

The Icelandic Fixed Income Market: Facts and Figures

Focus

2006:1

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Listed fixed income securities

In recent years the Icelandic fixed income market has attracted increased interest from foreign investors due to the fact that the majority of the value of listed bonds are state-guaranteed, investment grade issues that offer substantially higher yields than their international counterparts. The following is an overview of the Icelandic bond market, currency and monetary policy.

Market structure

The total market value of fixed income securities at the end of November 2005 was ISK 987 billion, or roughly equal to estimated GDP for the year.

The two largest issuers of fixed income securities listed on the Iceland Stock Exchange (ICEX) are the Icelandic Government (through the National Debt Management Agency (NDMA) and the state-owned Housing Financing Fund (HFF)). The NDMA Treasury notes are benchmarks for non-indexed bonds, while HFF bonds serve as indexed benchmarks. Smaller issuers include domestic banks, municipalities and larger domestic companies; practically all of their issues are indexed.

Government bonds

Fixed income instruments issued by the government are of three types: Treasury notes (RIKB), Treasury bonds (RIKS) and Treasury bills (RIKV). At the end of November 2005, listed government securities amounted to ISK 101 billion, of which ISK 64 billion are Treasury notes, ISK 25 billion are Treasury bonds and ISK 12 billion Treasury bills. Treasury notes and Treasury bills have been auctioned through a primary dealer system, while no Treasury bonds have been issued during the past 10 years.

Treasury notes

Treasury notes are non-indexed medium-term securities issued by NDMA on behalf of the Republic of Iceland. They are currently the main source of domestic borrowing by the government, but also serve as benchmarks for pricing other non-indexed bonds. It is therefore important that price formation of the Treasury notes be as efficient as possible. Currently the outstanding market value of Treasury notes is ISK 64 billion total. Treasury notes are cleared through Clearstream. Three issues of Treasury notes were listed on ICEX in December 2005, (see the accompanying table).

In December each year the NDMA announces scheduled auction dates for the following year, stating the type of bond to be auctioned on each date. In 2005 there were six auctions of Treasury notes, increasing the stock of RIKB10 bonds by ISK 10.1 billion and RIKB13 by ISK 570 million.

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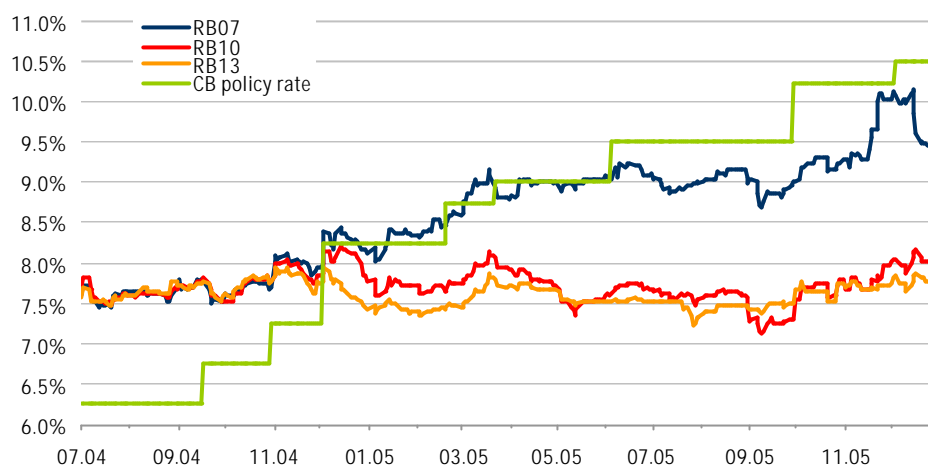
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Yields on Treasury-notes and the Central Bank's policy rate



Source: ICEX and the Central Bank of Iceland

Treasury bills

Zero-coupon Treasury bills are issued by the NDMA in a monthly auction. The Treasury bills issues have been small, often less than ISK 5 billion. This has hampered normal price formation and the secondary market in Treasury bills has not been efficient. In 2006 Treasury bills will be issued monthly with 30 and 45 day maturities, alternating every month. This is done to meet the national government's requirements for short-term funding. Treasury bills have a 30/360 day count rule.

