Medium-term Debt Management Strategy

2014 – 2017

Ministry of Finance
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1 Executive Summary

The Medium-term Debt Management Strategy 2014-2017 (MTDS) reflects the government's plans for financing its activities during this period. The principal objective of the strategy is to ensure that the Treasury's financing needs and payment obligations are met at the lowest possible cost that is consistent with a prudent risk policy. It is also intended to encourage the further development of efficient primary and secondary markets for domestic Treasury securities.

Benchmark Treasury notes series are structured so that each series will be large enough to ensure effective price formation on the secondary market. Each year effective price formation for 2Y, 5Y and 10Y benchmark Treasury notes series will be ensured. To reduce refinancing risk, the aim is to make the repayment profile of Treasury securities as even as possible. Average time to maturity should be at least 4 years.

Treasury borrowing in foreign currency is used to strengthen the Central Bank's foreign currency reserves. Regular issuance of Treasury market bonds on international markets, aimed at a diversified investor base, is envisaged in coming years.

At year-end 2013 gross Treasury debt amounted to around 82% of GDP. Gross debt is to be gradually reduced during this period to around 70% by year-end 2017. At year-end 2013 net debt was 47% of GDP and is to be reduced to around 37% of GDP by year-end 2017.

This strategy describes the objectives of debt management and the guidelines followed, gives a breakdown of the Treasury's current debt profile and explains the main risk factors in its debt management, as well as the Treasury's contingent exposures. It describes the institutional structure of debt management and how information disclosure to market actors and investors is carried out. The Ministry of Finance and Economic Affairs is responsible for the state's debt management, formulates its financing strategy and makes decisions on securities issuance. Government Debt Management, a special section within the Central Bank of Iceland, handles the implementation of the strategy under an agreement with the Treasury.

The Medium-term Debt Management Strategy is updated and revised annually.

2 Debt Management Objectives

The principal objectives of Treasury debt management are:

1. to ensure that the Treasury's financing needs and payment obligations are met at the lowest possible longer-term cost that is consistent with a prudent risk policy;
2. to ensure that the debt repayment profile accords with the Treasury's longer-term payment capacity and minimise refinancing risk;
3. to maintain and encourage the further development of an efficient primary and secondary market for domestic Treasury securities;
4. to attract a diverse group of investors in Treasuries and take advantage of a variety of funding sources.

2.1 Debt management strategy

The Medium-term Debt Management Strategy 2014-2017 (MTDS) reflects the government's plans for financing its activities during this period. The strategy is updated and revised annually.

The aim is to map out a clear debt management policy, with quantitative objectives, and develop analytical tools to identify, monitor and mitigate potential risk factors inherent in the debt portfolio.

The MTDS creates the policy framework for undertaking debt management actions aimed at minimising the Treasury's interest expense with a prudential degree of risk.

3 Debt Management Guidelines

This section describes the guidelines for active management of the Treasury's debt portfolio in the medium term.

In order to meet the demand for new Treasury issues and to increase the liquidity of benchmark series, efforts will be made to replace non-marketable Treasury debt with benchmark series insofar as market conditions permit. Such exchanges must be consistent with the objective of minimising the Treasury's interest expense in the long term while ensuring a prudential degree of risk.

3.1 Debt portfolio structure

The following discussion of the debt portfolio structure excludes loans taken to strengthen foreign currency reserves. A special policy applies to loans taken to reinforce currency reserves, which will be discussed in Chapter 5 on foreign loans.

The composition of the debt portfolio is aimed at minimising overall risk and encouraging a well functioning market which can attract a diverse group of investors and set pricing benchmarks for other financial products.

Non-indexed Treasury notes will be the main focus, as such issues form the basis of an active bond market. Inflation-indexed Treasury notes are issued at irregular intervals, subject to the funding needs and circumstances in each instance. New Treasury borrowing in foreign currency will be used to strengthen the Central Bank's foreign currency reserves. Although the policy does not envisage foreign currency borrowing to finance Government operations, there is some limited scope for such borrowing; the proportion will be kept low to facilitate efficient management of the portfolio in the face of exchange rate volatility.

The guidelines for the composition of the Treasury's debt portfolio are as follows:

Non-indexed debt	60-90%
Inflation-indexed debt	10-30%
Foreign-denominated debt	0-10%

Figure 1 gives a breakdown of the debt portfolio at year-end 2013, excluding loans to reinforce foreign reserves. Changes made to the Treasury's loan to the Central Bank in January 2014 altered the composition of the portfolio which is not foreign currency reserve loans, increasing the share of non-indexed loans to 74% and reducing the share of inflation-indexed loans to 23%.

Debt Portfolio Composition Excl. Currency Reserve Loans

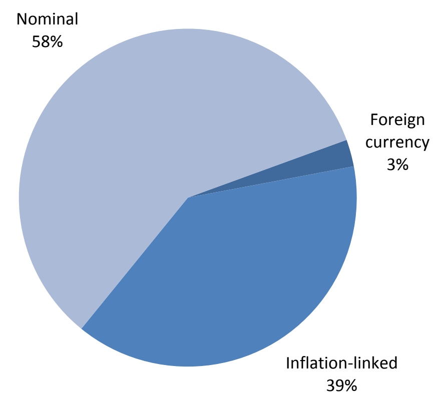

Figure 1

3.2 Borrowing guidelines

The Ministry of Finance and Economic Affairs has set guidelines for debt management based on the provisions of the Act on Government Debt Management. The principal guidelines for the debt portfolio are:

1. *Repayment profile:*
   The longer-term repayment profile of Treasury securities issued should be as smooth as possible, with the individual series issued of similar final size.
2. *Benchmark series:*
   Benchmark Treasury notes series will be structured so that each series will be large enough to ensure effective price formation on the secondary market. The number and size of the series shall be suited to the Treasury's debt. The aim is to have the final size of each series issued range from ISK 40-100 billion, however, with the exception that the minimum size of exclusively 2Y series shall be ISK 15 billion.
3. *Refinancing percentage:*
   Treasury debt maturing within each twelve-month period, net of any undrawn credit facilities, may not exceed 20% of GDP.
4. *Maturity:*
   The average term to maturity of the debt portfolio shall be at least four years.
4. *Deposits:*
   The guideline is to have domestic Treasury deposits with the Central Bank amount to ISK 60-70 billion on average

3.3 Quantitative targets

Clear, quantitative targets for debt management provide an assessment of Treasury debt sustainability. The targets are based on Iceland's economic programme and macroeconomic situation. In accordance with the medium-term baseline forecast for 2014-2017, the targets are:

1. Gross Treasury debt as a ratio of GDP will be 70% in 2017 and decrease to below 60% of GDP in the longer term.
2. Redemption of domestic Treasury notes as a ratio of GDP will be less than 10% annually.

