

Medium-Term Debt Management Strategy 2013 – 2016



MINISTRY OF FINANCE AND ECONOMIC AFFAIRS

Ministry of Finance and Economic Affairs
March 2013

Medium-Term Debt Management Strategy 2013 – 2016

Medium-Term Debt Management Strategy 2013-2016
ISSN 2298-1004
2013 Ministry of Finance and Economic Affairs
Layout: Ministry of Finance and Economic Affairs

Further information on the publications of the Ministry of Finance and Economic Affairs can be found on the Ministry's website: www.fjarmalaraduneyti.is

Table of Contents

1	Summary	5
2	Debt Management Objectives	6
	2.1 Goals of the MTDS.....	6
3	Guidelines for Debt Management	7
	3.1 Overall Composition of the Debt Portfolio.....	7
	3.2 Guidelines for Borrowing	8
	3.3 Quantitative Targets.....	8
4	Domestic Issuance Plan.....	9
	4.1 Financing needs	9
	4.2 Deposits	9
	4.3 Structure of Government securities	9
	4.3.1 Structure of benchmark series.....	9
	4.3.2 Issuance of Treasury bonds from 2013 onwards	10
	4.3.3 Redemption profile	11
	4.3.4 Average time to maturity	12
5	Foreign loans	13
6	Debt portfolio	14
	6.1 Government debt	14
	6.1.1 Domestic borrowing	15
	6.1.2 Foreign loans	16
	6.1.3 The IMF and the bilateral loans to the Central Bank.....	16
	6.1.4 Debt portfolio.....	16
	6.1.5 Redemption profile	17
	6.2 Investor base	17
7	Risk management	19
	7.1 Market risk.....	19
	7.1.1 Interest rate risk	19
	7.1.2 Exchange rate risk.....	20
	7.1.3 Inflation risk.....	20
	7.2 Refinancing risk.....	20
	7.3 Contingent liabilities.....	21
	7.3.1 State guarantees	21
	7.3.2 Municipalities	23
	7.3.3 Public-private partnership.....	24
	7.3.4 Icesave	24
8	Institutional Structure	26
	8.1 Ministry of Finance and Economic Affairs	26
	8.2 Agreement with the Central Bank of Iceland	26
	8.3 Consultative Committee on Debt Management.....	27
9	Market communication.....	28
	9.1 Medium-Term Debt Management Strategy.....	28
	9.2 Quarterly Government Debt Management Prospect.....	28
	9.3 Quarterly Government Debt Management Prospect.....	29
	9.4 Auction announcements.....	29
	9.5 Planned auction dates	29
	9.6 Market Information.....	29
	9.7 Government Debt Management website.....	29
	9.8 Primary dealers in Treasury securities.....	30
	9.9 Investors.....	30

1 Summary

The Medium-term Debt Management Strategy (MTDS) lays down the Government's debt financing plans for the next four years; i.e., during the period 2013 — 2016. The key objective in the strategy is to ensure that the Government's financing needs and payment obligations are met at the lowest possible cost over the medium to long term, consistent with a prudent degree of risk, and to promote the maintenance and further development of efficient primary and secondary markets for domestic Government securities.

Benchmark issues of Treasury bonds are structured so that each series is large enough to ensure effective price formation in the secondary market. Each year, two-, five-, and 10-year benchmark series will be issued. In order to reduce refinancing risk, it is intended to keep the redemption profile of Treasury securities as even as possible. In addition, the average time to maturity of the debt portfolio should be at least 4 years.

The Treasury borrows in foreign currencies primarily in order to expand the Central Bank's foreign exchange reserves. Going forward, the foreign currency borrowing strategy is aimed at securing regular access to international capital markets and maintaining a well diversified investor base.

The central government's total debt at year-end 2012 was equivalent to 87% of GDP. Government debt will gradually be reduced below 70% of GDP by year-end 2016. The net debt was 45% of GDP at the end of 2012 and is expected to be reduced to approximately 33% of GDP by year-end 2016.

