September 2026 non-call 2025 bail-in bond, issued in August 2023.

Nordea got around the pitfalls of issuing debt based on sustainability-linked loans by having “a clean use of proceeds, normal senior language and no step-up or step-down complications,” says Winberg, who worked on the transaction.

The deal has turned heads in the Nordic region, and other issuers are expected to follow. “We’ve had a lot of good discussions on the back of this successful transaction,” says Danske’s Mac Key, who was not involved with the trade.

But perhaps the next innovation could come from the SSA sector — as the Nordic Investment Bank is considering whether it, too, should repackage its sustainability-linked loan portfolio into a similar trade.

The supranational signed its first SLL in October 2021, a €60m deal with Swedish white goods manufacturer Electrolux. Its portfolio has since grown to

more than €965m, with the most recent loan signed on June 10 with Electrolux.

“We are looking into how we can finance our SLL portfolio,” says Hellerup. “We cannot use a straight green bond as they do not strictly fit into the use of proceeds language. It is still a work in progress, but ICMA has just released some guidelines on how to finance sustainability-linked loans.”

New guidelines

The International Capital Markets Association updated its Green, Social, Sustainability and Sustainability-Linked Bond Principles in late June to include guidance on issuing bonds solely to finance sustainability-linked loans.

SLL bonds “make sense as long as the transparency is there, and the portfolio of assets fit into the transition story,” says Mac Key. “We should encourage innovative and transparent ideas that allow investors to make their own decisions as to whether [a use of proceeds] is in line with their mandate.”

“From a bank perspective, I like this asset class as it gives a small edge on senior issuance, although I’m not claiming there’s a huge greenium available on it,” says Winberg. “The added label does, however, increase investor interest and diversification.

“We can tell corporate clients that if they sign up for an SLL and we include it in the asset pool on the funding side, then they can use it in their marketing and thus increase their own sustainability branding and perception,” adds Winberg.

If SLL financing bonds take off, there is plenty of collateral available — many hundreds of these loans have been signed in the past seven years.

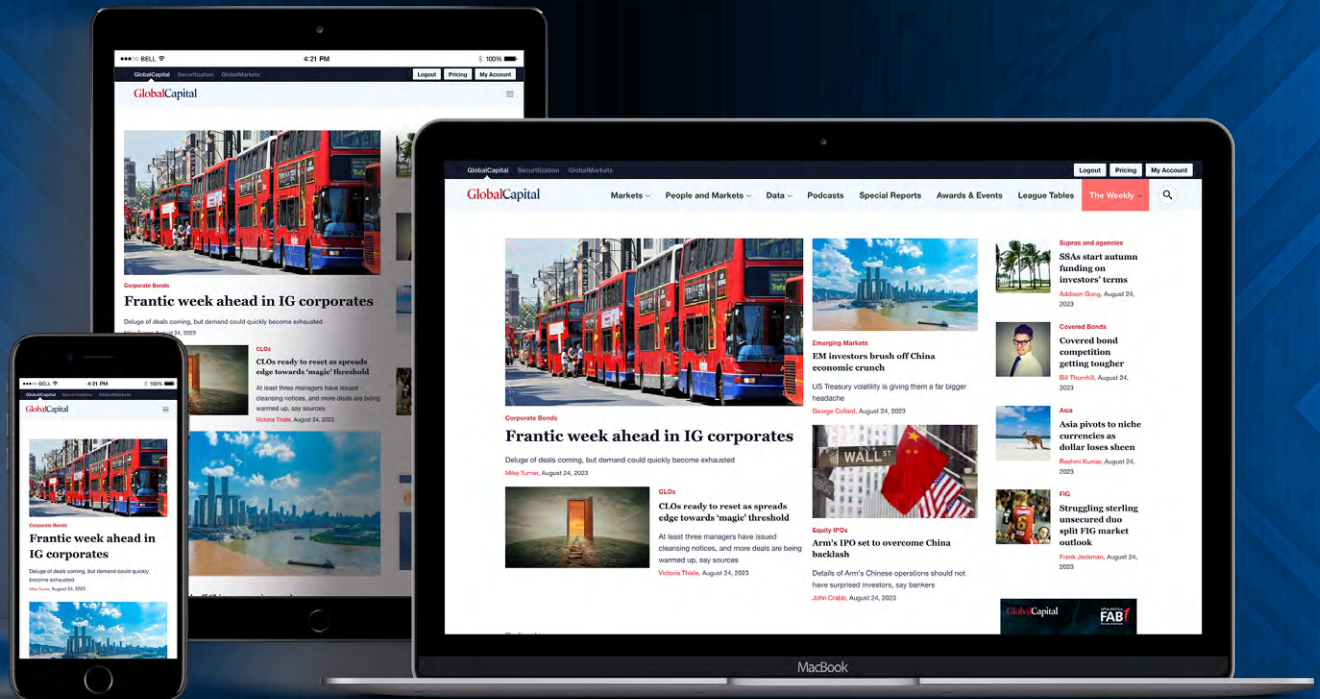
Just as the Nordic region helped pioneer green bond financing almost 20 years ago, thanks to the receptivity of its issuer and investor base, it is now shaping the next generation of ESG-linked financing. GC