Treasury bonds

Treasury bonds are indexed government bonds. In recent years the NDMA has actively strengthened a few benchmark bonds, particularly emphasising Treasury notes, and many Treasury bond series have been bought back, leaving only one series of Treasury bonds of significant size outstanding. It was originally issued in 1995 and matures on 1 October 2015. This is a zero-coupon bond, index linked to the CPI. The outstanding market value of the bond at the end of November 2005 was ISK 25 billion. This bond is smaller and less liquid than the HFF bonds which are now the active benchmarks for the indexed segment of the bond market.

Housing Financing Fund

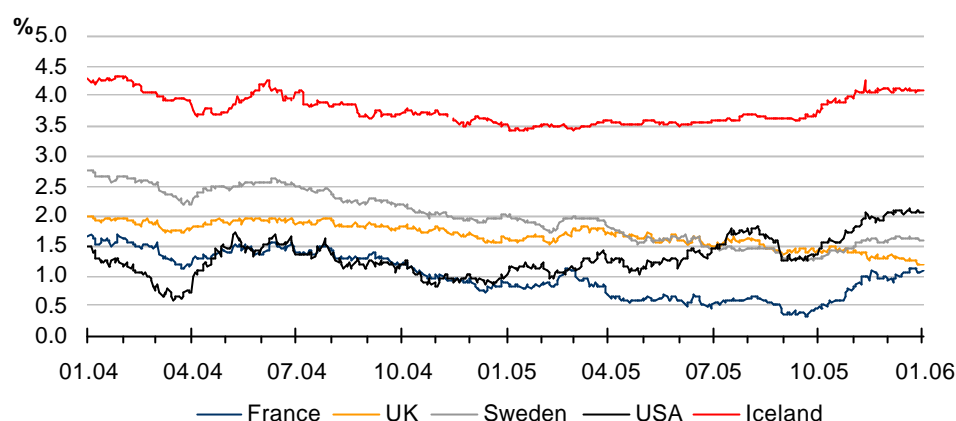
The Housing Financing Fund (HFF) is the largest issuer of Icelandic Bonds. HFF is a fully state-owned agency, set up to provide low-cost mortgages to the public. On 1 July 2004 the HFF commenced its issuance of HFF bonds, switching them for Housing Bonds and Housing Authority Bonds issued under its previous housing financing system. The HFF bonds finance the HFF's mortgage loans.

HFF bonds

The HFF bond series are the most-traded fixed income issues and form the basis for pricing other indexed obligations. There are currently four series available: HFF150914, HFF150224, HFF150434 and HFF150644. The numbers of each series indicate the maturity date of the bonds. All HFF bonds are CPI-indexed and bear fixed 3.75% interest. HFF bonds are non-callable annuities with semi-annual coupons and the day count rule is 30/360. HFF bonds are cleared in Euroclear.

Three of the four HFF series were created when the new HFF bond system was launched in July 2004. The fourth series, HFF150914, was added in November 2004. Five issues of HFF bonds took place in 2005, bringing the market value of the four HFF series at the end of November 2005 to ISK 42 billion (HFF150914), ISK 114 billion (HFF150224), ISK 103 billion (HFF 150434) and ISK 135 billion (HFF150644). Total HFF issuance amounted to ISK 467 billion at the end of November 2005, of which ISK 395 billion were HFF bonds.

Yield on indexed long-term bonds



Source: Ecowin and ICEX

Indexation

The outstanding principal on indexed bonds is adjusted every month to reflect changes in the CPI index published by Statistics Iceland on or around the 10th of each month. As an example, the change in the CPI value in January will accrue to indexed financial obligations on 1 February. As the HFF loans are annuities, each payment is adjusted correspondingly, i.e. the payment in period t is multiplied by CPI_t/CPI_0 where CPI_0 is the base value of the CPI for the bond.