These targets are subject to review of macroeconomic and Treasury assumptions. The assumptions will be updated as necessary.

4 Domestic Bond Issuance

The Treasury's financing needs will be met, firstly, through issuance of securities on the domestic market and, secondly, with a reduction in Treasury balances with the Central Bank of Iceland. This section focuses on medium-term financing needs and Treasury deposits. It also discusses Treasury securities issuance, including policy with regard to the repayment profile and average duration, as well as the build-up of benchmark issues.

4.1 Financing needs

The Treasury’s estimated financing needs are based on assumptions in the 2014 National Budget for the current year and on assumptions presented by the Ministry of Finance and Economic Affairs in *Fiscal policy 2015-2017* (Icel. *Ríkisfjármálaáætlun 2015-2017*).

The net financing balance shows whether operations for the year deliver a surplus to reduce debt. The balance is either positive or negative. A positive balance indicates a surplus on Treasury operations and financial activities which can be utilised to reduce debt. A negative balance reflects a deficit on Treasury operations and financial activities which will have to be financed by borrowing or a decrease in cash and cash equivalents.

Table 1 shows the net financing balance according Treasury estimates for 2014-2017. The surplus forecast for the next few years is reversed with a deficit in 2017.

Net financing balance (ISKm)

2014	2015	2016	2017
17,700	14,400	17,500	-3,300

Table 1

4.2 Deposits

Treasury deposits with the Central Bank of Iceland in ISK amounted to around ISK 87 billion at year-end 2013. The guideline is to have domestic Treasury deposits with the Central Bank amount to ISK 60-70 billion on average.

4.3 Treasury securities issuance

This section deals with the arrangements for issuance of Treasury securities.

4.3.1 Structure of benchmark series

Benchmark Treasury notes series will be structured so that each series will be large enough to ensure effective price formation on the secondary market. The number and size of the series shall be suited to the Treasury's debt. The aim will be to distribute each year’s Treasury note issuance more or less evenly among quarters. Furthermore, notes of varying maturities will be issued each year, with emphasis placed on issuing 2Y, 5Y and 10Y series.

When a 10Y benchmark series is first auctioned, it will mature after approximately 11 years. Notes will be sold from the series until 9 years remain to maturity, when issuance of the series will be provisionally suspended. The series will be re-opened when approximately 6 years remain to maturity and will be offered for sale until 4 years remain to maturity (5Y series). It will then be re-opened once more when 2 years remain to maturity (2Y series). Effective price formation will be ensured each year for 2Y, 5Y and 10Y benchmark series, while issuance for the year in each series will be determined by financing needs in each instance as well as by the size of the note series in question. Indexed and non-indexed Treasury notes with maturities other than 2, 5, and 10 years will be issued irregularly, depending on the Treasury's financing needs and current circumstances.

The aim is for the final outstanding stock in each series to range from ISK 40-100 billion, however, with the exception that the minimum size of exclusively 2Y series shall be ISK 15 billion. Efforts will be made to expedite building up the series until they reach a size sufficient to ensure effective price formation in the secondary market. The size of notes series is also determined by the Treasury's current financing needs.

Six-month Treasury bills will be issued in series which can be re-opened at three months to maturity, enabling monthly sales of 3M and 6M Treasury bills. Monthly issuance of Treasury bills will vary depending upon investor demand and current Treasury financing needs.

Table 2 shows planned benchmark issuance.

Series	Maturity	Issue size	Frequency of issuance
Treasury bills	3M and 6M	ISK 2-30 billion	Monthly
Non-indexed Treasury notes	2Y	ISK 40-100 if previously issued with a longer term, otherwise ISK 15-100 billion if issued for only 2Y	Annually
Non-indexed Treasury notes	5Y	ISK 40-100 billion	Annually
Non-indexed Treasury notes	10Y	ISK 40-100 billion	Annually
Non-indexed Treasury notes	Other maturities	ISK 40-100 billion	Irregularly
Indexed Treasury notes	Varying maturities	ISK 40-100 billion	Irregularly

Table 2

4.3.2 Treasury securities issuance schedule from 2014

Planned issuance for 2014 is ISK 50 billion, as stated in the Government Debt Management Prospectus published at the end of last year. Table 3 is a provisional issuance schedule for Treasury notes in the coming years. It should be borne in mind that the table is provided for illustrative purposes, to show how benchmark series will be built up, and actual issuance is subject to change. The table shows already issued Treasury securities with the identifier codes of the series concerned. The identifier RB 15 0408 means that the note is non-indexed and matures on 8 April 2015. Series yet to be issued are identified in a similar manner, the numbers preceding the dash indicate the maturity year while the numbers after it indicate the length of the note, i.e. 2-, 5-, or 10-year benchmark series. The shaded cells show when the series are open. Issuance in series with other maturities will be irregular, depending on the Treasury's financing needs and investor demand.

In 2014 effective price formation with the Treasury notes series RIKB 16 1013 (2Y), RIKB 20 (5Y) and RIKB 25 0612 (10Y) will be ensured. Issuance in these series will depend on their total size and the Treasury's financing needs. Issuance of other series will then be determined by issuance of these three series and the Treasury's financing needs.

Provisional issuance schedule

Year	2014	2015	2016	2017	2018	2019	2020	2021	2022
	RB	RB	RB	RB	RB	RB	RB	RB	RB
0	**14 0314**	**15 0408**	**16 1013**	17-2Y	18-2Y	**19 0226**	20-2Y	21-2Y	**22 1026**
1	**15 0408**	**16 1013**	17-2Y	18-2Y	**19 0226**	20-2Y	21-2Y	**22 1026**	23-2Y
2	**16 1013**	17-2Y	18-2Y	**19 0226**	20-2Y	21-2Y	**22 1026**	23-2Y	24-2Y
3			**19 0226**	20-5Y		**22 1026**			**25 0612**
4		**19 0226**	20-5Y		**22 1026**			**25 0612**	
5	**19 0226**	20-5Y		**22 1026**			**25 0612**		
6	20-5Y		**22 1026**			**25 0612**			28-5Y
7		**22 1026**			**25 0612**			28-10Y	
8	**22 1026**			**25 0612**			28-10Y		
9			**25 0612**			28-10Y			**31 0124**
10		**25 0612**			28-10Y			**31 0124**	
11	**25 0612**			28-10Y			**31 0124**		

2Y Treasury notes **5Y Treasury notes** **10Y Treasury notes**

Table 3

4.3.3 Repayment profile

One of the objectives of debt management is to ensure that the repayment profile of Treasury securities is as even as possible. To reduce refinancing risk, the aim is to keep the size of each series at or below ISK 100 billion upon maturity. Figure 2 shows the repayment profile of domestic Treasury debt at year-end 2013 if Treasury bills are excluded.