The MTDS includes a description of the composition of the debt portfolio, inherent risk factors and contingent liabilities. The institutional structure regarding debt management is also described in the MTDS. The Ministry of Finance and Economic Affairs is responsible for the central government's debt management, sets the strategy, and makes all decisions regarding issuance of securities. A special section within the Central Bank, Government Debt Management, is responsible for the implementation of the Treasury's debt management policies. The MTDS also includes a discussion of communication with market participants.

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

2 Debt Management Objectives

The Government's overall main debt management objectives are fourfold:

1. To ensure that, over the medium to long term, the Treasury's financing needs and financial obligations are met at the lowest possible cost that is consistent with a prudent degree of risk;
2. To establish a sustainable debt service profile consistent with the Government's medium-term payment capacity;
3. To promote the maintenance and further development of efficient primary and secondary markets for domestic Government securities;
4. To broaden the Government's investor base and diversify funding sources.

2.1 Goals of the MTDS

The Medium-term Debt Management Strategy (MTDS) lays down the Government's debt financing plans for the next four years; i.e., during the period 2013 — 2016. It is intended to be a working policy document that will be updated and revised annually.

The aim is to formulate a clear debt management policy and present quantitative targets, as well as developing analytical tools to identify, monitor, and mitigate potential risks in the debt portfolio.

The MTDS provides a policy framework for undertaking liability management operations aimed at minimising the Government's interest expense consistent with a prudent degree of risk.

3 Guidelines for Debt Management

This chapter describes the guidelines for active management of the central government's debt portfolio in the medium term.

In order to meet the demand for new Government securities issues and to increase the liquidity of marketable series, endeavours will be made to exchange non-marketable Treasury debt with marketable securities as market conditions permit. A precondition for paying off non-marketable Treasury debt with marketable securities is to ensure that the exchange must be compatible with the objective of minimising the Treasury's interest costs in the long run, consistent with a prudent degree of risk.

3.1 Overall Composition of the Debt Portfolio

The following discussion regarding the composition of the debt portfolio excludes loans to strengthen foreign currency reserves. Loans taken to reinforce the reserves are subject to a separate policy, which is discussed in Chapter 5 on foreign loans.

The composition of the debt portfolio is designed to minimise overall risk and promote the development of a well-functioning market that appeals to a broad range of investors and establishes pricing benchmark for financial markets.

The Government will mainly issue nominal debt, as nominal Treasury bonds form a base for an efficient bond market. Inflation-linked Treasury bonds will also be issued targeted towards long-term investors who have traditionally invested in such assets. There is scope for foreign-denominated borrowing, but the proportion of foreign currency debt will be low, to make management of the debt portfolio respond effectively to volatility in foreign exchange markets.

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

Non-indexed loans	60-80%
Indexed loans	10-40%
Foreign loans	0-20%

Figure 1 shows the composition of the debt portfolio excluding currency reserve loans in December 2012.

Debt portfolio composition, excluding currency reserve loans

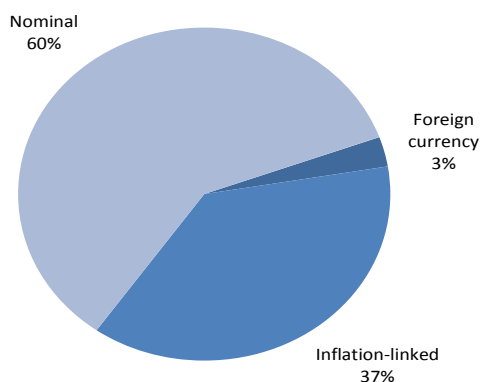


Figure 1

3.2 Guidelines for Borrowing

The Ministry of Finance and Economic Affairs, on the basis of the provisions of the Act on Government Debt Management, have set the guidelines to be applied to debt management. The main guidelines for the debt portfolio are:

1. *Examining their redemption profile:*
The redemption profile of Government securities should be as smooth as possible over time, with similar final size of individual issuances.
2. *Benchmark series:*
Benchmark issues will be structured so that each series is large enough to ensure effective price formation in the secondary market. The number and size of the series shall take account of Treasury debt.
3. *Refinancing percentage:*
Debt maturing within a twelve-month period), less any undrawn credit facilities, to a maximum of 30% of the entire Treasury's total outstanding debt.
4. *Duration of loan:*
The average time to maturity of the debt portfolio shall be at least 4 years.