▼ Vestas, the wind turbine maker, has been most of the most prominent Nordic sustainability-linked bond issuers



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Nordic banks tightened the spreads they had to pay on senior unsecured new bond issues over the first six months of 2024, from an average of 127bp for fixed rate euro funding in the fourth quarter last year to an average of 77bp in the last, data from *GlobalCapital's* Primary Market Monitor show.

Finnish banks have been the tightest senior funders in euros so far this year, with trades coming at 76.5bp to mid-swaps on average, narrowly beating Norway's 77.2bp. Swedish borrowers have paid 88bp to fund on average, while Danish firms — the most prolific of the year so far — have offered 115bp. Danish and Swedish deals have tightened the most on average since last year, down some 34bp and 26bp, respectively.

But some names have managed to move the needle even further. Nordea, for example, was able to print a €1bn 3.375% June 2029 senior preferred deal at 48bp over mid-swaps in early June — less than half the 110bp spread it needed to seal a €1bn 4.125% May 2028 senior non-preferred print in early May last year.

The move tighter is also pronounced further down the capital stack. Nordea issued a €750m 4.125% May 2035 non-call May 2030 green tier two deal at 135bp over mid-swaps in late May this year, some 50bp inside where it had issued a €500m 4.875% February 2034 non-call February 2029 deal last November. Despite the tighter spread, the larger, later deal attracted almost €1bn more demand, with the book closing at €3bn.

Of course, Nordea has some way to go before it matches the 92bp level it was able to achieve on a €1bn 0.625% August 2031 non-call August 2026 tier two in May 2021.

Nordic banks tighten the screws

Nordic banks have had a great start to 2024 in the bond market, compressing their unsecured spreads to well below where they could fund in previous years. Despite these rich levels, investors have shown no reticence when it comes to placing orders, reports **Frank Jackman**

Despite these tight spreads, issuers are not having to pay big new issue premiums.

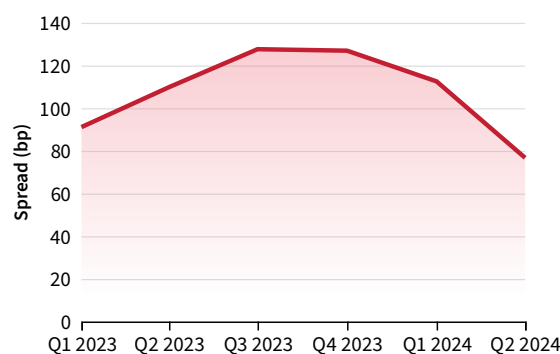
Falling premiums

NIPs have fallen for Nordic senior unsecured funders across the board this year, and banks have looked to make the most of a buoyant market. Last year, Swedish banks needed on average 11.1bp of concession to seal a deal, but this year these funders have managed to come on average 0.75bp through the curve.