In 2008 the Treasury issued a 5Y indexed bond to refinance the Central Bank of Iceland after the failure of the commercial banks. The bond matured on 1 January 2014. In recent quarters the Ministry of Finance and Economic Affairs and the Central Bank have been working on revising the financial relationship between the Treasury and the Central Bank. A new rule on capital requirements which will be proposed in a bill amending Act 91/2001, on the Central Bank of Iceland, and is expected to be presented to the Icelandic Parliament *Althingi* in the autumn months, will release some ISK 26 billion which will be used to reduce the Treasury's obligations to the Central Bank. The balance on the bond at year-end 2014 will therefore be ISK 145 billion. The outstanding balance on the bond will be extended and the terms of the bond altered to make it non-indexed; the interest will be based on the Central Bank's deposit rate and the bond given an instalment period of 29 years.

The Treasury's largest individual maturity will be in 2018, when the series RIKH 18 1009 matures in a total amount of ISK 213 billion. This series was issued especially to finance equity contributions by the state, and against it the state holds assets in the form of share capital and subordinated debt. In coming years measure may be taken to reduce refinancing risk on loans with large maturities, including buybacks and bond swap auctions, including for RIKH 18.

Domestic Redemption Profile

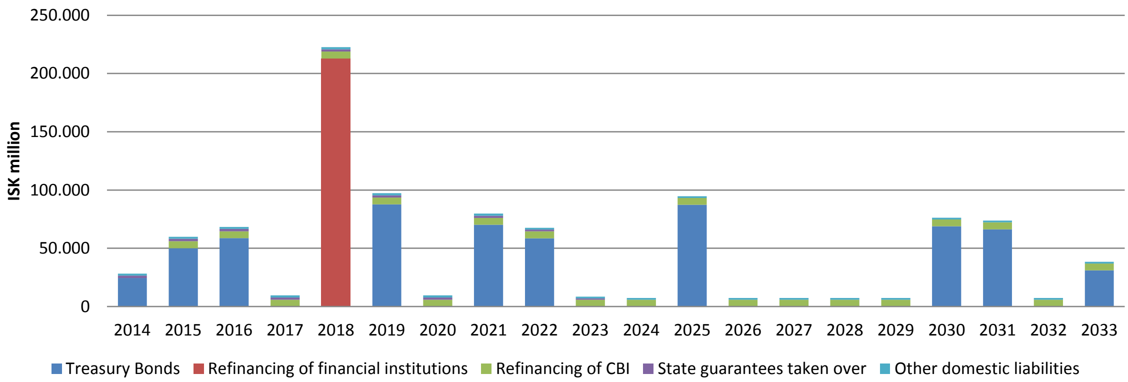

Figure 2

4.3.4 Average term to maturity

The aim is to have the average term to maturity of Treasury securities at least 4 years. In recent years specific efforts have been directed at lengthening the average term to maturity of outstanding loans. The average term to maturity is managed with issuance of securities of varying maturities. If domestic market conditions permit, the Treasury can also use interest rate swaps, buybacks and/or swap auctions to keep the average term to maturity above the set minimum. As of year-end 2013 the average term to maturity was 6.3 years.

5 Foreign Issues

The Treasury borrows in foreign currencies primarily to strengthen the Central Bank's foreign reserves and not to finance Treasury operations. Some scope, however, is provided in the Treasury's debt portfolio structure for foreign currency borrowing to finance its operations, but the proportion of such loans will be kept low to facilitate efficient management of the portfolio in the face of volatility of foreign currencies.

The strategy for foreign debt financing aims at ensuring regular access to international credit markets and maintaining access to a diverse investor group. To this end regular issuance by the Treasury of market bonds on foreign markets is envisaged. The main purpose of this strategy is to refinance outstanding market bonds and debt in connection with the economic recovery programme agreed by the Icelandic government and IMF. Regular issuance of debt instruments on international capital markets is also intended to enhance name recognition of the Republic of Iceland as an issuer.

The Central Bank seeks to steer the currency composition of its foreign reserves to keep the value of its foreign-denominated assets net of foreign-denominated debt as constant as possible. The currency breakdown of the reserves therefore reflects the breakdown of foreign loans provided by the Treasury to the Central Bank of Iceland to reinforce its foreign reserves. Generally speaking, this is an asset and liability strategy where the Treasury and Central Bank's balance sheets are considered on a consolidated basis.

Foreign currency redemption profile

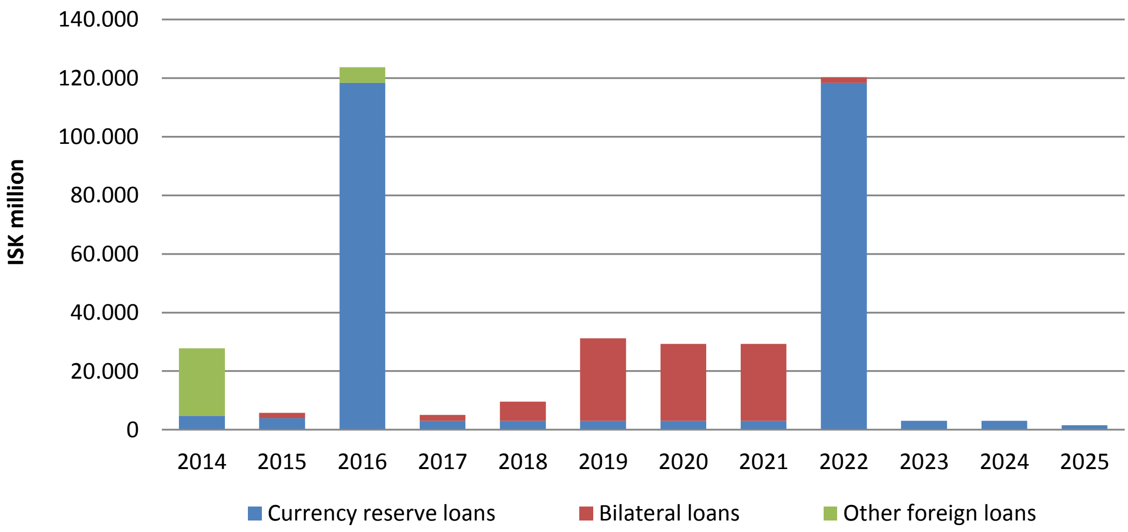

Figure 3

Figure 3 shows the repayment profile of Treasury obligations in foreign currencies as of year-end 2013. In March 2014 debt of USD 200 million matured, an issue from 2004. The largest maturities in the coming years are in 2016 and 2022, Treasury issues in 2011 and 2012 of USD 1 billion in each instance. From 2019 to 2021 inclusive, bilateral loans from Nordic countries and Poland, taken in connection with the economic recovery programme agreed by the Icelandic government and IMF, mature. Norway and the IMF granted loans directly to the Central Bank of Iceland and these are not on the Treasury's balance sheet. In 2012 the Treasury and the Central Bank prepaid part of the loans from Nordic countries (59%) and the IMF (63%) and the aim is to prepay the outstanding balances on these loans if market circumstances permit; they can be prepaid without a prepayment charge.