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 assumptions. The medium-term baseline projections show that between 2013 and 2016:

1. Debt to GDP will be below 70% by 2016 and below 60% for the long term.
2. Redemption to GDP will be below 6%.
3. Domestic cash and cash equivalents on the Treasury Single Account shall total at least ISK 80 bn at all times.

These targets are subject to revision in the macro and fiscal assumptions. The Government will update them as circumstances require.

4 Domestic Issuance Plan

The financing needs of the Treasury will be funded through issuance of Government securities in the domestic market and a decrease in the Treasury's deposits at the Central Bank of Iceland. This chapter focuses on financing needs and Treasury deposits. It also discusses Treasury securities issuance, including the redemption profile policy and the average duration, as well as build-up of benchmark issues.

4.1 Financing needs

The Treasury's estimated financing needs are based on the assumptions in the 2013 National Budget for this year and on the assumptions presented by the Ministry of Finance and Economic Affairs in the report *The Domestic Economy 2013-2016: Fiscal policy and macroeconomic programme*, "Ríkisbúskapurinn 2013-2016, Ríkisfjármálastefna og þjóðhagsáætlun".

The net borrowing requirement is the sum of net cash provided by operating activities and financial transactions. Table 1 shows the net financing balance according to estimated Treasury performance for 2013-2016. The aim is to achieve a significant improvement in public sector finances during the period. The surplus projected for the latter part of the period will be used to pay down Treasury debt.

Net borrowing requirement (ISK m.)

2013	2014	2015	2016
-40.900	-2.600	20.000	29.500

Table 1

4.2 Deposits

The Treasury's deposits at the Central Bank of Iceland amounted to approximately ISK 135 bn at year-end 2012. At any given time, the Treasury aims to hold deposits in its account at the Central Bank amounting to at least ISK 80 bn.

4.3 Structure of Government securities

The gross borrowing requirement is the sum of the net borrowing requirement and debt repayments. This section deals with the structure and setup of Government securities.

4.3.1 Structure of benchmark series

Benchmark series will be structured so that each series is large enough to ensure active price formation in the secondary market. The aim will be to distribute each year's Treasury bond issuance as evenly as possible among quarters. Furthermore, Treasury bonds with various maturities will be issued each year. To fulfil these aims, each year the benchmark Treasury bond series will be issued with maturities of 2, 5 and 10 years.

When the 10-year benchmark series is first auctioned, it will mature after approximately 11 years. Bonds will be sold from the series until 9 years remain to maturity, whereupon issuance

will be suspended. The bond is reopened at about 6 years to maturity and will be offered for sale until about 4 years remain to maturity. Finally, the bond is reopened at 2 years to maturity.

Nominal and inflation-indexed Treasury bonds with maturities other than 2, 5, and 10 years will be issued irregularly, depending on the Treasury's financing need at any given time.

The goal is that each series shall have a final size of ISK 40-100 bn, except for 2-year bonds, whose minimum final size will be ISK 15 bn. Attempts will be made to expedite the build-up of the series until they reach a size sufficient to ensure effective price formation in the secondary market. Table 2 shows intended benchmark issuance.