Svenska Handelsbanken was able to add duration in February without paying up to do so, for instance. The Swedish firm issued a €750m February 2034 deal at 110bp over mid-swaps, 5bp through its secondary curve. Not only is this one of the smallest concessions of the year so far across the Nordic region, but it was also the first 10 year unsecured senior print from a Nordic bank in almost three years, PMM data shows.

Senior unsecured funders in the Nordic region were forced to tap the short end of the curve by the fallout following the collapse of Credit Suisse, which shut the market down for several weeks during the second quarter of 2023. The average tenor

Average Nordic euro senior unsecured new issue spread over mid-swaps



Source: *GlobalCapital's* Primary Market Monitor

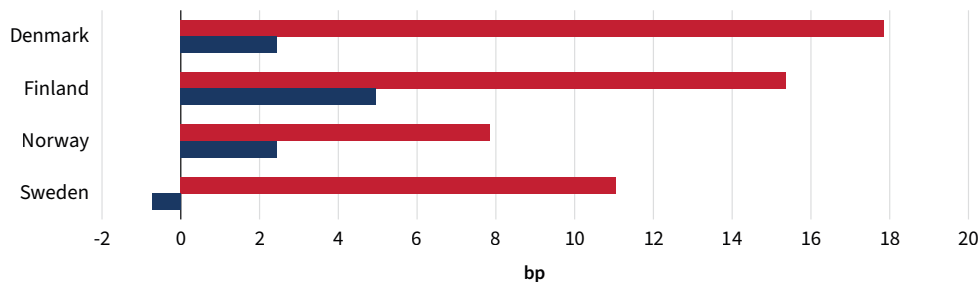
fell slightly from 4.98 years before Credit Suisse's collapse to 4.82 years throughout the rest of 2023, as issuers pushed to fund around the five year mark. Only two issuers — Danske and Swedbank — priced seven year trades in the latter part of last year, with both paying 15bp of concession to do so.

But 2024 started strongly as a renewal in risk sentiment and talk of rates cuts sent investors further out along the curve. The average tenor so far this year has been just shy of six years, 5.98 years, with two banks — the aforementioned Svenska Handelsbanken and Nordea — finding success at 10 years.

Nordic banks have not had to worry about investors shying away as spreads and new issue premiums compress. The average bid to cover ratio for Nordic benchmark prints has remained stable at 2.1 times in the first half of 2024, up slightly from last year's 1.9 times. However, despite the strong conditions, deal sizes are down slightly on average, falling from €809m in 2023 to €615m so far this year, *GlobalCapital* data show. **GC**

Average new issue premium for fixed rate senior unsecured bonds

● 2023 ● H1 2024



Source: *GlobalCapital's* Primary Market Monitor

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Banks keep up brisk pace in euro covered bonds

After a rough 2023 when Nordic banks were forced to issue covered bonds at shorter tenors, borrowers have relished the chance to fund further out on the curve so far this year, securing tightly priced and popular deals, writes **Frank Jackman**

Nordic banks have issued €12.25bn of benchmark covered bonds in euros during the first half of this year, according to data from *GlobalCapital's* Primary Market Monitor, putting them on track to match the €20bn raised last year.

Of course, 2023 was not an easy year for covered bond funding — March's regional banking crisis in the US and the collapse of Credit Suisse shuttered the covered bond market for two weeks during what should have been the end of a busy first quarter.

But covered issuance returned strongly at the end of March. In fact, it was a Swedish borrower — Stadshypotek — which reopened the European covered bond market. The Swedish firm attracted a €2.25bn final book as it sealed a €1bn 3.125% April 2028 green bond, its first in the format, at a spread of just 16bp over mid-swaps. A strong second quarter followed as Nordic banks scooped €7.25bn of benchmark paper out of the market — €2.5bn more than the second busiest quarter.