6 Treasury Debt Position

This chapter describes Treasury debt and the composition of the debt portfolio, including loans taken by the Central Bank of Iceland to reinforce currency reserves.It also reviews the debt repayment profile and provides information on the Treasury's investor base. Figure 4 shows the development of Treasury debt, excluding pension liabilities, from 2007 to 2013, with forecasts for the years after that until 2017.

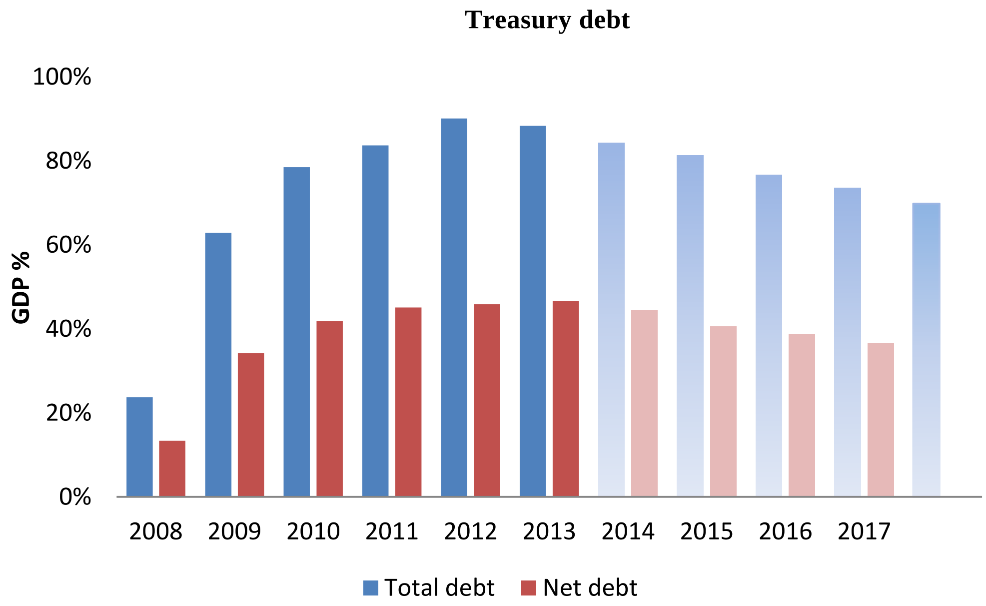

Figure 4

6.1 Treasury debt

Treasury debt has increased substantially since 2007, rising from ISK 311 billion to around ISK 1,461 billion at year-end 2013. At year-end 2013 the position was equivalent to around 82% of GDP. The intention is to reduce this in stages to around 70% of GDP by year-end 2017. Table 4 shows a breakdown of Treasury debt at year-end 2013.

At year-end 2013 net debt was 47% of GDP. Net debt is total debt net of interest-bearing assets, receivables and cash. Cash and receivables amounted to ISK 730 billion at year-end 2013.

Treasury debt as of 31 December 2013

			Amounts in ISKm
Domestic			
Market securities			
	Treasury bills		21,600
	Indexed notes		199,800
	Non-indexed notes		410,700
	Refinancing of financial institutions		212,900
Non-market debt			
	Refinancing of CBI		170,900
	Other domestic liabilities		57,000
		Total	1,072,900
Foreign borrowing			
Currency reserve loans			
	Bilateral loans		93,000
	Currency reserve loans		230,600
	Other foreign loans		64,900
		Total	388,500
		Total	1,461,400

Table 4

6.1.1 Domestic borrowing

Market securities include Treasury bills, indexed and non-indexed Treasury notes and a special benchmark bond issue to finance capital injections and subordinated loans to financial institutions. The special issue matures in 2018. As of year-end 2013 the outstanding balance on the issue was ISK 213 billion. It was issued at a variable interest rate to reduce interest rate risk in connection with the banks' obligations.

At year-end 2013, outstanding market securities amounted to ISK 845 million.

Non-market securities include the five-year inflation-indexed Treasury bond issued to recapitalise the Central Bank of Iceland after the banks' collapse in 2008. In addition to these liabilities most other non-market debts are attributable to the Treasury's acquisition of shares of Reykjavík and Akureyri in the National Power Company, Landsvirkjun. The Treasury's issue in connection with the acquisition of Landsvirkjun is an indexed amortised loan with final maturity in 2034.

At year-end 2013, outstanding non-market securities amounted to ISK 228 million.

6.1.2 Foreign borrowing

Loans concluded within the framework of the economic recovery programme agreed by the Icelandic government and IMF are used to strengthen the foreign exchange reserves of the Central Bank. The Treasury was granted loan facilities from Denmark, the Faroe Islands, Finland, Poland and Sweden, while the Central Bank received loans from the IMF and Norway.

The total amount of the Treasury's facilities was equivalent to ISK 235 billion (EUR 1,480 m).[1] The Treasury has drawn the full amount of loans from the Nordic countries and the Faeroe Islands, as well as about one-third of the Polish loan.

The loan from the IMF to the Central Bank was valued at ISK 248 billion (SDR 1,400 m) and the loan from Norway at ISK 76 billion (EUR 480 million).

The Treasury and the Central Bank of Iceland have repaid 63% of the original amount borrowed from the IMF and 59% of the original amount of loans from the Nordic countries. At the end of December 2012, the Treasury prepaid a loan in the amount of DKK 300 million from the Faroese government.

At year-end 2013, the Treasury's outstanding bilateral loans amounted to ISK 93 million.

Other loans taken to strengthen the Central Bank's foreign exchange reserves include two bond issues in 2011 and 2012, each in the amount of USD 1 billion. The outstanding balance on these loans as of year-end 2013 was ISK 231 billion.

Other foreign loans amount to ISK 65 billion.

6.1.3 Treasury debt structure

Figure 5 shows market and non-market Treasury debt, including loans to reinforce the foreign exchange reserves, as of year-end 2013. The loans are divided into three categories: non-indexed (44%), inflation-indexed (29%) and foreign currency loans (27%). Changes made to the Treasury's loan to the Central Bank in January 2014 altered the debt composition, increasing the share of non-indexed loans and reducing the share of inflation-indexed loans.