Benchmark bonds; values from December 2005

Issue name	Rating Moody's	Market cap	Maturity	Coupon	Frequency	CPI indexed	Type	Duration	Yield
<i>Government Issues:</i>									
RIKB 07 0209	Aaa	ISK 22 billion	9.2.2007	0.00%	-	No	Zero Coupon	1.2y	9.97%
RIKB 10 0317	Aaa	ISK 19 billion	17.3.2010	7.00%	Annually	No	Coupon bond	3.6y	7.85%
RIKB 13 0517	Aaa	ISK 26 billion	15.5.2013	7.25%	Annually	No	Coupon bond	5.8y	7.65%
RIKS 15 1001	Aaa	ISK 24 billion	1.10.2015	0.00%	-	Yes	Zero Coupon	9.8y	4.21%
<i>Housing Financing Fund issues:</i>									
HFF150914	Aaa	ISK 44 billion	15.9.2014	3.75%	semi-annually	Yes	Annuitet	4.2y	4.46%
HFF150224	Aaa	ISK 121 billion	15.2.2024	3.75%	semi-annually	Yes	Annuitet	8.0y	4.41%
HFF150434	Aaa	ISK 110 billion	15.4.2034	3.75%	semi-annually	Yes	Annuitet	11.6y	4.19%
HFF150644	Aaa	ISK 145 billion	15.6.2044	3.75%	semi-annually	Yes	Annuitet	14.4y	4.12%

Source: ICEX

"Glacier bonds"

Foreign financial institutions and companies with high credit ratings began issuing non-indexed ISK Eurobonds (Glacier bonds) at the end of August 2005. These issues have proved attractive to both investors and foreign borrowers, as they enable the issuers to utilise the comparable advantages inherent in close proximity and good connections with end-investors, a well known, highly rated credit history, and the high interest rates on ISK securities. This has enabled the issuance of ISK-denominated Eurobonds that are sold to investors at yields currently below those of government bonds in the domestic market.

These issues proliferated rapidly during the fall of 2005 and outstanding ISK Eurobonds totalled ISK 152 billion at the end of December 2005, as compared to total outstanding Treasury notes of ISK 64 billion and total government issued securities of ISK 101 billion. Of the ISK 152 billion Glacier bonds outstanding, over ISK 50 billion (about 5% of GDP) mature in September and October 2006.

The ISK Eurobond issues have resulted in lower Treasury note yields, particularly the RIKB07 and RIKB10 notes which are of comparable duration (1-2 years) to the bulk of the issues. The issues have also exerted firm upward pressure on the ISK in the short run.

Investors

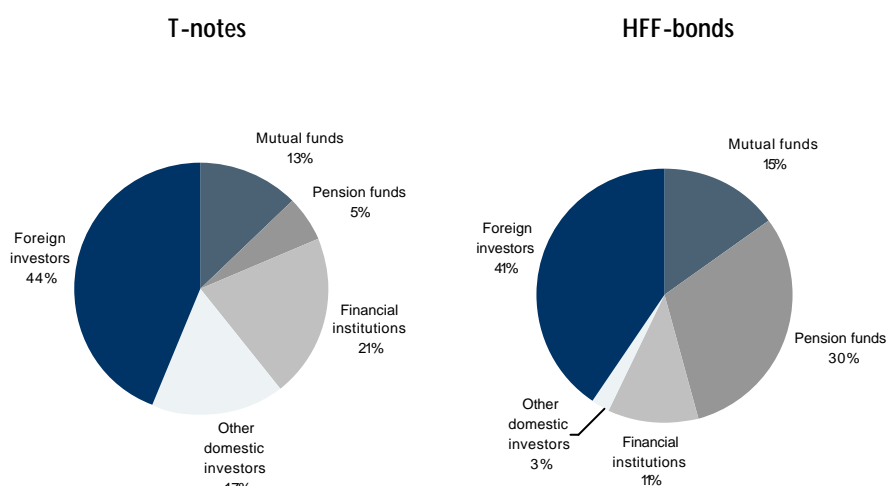
The largest domestic holders of fixed income securities are pension funds, mutual funds and financial enterprises, although foreign investors have become more active in the Icelandic fixed-income market in recent years.