Series	Maturity	Amount issued	Frequency of issuance
Treasury bills	3 and 6 months	ISK 5-30 bn	Monthly
Nominal Government bonds	2 yr	ISK 40-100 bn if previously issued for a longer period; otherwise, ISK 15-100 bn if issued for only 2 years	Annually
Nominal Government bonds	5 yr	ISK 40-100 bn	Annually
Nominal Government bonds	10 yr	ISK 40-100 bn	Annually
Nominal Government bonds	Other maturities	ISK 40-100 bn	Irregular
Indexed Government bonds	Long-term	ISK 40-100 bn	Irregular

Table 2

Six-month Treasury bills will be given out in series that will be reopened for expansion at 3 months to maturity. This allows for the monthly sale of 3- and 6-month Treasury bills. The monthly issuance of Treasury bills will be variable, depending on the Treasury's financing needs at any given time.

4.3.2 Issuance of Treasury bonds from 2013 onwards

Planned issuance for 2013 is ISK 90 bn, as is stated in the Government Debt Management Prospect published at the end of 2012.

A sample issuance calendar of Treasury bonds for coming years is demonstrated in Table 3. The table is only for illustrative purposes, and actual issuance plans may be subject to change. The table shows already issued Treasury bonds with the identifier codes of the series concerned. The identifier RB 13 0517 means that the bond is a nominal bond maturing on 17 May 2013. For Treasury bonds that have not been issued, the numbers preceding the dash indicate the maturity year, and the numbers after the hyphen indicate the length of the bond; 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 financing needs and investor demand.

Sample issuance calendar

Year	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
	RB	RB	RB	RB	RB	RB	RB	RB	RB	RB
0	13 0517	14 0314	15 0408	16 1013	17-2 Yr	18-2 Yr	19 0226	20-2 Yr	21-2 Yr	22 1026
1	14 0314	15 0408	16 1013	17-2 Yr	18-2 Yr	19 0226	20-2 Yr	21-2 Yr	22 1026	23-2 Yr
2	15 0408	16 1013	17-2 Yr	18-2 Yr	19 0226	20-2 Yr	21-2 Yr	22 1026	23-2 Yr	24-2 Yr
3	16 1013			19 0226	20-5 Yr		22 1026		25 0612	
4			19 0226	20-5 Yr		22 1026				
5		19 0226	20-5 Yr		22 1026			25 0612		
6	19 0226	20-5 Yr		22 1026			25 0612			28-5 Yr
7	20-5 Yr		22 1026			25 0612			28-10 Yr	
8		22 1026			25 0612			28-10 Yr		
9	22 1026			25 0612			28-10 Yr			31 0124
10			25 0612			28-10 Yr			31 0124	
11		25 0612			28-10 Yr			31 0124		

Treasury Bond 2Yr
 Treasury Bond 5Yr
 Treasury Bond 10Yr

Table 3

4.3.3 Redemption profile

One of the objectives of debt management is to ensure that the redemption profile of Treasury bonds is as even as possible. In order to reduce refinancing risk, the aim is to keep the size of each series at or below ISK 100 bn upon maturity. Figure 2 shows the redemption profile of domestic liabilities at year-end 2012, excluding Treasury bills.

In 2008, the Treasury issued a five-year inflation-indexed bond to recapitalise the Central Bank of Iceland after the collapse of the banks. The balance of the bond, including indexation, is now about ISK 170 bn. The loan matures on 1 January 2014, but it has been decided to extend it and amend the terms so that, from 1 January 2013 onwards, it will be a nominal amortisation bond. More information on the amended terms and conditions will be made public at a later date.

The Treasury's largest maturity is in 2018, when RIKH 18 1009 matures in the amount of ISK 213 bn. The series was issued for the express purpose of financing the Treasury's capital contributions and subordinated loans to financial institutions; therefore, it is backed by assets. For those years where redemptions exceed the target range, measures will be taken to reduce the redemption amount. If necessary, the Treasury will make buyouts and hold switch auctions to maintain the annual redemptions within the target range.