Breakdown of debt portfolio

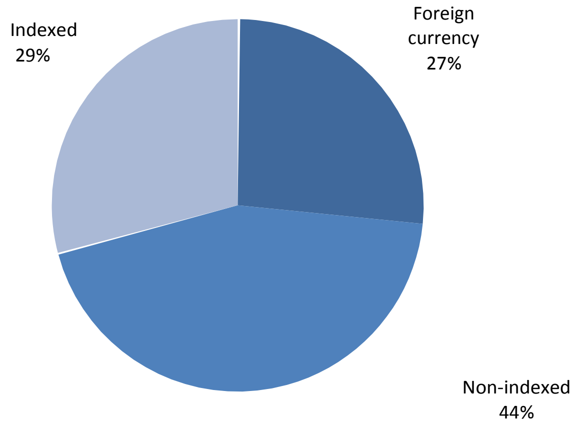

Figure 5

[1.] Central Bank's mid rate on 31 Dec. 2013: EUR/ISK 158.5 USD/ISK 115.03 and SDR/ISK 177.3.

6.1.4 Repayment profile

Figure 6 shows the repayment profile for Treasury debt as of year-end 2013. The largest maturities are in 2015, 2016, 2018 and 2022.

Repayment profile for Treasury debt

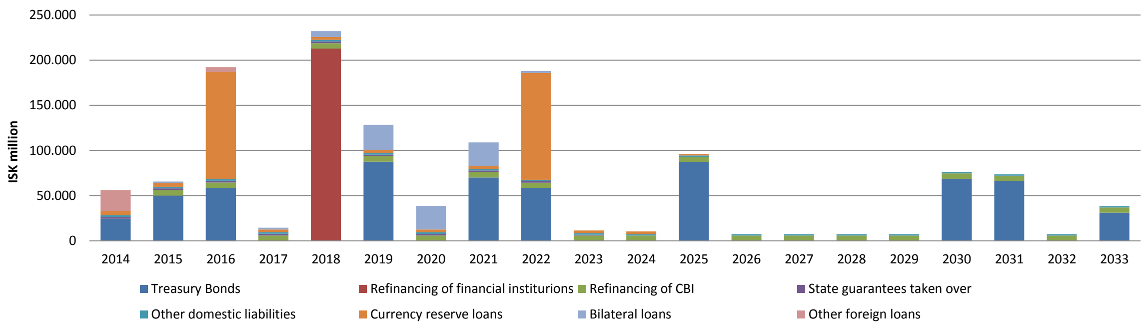

Figure 6

In 2008 the Treasury issued a 5Y indexed bond to refinance the Central Bank of Iceland after the failure of the commercial banks. The bond matured on 1 January 2014 but was extended by one year at year-end 2013. Following a Bill amending Act 91/2001, on the Central Bank of Iceland, which is to be presented to the Althingi in the autumn, changes are expected to the terms of this bond making it a non-indexed amortised bond with a 29 year maturity. The above figure takes these changes into consideration.

Foreign-denominated bonds issued in 2011 and 2012 (each in the amount of USD 1 billion) are scheduled to mature in 2016 and 2022, respectively. If market conditions are favourable, the Treasury may examine possibilities of reducing the refinancing risk before maturity with bond swaps or buybacks.

The bond issued to refinance the new banks matures in October 2018. At year-end 2013, the nominal value of the bond was ISK 213 billion. Treasury assets against this are shares and guarantee capital in financial undertakings and loans granted to them. Efforts will be directed at reducing the outstanding balance on this series with buybacks and bond swaps up until its maturity. Plans will be reviewed in the light of proposals to sell holdings.

6.2 Investors in domestic Treasury securities

The Treasury issues debt securities with varying maturities, intended to appeal to a broad base of investors and minimise financing costs. Figures 7 and 8 give a breakdown of owners of Treasury notes and Treasury bills as of year-end 2013.[2.]

[2.] Consideration is also given to securities lending when examining the ownership of Treasury securities.

Owners of Treasury securities

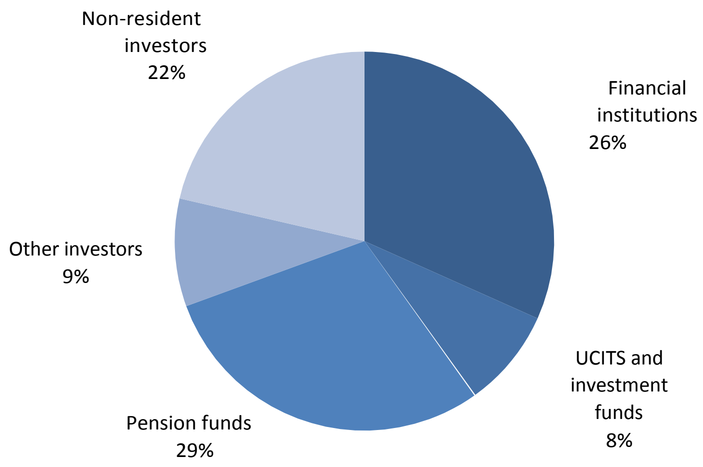

Figure 7

Financial institutions are among the leading holders of domestic Treasury securities with about 26% of the outstanding stock. The main reason for this is that the new banks were capitalised with the special Treasury bond issue, RIKH 18 1009.

Non-residents[3] own around 22% of domestic Treasury securities and pension funds around 29%. UCITS and investment funds own some 8% and other investors around 9%.

Owners of Treasury securities

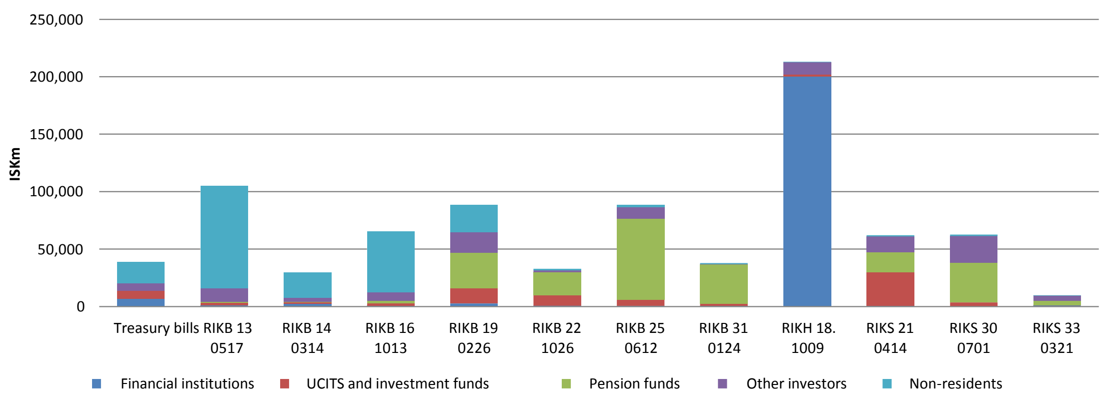

Figure 8

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3. In the Icelandic Securities Depository foreign investors are defined as legal entities with foreign registration numbers; however, it should be noted that some of these foreign registration numbers may belong to foreign investment companies owned by Icelanders.