Pension funds

At the end of Q3 of 2005, Icelandic pension funds held ISK 22 billion in government bonds and ISK 177 billion in bonds issued by HFF and its predecessors. Pension funds' total assets had grown by 16% (12% after adjusting for inflation) over the preceding 12 months, while their holdings of government bonds had grown by 53% (46% after inflation) and of HFF bonds by 16% (11%). Pension funds' total assets at the end of September 2005 amounted to ISK 1123 billion, 127% of the previous year's GDP. Government bonds have been a fairly stable component in pension funds' portfolios, fluctuating around 2% of total marketable bonds. Since HFF bonds were first issued they have comprised about 11% of pension funds' portfolios.

Holders of government bonds

Holders of Treasury notes and HFF bonds at the end of October 2005



Source: National Debt Management Agency, Central Bank of Iceland, ICEX and Landsbanki Research estimates.

Holders of HFF bonds

Outstanding issues of HFF bonds at the end of September 2005 totalled ISK 412 billion. HFF bonds are indexed, long-term securities and therefore particularly suitable investments for pension funds. Holdings of HFF bonds by the latter at the end of September 2005 were ISK 117 billion (28% of the stock of HFF bonds) which, combined with their holdings of Housing Bonds and Housing Authority Bonds, adds up to ISK 177 billion. While pension funds' holdings of HFF bonds have held steady at around 11% in their portfolio of marketable securities, the share of Housing Bonds has fallen during the same time from roughly 17% to under 4%. Mutual funds held ISK 80 billion in HFF bonds at the end of September (19% of the stock) and other domestic agents owned an additional ISK 45 to 50 billion. The remaining ISK 170 billion, or roughly 40%, was owned by foreign investors.

FX market

A formal FX market has operated in Iceland since 1993. The market makers are the three largest domestic banks, Landsbanki, Kaupthing Bank and Islandsbanki. Participation in the FX market is governed by rules set by the Central Bank (CB), which oversees the market and can trade in the market at any time.

Annual FX market turnover has grown rapidly since 1993. The 1994 turnover was ISK 53.4 billion, with 85% of the volume related to trading by the CB. Turnover in 2001 was ISK 1218 billion, but only 2.4% of this involved the CB. Annual trading volume has fluctuated around ISK 1000 billion since 2001, but turnover increased significantly in 2005, exceeding ISK 2070 billion during the year.

Landsbanki's FX information page on Reuters is 'LAIS'.

REIBOR/swap market

REIBOR market

The ISK interbank money market has operated in its current form since 1998. Market participants quote borrowing and lending rates for overnight, 1 week, 2 weeks, 1 month, 2 months, 3 months, 6 months, 9 months and 12 months. Market volume is heavily concentrated at the short end. The CB oversees the market but does not participate.

Swap market

The swap market was established in 2001. Swaps are made in ISK and USD and market participants are required to quote firm bid and ask prices for the USD for horizons of 1 week, 2 weeks, 1 month, 2 months, 3 months, 6 months, 9 months and 12 months.

Eurobond swaps (Glacier Bonds)

Landsbanki is active in longer-term swaps in the ISK, including both interest rate and cross currency swaps. Due to the recent Eurobond issuance in ISK, demand for such instruments has been high. Landsbanki has quoted prices for up to 5-year maturities with the bulk of the interest in 1-3 year maturities.

Landsbanki's main index page on Reuters is 'Landsbanki'. Its pages include information on ISK money market and swap rates.

Landsbanki on Reuters Dealing is 'LAIX'.