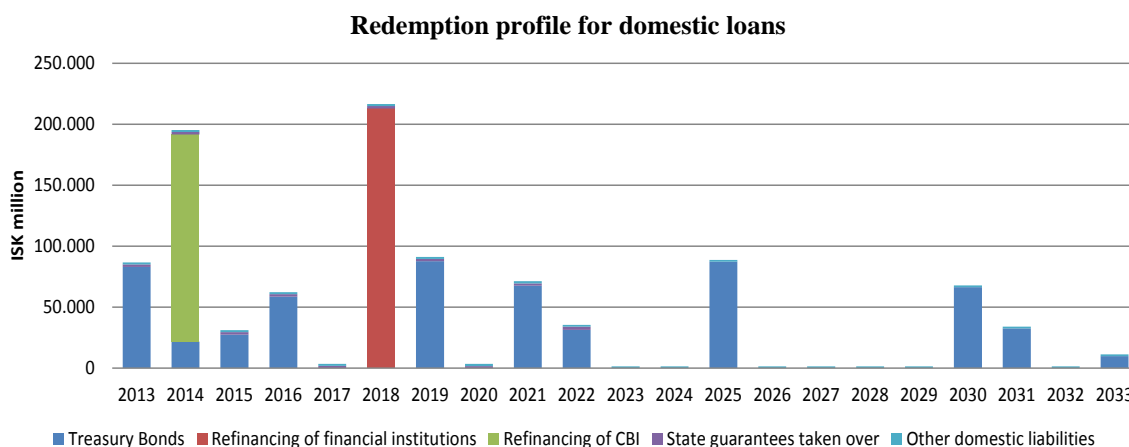


Figure 2

4.3.4 Average time to maturity

The aim is to keep the average time to maturity of Treasury securities at a minimum of 4 years. In recent years, systematic attempts have been made to lengthen the average time to maturity of outstanding loans. The average duration is managed with issuance of securities of varying maturities. If domestic market conditions permit, the Treasury will also make use of interest rate swap agreements, make buyouts and/or hold switch auctions to maintain the average time to maturity within the defined guidelines. As of year-end 2012, the average time to maturity was 6.4 years.

5 Foreign loans

The Treasury borrows in foreign currencies primarily in order to expand the Central Bank's foreign exchange reserves, but not to finance Treasury operations. The strategy for foreign debt financing aims at promoting regular access to international credit markets and maintaining access to a diverse investor group. In order to do so, the Government aims at a regular issuance of marketable bonds. The main purpose of this strategy is to refinance already outstanding marketable bonds and over time to replace non-marketable debt – i.e., IMF programme-related debt – with marketable instruments. Regular issuance of marketable instruments in the international capital markets is also intended to enhance name recognition of the Republic of Iceland as an attractive investment option.

The Central Bank manages the reserves and uses the profile of foreign currency Treasury debt as a benchmark for currency composition and duration of reserve assets. The aim is to minimise fluctuations in the value of the Central Bank's net assets in foreign currencies. In broad terms, this is an asset and liability strategy where the government and Central Bank's balance sheets are considered on a consolidated basis.

Figure 3 shows all outstanding foreign currency obligations of the Treasury as of end-2012. Partner country loans related to the IMF-led economic programme may be prepaid without a prepayment penalty.