7 Risk Management

Management of the debt portfolio must take into consideration various risk factors arising from market volatility, such as fluctuations in interest rates, exchange rates and inflation, as well as refinancing risk on outstanding loans. Management of these various risk factors is discussed in this chapter.

7.1 Market risk

Financial market volatility, whether due to fluctuations in interest rates, exchange rate movements or changes in inflation, results in fluctuations in the market value of the debt portfolio These risks, generally referred to as market risk, are discussed in more detail in the following sections.

Effective risk management is aimed at reducing risk while simultaneously minimising the interest expense on the portfolio. These goals can be achieved through active Treasury debt management and the targeted use of derivative products.

7.1.1 Interest rate risk

Interest rate risk is the risk of the Treasury's financing costs increasing due to changes in interest rate terms. The interest rate risk depends upon the structure of the debt portfolio. Variable interest rates create a risk of rate rises boosting the Treasury's interest expense.

Figure 9 gives a breakdown of the debt portfolio by type and interest rates as of year-end 2013. The majority of domestic and foreign Treasury notes, around 75%, bear fixed interest rates, making their payment flows known for their duration. For the remaining 25% with variable rates the payment flows will change in line with changes in the base interest rate of the loans in question. Interest rate swaps are used, for example, to increase the share of variable interest rate debt as part of risk management.

Interest rate breakdown December 2013

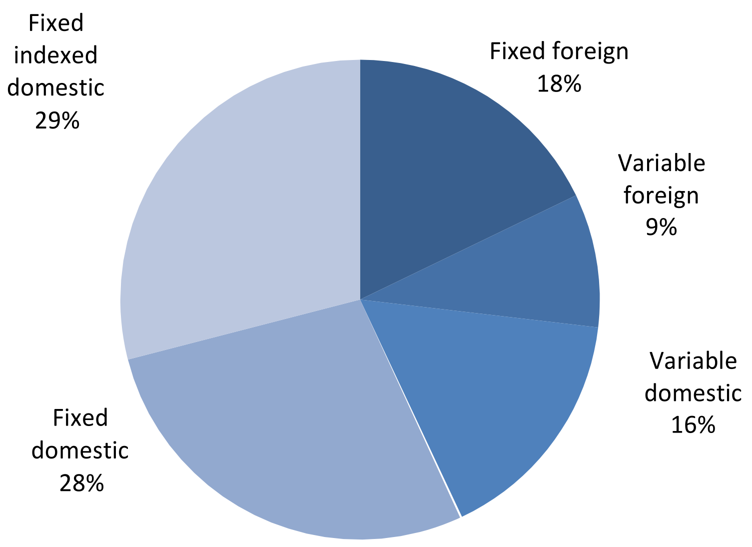

Figure 9

7.1.1.1 Interest rate swaps

The objective of the Treasury's debt management is to minimise interest expense in the long term while ensuring a prudential risk degree of risk. Interest rate swaps can serve as a means of minimising interest expense. Market actors have shown some interest in having the Treasury take the initiative here, as this would give them possibilities of increasing the variety of their offerings to include longer term products. The Ministry of Finance and Economic Affairs has obtained an independent expert to assess the advantages of such swaps for the Treasury. The conclusions are expected to be available in the autumn months, after which a decision will be taken on their use.

7.1.2 Currency risk

Currency risk is the risk that the Treasury’s debt position will deteriorate due to changes in the exchange rate of the ISK against other currencies. The Treasury’s direct currency risk is limited because foreign currency holdings and foreign-denominated bonds it holds offset its foreign debt. Foreign reserves are actively managed in accordance with guidelines for their currency composition by the Central Bank of Iceland to minimise currency risk.

7.1.3 Inflation risk

Inflation risk is the risk that indexation on inflation-indexed Treasury notes will mean higher financing costs as a result of increased inflation At year-end 2013 the Treasury's indexed debt amounted to ISK 421 billion, which is around 30% of its debt portfolio.

Inflation risk can also be managed with derivatives; however, current activity on the Icelandic derivative market is limited. The Treasury will be able to manage its inflation risk more effectively once the derivative market has picked up once more. The share of inflation-indexed debt in the overall portfolio is purposefully kept low due to the risk of higher inflation from ISK weakening upon the removal of capital controls. It should be borne in mind, however, that the Treasury holds a number of inflation-indexed assets, such as loans to the Icelandic Student Loan Fund, which mitigates inflation risk to some extent.

7.2 Refinancing risk

One of the greatest risks to the debt portfolio arises from its refinancing. To reduce refinancing risk, the Ministry of Finance and Economic Affairs aims to keep the repayment profile of government securities as smooth as possible over the long term.

The largest maturities of Treasury debt in coming years, involving the main refinancing risks for the portfolio, are:

a) 2016	ISK 115 billion	To reinforce currency reserves (foreign-denominated, taken 2011)
b) 2018	ISK 213 billion	Capital contributions to financial institutions
c) 2022	ISK 115 billion	To reinforce currency reserves (foreign-denominated, taken 2012)

a) In June 2011, the Treasury issued a bond in the amount of USD 1 billion, equivalent to ISK 115 billion (at the exchange rate USD/ISK at year-end 2013) with a yield of 4.993%. The intention is to refinance the bond prior to the due date in 2016 by issuing a bond on foreign credit markets.

b) In 2008, the Treasury issued a special 10Y bond series (RIKH 18) to finance capital contributions and subordinated loans to financial institutions. At year-end 2013 the outstanding balance was ISK 213 billion. This loan is offset by subordinated loans made to two financial undertakings equivalent to ISK 54 billion and which mature in 2019.

c) In May 2012, the Treasury issued a bond in the amount of USD 1 billion, equivalent to ISK 115 billion (at the exchange rate USD/ISK at year-end 2013) with a yield of 6.0%. The intention is to refinance the bond prior to the due date in 2022 by issuing a bond on foreign credit markets.

One of the uncertainties related to refinancing centres on whether non-residents will choose to continue investing in Icelandic government securities once capital controls have been lifted. It will be the government's task to minimise the impact of capital account liberalisation on the Treasury's financing.