Trading Mechanisms and Institutions

NOREX and the SAXESS electronic trading system

ICEX is a member of the NOREX alliance and uses its SAXESS electronic trading system.

In the trading system, exchange members can enter bids for and offers of securities listed on ICEX. The market opens at 9:45 GMT with a 15-minute pre call. Upon its conclusion, continuous trading in all listed securities begins, with automatic matching, i.e. transactions are automatically concluded if the price and size of bids and offers match. The bond market is open for continuous trading from 10:00 GMT to 16:00 GMT. If exchange members conclude transactions in listed securities outside ICEX (off-exchange trading), such trading must be reported within five minutes of its conclusion.

Primary Dealers (Market Makers)

Both NDMA and HFF have signed agreements with dealers regarding the benchmark series. The purpose of these agreements is to increase liquidity and stabilise the Icelandic financial market.

Primary dealers are market makers in the secondary market for four benchmark series of Treasury notes and Treasury bonds. As of 1 June 2005, six financial institutions have been

appointed primary dealers in Treasury notes and bonds. Primary dealers are obliged to quote both bid and ask offers on ICEX for at least a market value of ISK 80 million in each of the four benchmark series. Their bid and ask quotes are governed by maximum spreads prescribed in the agreements (0.10%-0.45% depending on the series).

Primary dealers have exclusive rights to bid in NDMA's auctions and exclusive access to NDMA's securities lending facility. For HFF bonds, as of 1 July 2005, four primary dealers have signed market making agreements. Each is obliged to quote offers for a market value of at least ISK 100 million in each of the four HFF issues. The agreement provides for maximum spreads between 0.35%-0.55%, depending on the duration of the issues.

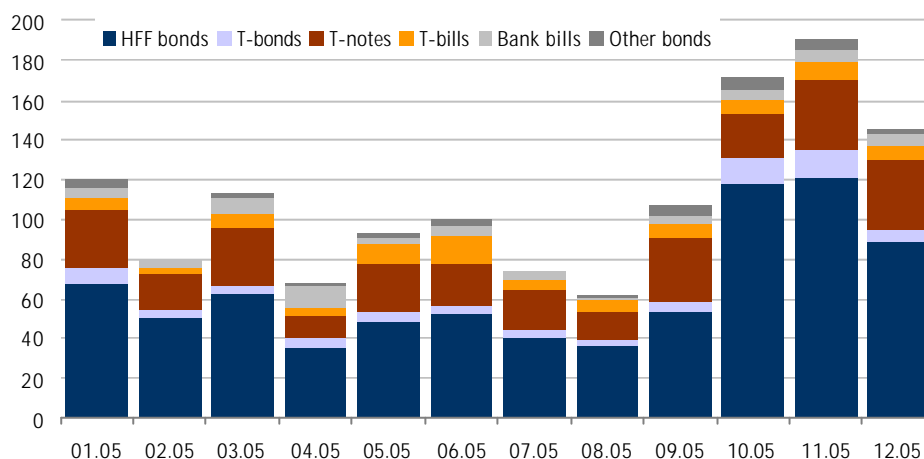
Landsbanki is a primary dealer in all listed HFF and national government fixed income securities. Real-time information on best bid and ask prices for these issues can be found on Landsbanki's Icelandic bond page on Bloomberg: LAIB<GO>.

Market Liquidity and Turnover

The minimum market depth in HFF bonds is ISK 400 million (primary dealers), but it is not unusual for market depth to be around ISK 500-800 million. The average trade size in HFF bonds is ISK 180 million. Average monthly turnover in 2005 was ISK 65 billion.

For Treasury notes and bonds the minimum market depth at any given time is ISK 480 million (primary dealers). The average trade size is ISK 64 million and average monthly turnover in 2005 was ISK 31 billion.

Monthly turnover of fixed income securities



Source: ICEX

Landsbanki is one of Iceland's three largest banks and, as such, has a major presence in the fixed income market. As of the end of November 2005, Landsbanki's share in the total turnover of all fixed income securities listed on ICEX was 23%.