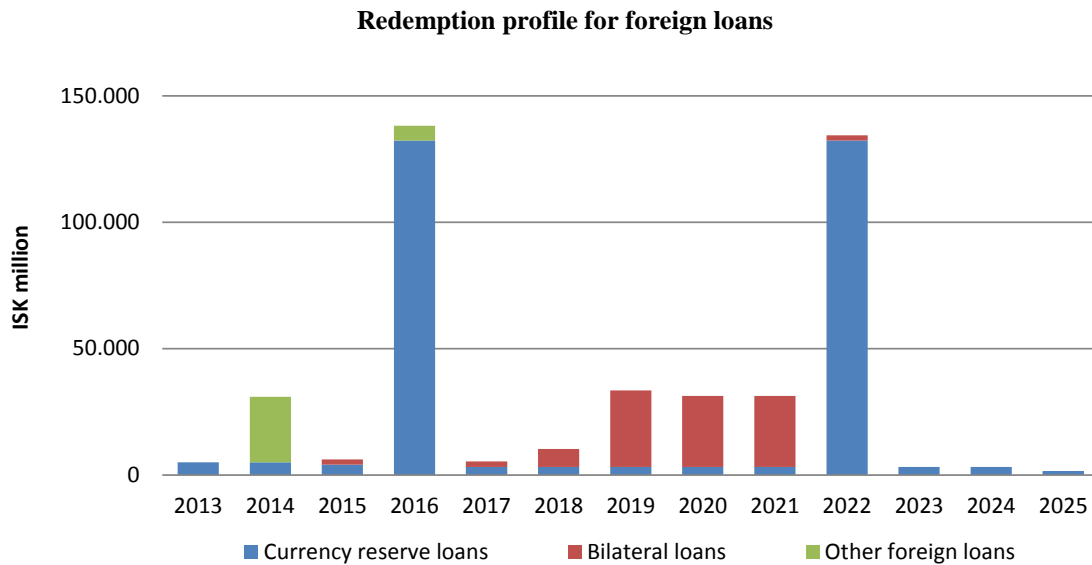


Figure 3

6 Debt portfolio

This section describes the total Government debt portfolio, including loans taken by the Central Bank to expand the foreign exchange reserves. The chapter also includes information on repayment profile of the loans and on the investor base of Government securities. Figure 4 shows the development of Government debt net of pension obligations from 2007-2012 and expected development to the year 2016.

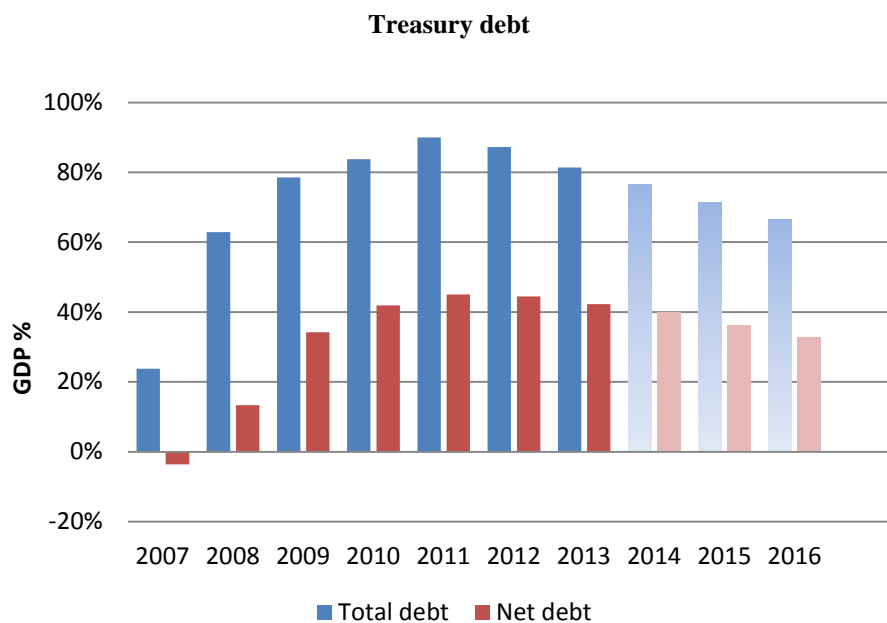


Figure 4

6.1 Government debt

Government debt has increased substantially in the wake of the collapse of the banks, rising from approximately ISK 311 bn in 2007 to about ISK 1,500 bn at the end of 2012. The end-2012 position is equivalent to about 87% of GDP. Government debt will gradually be reduced below 70% of GDP by year-end 2016. Table 4 shows the composition of Treasury debt at year-end 2012.