This year, however, supply has progressed at a steadier pace in the absence of a market-wrecking black swan event. Nordic banks issued €5.5bn in the first three months of 2024, before raising €6.75bn in the second quarter, PMM data shows.

Thankfully, this steady pace has kept up with last year, with the €12.25bn raised in the first half just €500m more than what was issued during the same period last year. And as a result, Nordic banks have avoided the volatility that racked the market following French president Emmanuel Macron's decision in early June to hold a snap election.

Nordic bank treasurers can go into the midsummer period happy that not only are their coffers full,

but also they have extended duration and funded at attractive levels.

After being forced to fund at the short end of the curve in 2023, Nordic banks have leapt at the chance to extend their duration in 2024. Last year, Nordic banks funded at an average tenor of 5.12 years, rising to 6.28 years in the first half of 2024. Seven years is the most popular tenor for Nordic issuance so far this year, with €4bn worth of deals printed, up from €2.5bn throughout the whole of 2023, *GlobalCapital* data shows.

Not only are Nordic banks able to fund further down the curve, but they have found themselves coming very close to, or even through, secondary levels this year.

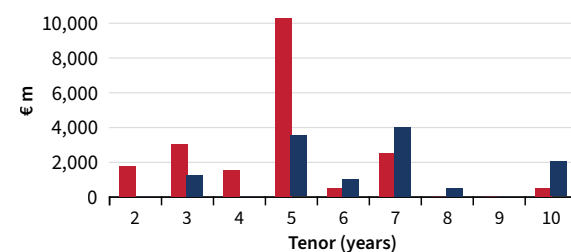
Last year for instance, Norwegian banks paid on average 4.7bp of concession, but that has fallen to minus 0.25bp this year. In fact, Eika Boligkreditt's €500m 2.875% March 2029 note, sold on March 12, paid the smallest concession for a European deal so far this year, PMM data shows. The five year bond landed at 28bp over mid-swaps — 4bp inside fair value. And despite the tight level, accounts still showed a willingness to invest as they poured €3.4bn of orders into the book at the final terms.

Of course, these smaller premiums are being paid on wider spreads. Eurozone spreads inched wider throughout the latter half of 2023 before showing signs that they might tighten again late in the second quarter this year.

The average spread for a fixed rate Nordic deal rose from 17.3bp in the first quarter last year to 41.3bp in the final quarter. However, this latter spread is elevated slightly thanks to the wide 90bp spread paid by Danish Ship Finance for its €500m 4.375% October 2026 ship covered bond in October. Omitting this deal brings the average spread down to 33.2bp

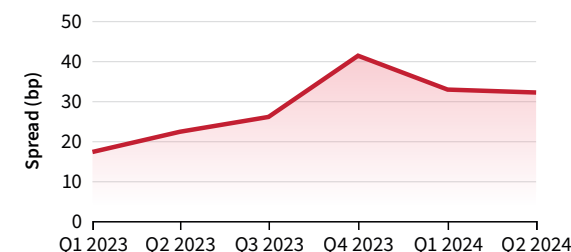
Benchmark euro new issues by tenor

● 2023 ● H1 2024



Source: *GlobalCapital's* Primary Market Monitor

Average Nordic euro covered bond spread to mid-swaps



Source: *GlobalCapital's* Primary Market Monitor

— a level that is still close to twice what was paid in the first quarter, according to PMM data.

New issue spreads have stabilised in 2024, remaining at 32.8bp and 32.1bp in the first and second quarters, respectively.

These elevated levels, however, do represent an excellent entry point for investors looking to lock in high spreads and high yields ahead of further eurozone rate cuts later this year. This played out in higher average orderbook subscription ratios across the Nordic region. Nordic covered bonds were on average 1.7 times subscribed in 2023, rising to 3.3 times in the first quarter 2024 before falling slightly to 2.7 times in the second quarter. **GC**



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