Settlement

Clearstream offers settlement and custody of Icelandic Treasury notes and bonds. Transactions can only be settled free of payment through Clearstream with the payment settled through the counterparty's ISK account in Landsbanki. HFF Bonds are eligible for settlement and custody both in Euroclear and Clearstream, where they can be settled against payment.

The standard settlement period in the Icelandic market is T+1. Landsbanki does, however, offer non-standard settlement periods and frequently settles transactions with foreign clients on a T+3 basis.

Taxation

Interest paid to non-residents is not subject to withholding tax. Non-residents must apply to the Directorate of Revenue for tax exemption, but applying for a withholding tax exemption is a simple process which can be done through Landsbanki.

Fixed Income Mutual Funds

As well as being a primary dealer in the Icelandic fixed income market, Landsbanki also runs a well established Asset Management Division, which focuses primarily on the Icelandic market and manages a wide range of equity and fixed income mutual funds (both UCITS and non-UCITS funds). The funds cover the whole spectrum of the Icelandic fixed income market; money market, government bonds and high yield corporate bonds. Landsbanki's Money Market Fund and High Yield Fund are the largest funds in their respective categories in Iceland. Total assets under management in Landsbanki's fixed income funds amounted to ISK 110 billion as of November 2005.

Monetary Policy

Inflation targeting

The Icelandic CB pursues an inflation target of 2.5%, measured by the 12-month increase in the CPI. Inflation targeting as conducted by the CB of Iceland is comparable to similar practices in other countries. Since this regime was adopted in early 2001, the objective of ensuring price stability takes priority over any other activity of the CB, such as the objective of ensuring stability in the Icelandic economy. The CB is free to use its instruments as it deems necessary to attain the 2.5% inflation target.

Policy rate decisions

In 2006 monetary policy decisions will be announced on predetermined dates: 26 January, 30 March, 18 May, 6 July, 14 September and 2 November. Three of these six dates, in March, July, and November, coincide with the publication of the CB's Monetary Bulletin, where national accounts and inflation forecasts are published.

The economy

Currently the Icelandic economy is nearing the peak of a strong, demand-driven expansion. Investment in aluminium smelters and accompanying power plants 2003-2008 amounts to about 20% of annual GDP. The bulk of this investment falls in 2005 and 2006. In addition, the banks' greatly increased presence on the mortgage market that started in July 2004, has resulted in a housing price boom and household equity withdrawal through refinancing of mortgages, which has also boosted domestic demand. In response to these circumstances, the CB has increased its policy rate 12 times, from 5.3% to 10.75%, in the period from May 2004 to January 2006. The CB is expected to continue raising interest rates in early 2006 and to keep its policy rate high throughout the year. Despite the 5.45 percentage point rate rise the inflation rate has now been above the target since the spring of 2004 and the 12-month inflation rate in January 2006 was 4.4%.

FX interventions/foreign currency reserves

The CB can intervene directly in the FX market, affecting the exchange rate and thus inflation, in order to bring inflation to the target. However, the CB almost never exercises this option, endeavouring to achieve its goals solely by adjusting the policy rate. The last time the CB intervened in the FX market to influence the exchange rate was on 12 October 2001.

Since September 2002, the CB has made regular foreign currency purchases in the FX market following a schedule which has been updated several times. The current plan for 2006 is to buy USD 2.5 million twice a week, primarily to service the government's interest on and repayments of foreign debt, and partly to boost its foreign reserves to the level of the average three-month imports of the past five years.

Fiscal budget

The treasury balance for 2005 and 2006 is estimated at a surplus close to 5% of GDP each year. This is primarily due to the rapid growth of most income bases, as the economy experiences unusually favourable conditions for growth. Growth of government investment has also been cut back considerably, particularly in 2007 when government investment is forecast to be around 1% of GDP.

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