The Treasury's domestic balance with the Central Bank of Iceland amounted to ISK 87 billion at year-end 2013. The guideline is to have domestic Treasury deposits with the Central Bank amount to ISK 60-70 billion on average. In addition, foreign balances were around ISK 309 billion. The Treasury's foreign balances are part of the Central Bank's foreign currency reserves. There are no plans to reduce these foreign balances unless successful moves are made towards relaxing capital controls. The substantial currency reserves have been considered necessary in view of the risk of ISK weakening which could result from the removal of capital controls. The domestic deposits are intended to meet fluctuations and in 2013 were reduced to cover a Treasury deficit rather than increase Treasury notes issuance for the year. From 2014 onwards a Budget surplus is expected, reducing the need for issuance in the current year. Should there be major deviations from the forecast outcome for the year this will be met with increased Treasury notes issuance or by reducing the balance with the Central Bank.

7.3 Contingent exposures

Contingent liabilities are financial obligations that could fall on the Treasury; for example, due to state guarantees or administrative decisions that entail involvement in the financing of municipalities or corporations of key importance in Icelandic society. The scope of this risk factor is discussed in sections
7.3.1-7.3.4.

7.3.1 State guarantees

State guarantees represent the Treasury's largest indirect liability. State guarantees are governed by Act No. 121/1997. The Treasury may not grant state guarantees without a statutory authorisation from the Althingi.

Matters connected to state guarantees are handled by the State Guarantee Fund, which compiles information on the position of the undertakings benefiting from guarantees and assesses the risk of granting guarantees. The Central Bank of Iceland oversees state guarantees under an agreement with the Minister of Finance and Economic Affairs. The State Guarantee Fund notifies the Minister of Finance and Economic Affairs if a state guarantee is likely to be called upon. Table 5 shows the status of state guarantees as of the end of December 2013.[4.]

[4.] Market information in January 2014. (http://www.lanamal.is/en/news/market-information)

State guarantees

Position 31 Dec. 2013	Amt. in ISKm	%
Housing Financing Fund	923,492	73%
Landsvirkjun	309,531	24%
Others	31,226	2%
Total	1,264,249	

Table 5

As of 31 December 2013, state guarantees amounted to ISK 1,264 billion or the equivalent of 71% of GDP. The largest entities enjoying state guarantees on their borrowing are the Housing Financing Fund, with around 73% of the total, and Landsvirkjun, with around 24%.

7.3 1.1 Housing Financing Fund (HFF)

Pursuant to the Housing Act, No. 44/1998, the role of the Housing Financing Fund is to provide loans for the purchase of residential housing in Iceland. HFF is supervised by the Financial Supervisory Authority.

In 2013 the Fund's operating results were negative by ISK 4,354 million, compared to a loss of ISK 7,856 million the previous year. At year-end HFF’s capital was ISK 14.8 billion, taking into consideration an increase to its initial capital of ISK 4.5 billion. HFF's capital ratio, calculated as provided for in Regulation No. 544/2004, on the Housing Financing Fund, is 3.4%.

The risks facing the Housing Financing Fund are credit risk, liquidity risk, interest rate and inflation risk, prepayment risk, refinancing risk and operational risk. Of these, prepayment and credit risk are by far the most significant, which is reflected in the fact that HFF's losses in recent years are primarily due to loan impairment and increased paybacks of its loans.

Interest rate risk is also an important risk factor, as net interest income is a large item of HFF’s profit and loss account. HFF's low capital ratio makes more difficult for it to meet the risks in its operations, making the financial risk to the Treasury greater as a result.

Since 2010, Althingi has approved contributions of ISK 46 billion to boost its equity. The 2014 Budget provides for a contribution of ISK 4.5 to HFF. Other things remaining equal, the Fund will require further capital injections in coming years.

A working group about the future of housing market has generated Minister of Social Affairs and Housing their proposals and they are to be processed in the Ministry of Welfare.

7.3.1.2 Landsvirkjun

Landsvirkjun’s financial position is acceptable, with EBITDA amounting to USD 329.1 million in 2013, compared with USD 321.3 million the previous year. At the end of the period its equity ratio was 36.3% compared with 37.6% at year-end 2012. The company’s liquidity is sound because of its strong cash position and undrawn revolving credit facilities, and the group is well situated to service its debt in coming years. While its net debt is unchanged from the previous year, the undertaking’s net liabilities have been reduced by a total of USD 420 million since 2008. It is nonetheless important to continue this process in light of the undertaking’s comparatively high indebtedness. Landsvirkjun’s basic operations, electricity generation and delivery, have been successful, with electricity purchases by its customers increasing in the first half of last year by 5%, or the equivalent of 300 gWh over the same period the previous year.

Landsvirkjun’s basic operations, electricity generation and delivery, have been successful, with electricity purchases by its customers increasing in the first half of last year by 5%, or the equivalent of 300 gWh over the same period the previous year.

Landsvirkjun’s financial risk consists of market risk, liquidity risk and counterparty risk. It has systematically reduced its market risk. An agreement negotiated in 2010 between Landsvirkjun and Alcan Iceland removed the electricity price linkage to aluminium prices in the previous contract and linked all sale of electricity to Alcan to the US CPI. The share of Landsvirkjun’s electricity sales indexed to aluminium prices has therefore decreased considerably, from 70% to 45% in recent years.

The company's operations will continue to be sensitive to changes in aluminium prices and interest rates. More equal distribution of instalments and interest, and long residual maturities of outstanding debt reduce refinancing risk. The company's most recent bond issue, in August 2013, was without a state guarantee.

7.3.2 Municipalities

While there is no legally mandated state guarantee on local authorities' debt, their financial position can generally threaten the ability of individual local authorities to fulfil their tasks and their overall debt level poses a risk to the economy and the Treasury. As a result the high indebtedness of some municipalities and their weak financial position is cause for concern.

Althingi passed legislation on municipal affairs in 2011 providing for increased discipline and setting clearer rules for local authorities' finances, as well as increased supervision and information disclosure on financial affairs. It stipulates, firstly, that that combined Part A and Part B revenues and expenditures of municipal consolidations must be in balance each three-year period. Secondly, total debts and obligations may not exceed 150% of revenues. Clearly many local authorities will need a number of years to adapt their debt position to this maximum. The Act provides for a maximum period of 10 years. It is important to use this time well so that local authorities' finances become sustainable as soon as possible. The Act makes decisions on municipal investment, development, or other contractual obligations exceeding 20% of the current year’s tax revenues subject to an impartial appraisal of the impact on the municipality’s financial position.

7.3.3 Public-private partnerships

Public-private partnerships can entail financial risk for the Treasury, even in the absence of a state guarantee. Public-private partnerships are governed by the Regulation on Service Agreements, No. 343/2006. The purpose of the Regulation is to define the role and responsibilities of parties managing long-term projects for individual ministries and public institutions. According to the Government Financial Reporting Act, agreements of this kind must be approved by Althingi. While such partnerships usually represent little direct financial risk to the Treasury, circumstances can develop where the projects need capital exceeding current budget allocations. The main public-private partnerships currently underway are operation of the Harpa Concert Hall and Convention Centre and the Vaðlaheiðargöng tunnel.

8 Institutional structure

In the national Budget each year, Althingi authorises the Ministry of Finance and Economic Affairs to borrow funds and issue state guarantees. The Act on Government Debt Management states that the Ministry is responsible for and implements debt management and state guarantees. The Ministry of Finance and Economic Affairs has an agreement with the Central Bank of Iceland for provision of advice and execution in connection with the Treasury's debt management. The agreement contains explicit provisions on division of tasks and responsibilities to ensure that debt management decisions are taken independent of the Central Bank's monetary policy.

8.1 Ministry of Finance and Economic Affairs

The Ministry of Finance and Economic Affairs handles Treasury debt management and makes decisions on the volume of issuance, planned bond auctions and liquidity management. The Ministry decides on yields and the amounts of bids accepted in Treasury auctions. It also determines the structure, maturity and characteristics of new series, as well as deciding on buybacks and/or swaps.

8.2 Central Bank of Iceland

The Ministry of Finance and Economic Affairs has an agreement with the Central Bank of Iceland for advice and implementation of debt management.[5.]

The agreement is aimed at promoting more economical, efficient and effective debt management based on the Ministry's debt management strategy. A special department within the Central Bank of Iceland, Government Debt Management, is mandated by the Ministry of Finance and Economic affairs to handle Treasury debt management in accordance with guidelines adopted by the Ministry. Government Debt Management is responsible for ensuring that borrowing and debt management comply with the strategy set out by the Ministry.

It also supervises state guarantees and assesses the Treasury's risk arising from such guarantees. The department provides the Ministry with opinions on state guarantees and grants them if authorised by Althingi.

On behalf of the Ministry of Finance and Economic Affairs, Government Debt Management handles regular information disclosure on the Treasury's domestic and foreign liabilities to market actors, and publishes information on auction dates and volume of issuance each year based on the Treasury's estimated financing needs. It also issues news announcements regarding debt management on behalf of the Ministry of Finance and Economic Affairs.

8.3 Consultative Committee on Debt Management

The Ministry of Finance and Economic Affairs appoints a Consultative Committee on Debt Management, comprised of representatives of the Ministry and the Central Bank.

[5.] The Government Debt Management Agreement of 18 October 2010, based on an agreement of 4 September 2007.

The Consultative Committee serves as a forum for the exchange of views on the situation and outlook on capital markets, and on the Treasury's domestic and foreign borrowing and borrowing plans. It is also intended to encourage such improvements to the domestic credit market as it deems appropriate.

The Committee makes proposals to the Ministry of Finance and Economic Affairs on the structure of individual bond series, their maturity and size, as well as arrangements for market-making and auctions. It also proposes risk management guidelines for the Treasury's domestic and foreign debt portfolios. The Committee discusses and adopts proposals for the Treasury's issuance schedule in domestic and foreign markets. This schedule specifies the volume of issuance for the year, dates of issuance and planned borrowing actions. It must be approved by the Ministry of Finance and Economic Affairs and then announced to market actors. The Committee is to meet on a monthly basis or more frequently if necessary.

9 Information Disclosure to the Market

The Ministry of Finance and Economic Affairs and Government Debt Management communicate with market actors through regular information disclosure and meetings with both primary dealers and investors. All news announcements are published on the website of NASDAQ OMX Nordic Exchange in Iceland and on Bloomberg, and are distributed to the media and market actors. The Exchange uses the data vendor GlobeNewsWire to distribute announcements to foreign media and market actors.

Publications on debt management issued by the Ministry of Finance and Economic Affairs include:

- Medium-term Debt Management Strategy
- Annual Debt Management Schedule
- Quarterly Debt Management Prospectus
- Auction announcements
- Planned auction dates
- Market Information

9.1 Medium-term debt management strategy

The Ministry of Finance and Economic Affairs prepares the Medium-Term Debt Management Strategy (MTDS), which is revised and published annually. It includes the following topics:

- Debt management objectives
- Debt management guidelines
- Issuance policy
- Structure of Treasury debt
- Risk management
- Contingent liabilities

9.2 Annual Debt Management Schedule

The Annual Debt Management Schedule is intended to provide market actors with general information on Treasury issuance for the coming year. The Schedule is published after Althingi has adopted the Budget and includes the following information:

- Total volume of issuance for the year in question
- Issuance policy for the year in question
- Buybacks
- Bond swap auctions

9.3 Quarterly prospectus

At the end of each quarter, Government Debt Management issues a prospectus for the coming quarter including the following information:

- Planned issuance of Treasury notes for the quarter
- Planned issuance of Treasury bills
- Summary of issuance in the previous quarter
- Actions scheduled for the coming quarter

9.4 Auction announcements

News announcements on individual auctions are published on NASDAQ OMX Nordic Exchange in Iceland at least one business day prior to each auction, indicating what series are to be offered in each instance. The results are published following the auction on that same day.

9.5 Planned auction dates

In December of each year, scheduled Treasury bills and Treasury notes auction dates for the upcoming year are published on the Government Debt Management website and distributed directly to market actors.

9.6 Market Information

Government Debt Management publishes a monthly newsletter entitled Market Information containing important information on Treasury debt and state guarantees. Market Information is distributed to the media and to market actors and published on the Government Debt Management website. It includes the following information:

- Last month's main news
- Results of Treasury auctions
- Government debt statistics
- Positions of benchmark series
- Structure of Treasury debt
- Repayment profile for Treasury debt
- Owners of Treasury securities
- Securities loans
- State guarantees

9.7 Government Debt Management website

On its website, www.lanamal.is, Government Debt Management makes available information on Treasury debt management, market prices and yields and historical statistics on Treasury securities, as well as issue prospectuses. The following information is also available there:

- Medium-term Debt Management Strategy
- Annual Debt Management Schedule
- Quarterly Government Debt Management Prospectus
- Auction announcements
- Market Information
- News announcements
- Sovereign ratings of the Republic of Iceland

Information on Treasury debt is also available on the Ministry of Finance and Economic Affairs website: www.fjr.is.

9.8 Primary dealers in Treasury securities

Government Debt Management monitors primary dealers on a daily basis to ensure they fulfil their market-making obligations in the secondary market. Meetings with primary dealers are held at least quarterly, and more frequently if necessary.

9.9 Investors

Representatives from Government Debt Management and the Ministry of Finance and Economic Affairs meet with investors to present emphases in Treasury debt management.