The net debt is 45% of GDP at the end of 2012 and is expected to be reduced to approximately 33% of GDP by year-end 2016. Net debt is total debt excluding receivables and cash in hand. Cash in hand and receivables amounted to ISK 730 bn at the end of 2012.

Treasury debt as of end-December 2012

<i>ISK million</i>	Central Government
Domestic	
<i>Marketable securities</i>	
Treasury bills	38.600
Treasury bonds inflation-linked	173.400
Treasury bonds nominal	404.000
Refinancing of financial institutions	212.900
 <i>Non-Marketable debt</i>	
Refinancing of CBI	169.800
State guarantees taken over	19.600
Other domestic liabilities	48.900
Total	1.067.200
 External borrowing	
<i>Currency reserve loans</i>	
Bilateral loans	99.700
Other currency reserve loans	301.900
 <i>Other loans</i>	
Foreign loans	31.700
Total	433.300
Total	1.500.500

Table 4

6.1.1 Domestic borrowing

Marketable securities include Treasury bonds, Treasury bills, and a special benchmark bond issued to finance capital injections and subordinated loans to financial institutions. The special issue matures in 2018. The outstanding amount at year-end 2012 was ISK 213 bn. The balance rose by ISK 19 bn year-on-year due to an increased capital contribution for SpKef savings bank. This series bears variable interest in order to hedge some of the interest rate risks on the banks' liabilities.

As of year-end 2012, outstanding marketable securities totalled ISK 829 bn.

Non-marketable securities include the five-year inflation-indexed Treasury bond issued to recapitalise the Central Bank of Iceland after the collapse of the banks in 2008. In 2012, the Treasury also took over a Government-guaranteed loan of ISK 1 bn in addition to the loan taken over by the Treasury at year-end 2011. In addition to these loans is other non-marketable debt, which is mostly attributable to the Treasury's acquisition of Reykjavik and Akureyri's stakes in Landsvirkjun. These are inflation-linked annuity loans maturing in 2034.

At year-end 2012, outstanding non-marketable securities totalled ISK 238 bn.

6.1.2 Foreign loans

Loans that are contracted within the framework of the Government's IMF-supported economic programme are used to strengthen the foreign exchange reserves of the Central Bank. The Treasury was granted loan facilities from Denmark, the Faeroe Islands, Finland, Poland, and Sweden, and the Central Bank received loan facilities from the IMF and Norway (see Section 6.1.3.). The Treasury's loan facilities totalled EUR 1,480 m (ISK 252 bn).¹ The Treasury has drawn the full amount of the loans from the Nordic countries and the Faeroe Islands, as well as about one-third of the Polish loan.

In March and June, the Treasury and the Central Bank prepaid the equivalent of ISK 287 bn of the loans from the IMF and the Nordic countries. The Treasury's portion of the repayment was just over ISK 124 bn. With these payments, the Icelandic authorities have repaid 53% of the original amount borrowed from the IMF and 59% of the original loan facility from the Nordic countries. At the end of December, the Treasury prepaid the loan from the Faeroese Government in the amount of 300 million Danish kroner.

At year-end 2012, the outstanding amount of partner country loans was ISK 100 bn.

Other loans to strengthen the Central Bank's foreign exchange reserves include two bond issues in 2011 and 2012, each in the amount of USD 1 bn, and a bond from 2010, with EUR 311 m outstanding. The outstanding balance of these loans was ISK 302 bn at end-2012.

Other foreign loans amount to ISK 32 bn. The proportion they make up of the total debt portfolio has been steadily decreasing.

6.1.3 The IMF and the bilateral loans to the Central Bank

The loan from the IMF to the Central Bank is valued at ISK 278 bn (SDR 1,400 m) and the loan from Norway is valued at ISK 82 bn (EUR 400 m). As is stated in Section 6.1.2, two prepayments were made on these loans in 2012, and the Central Bank's portion of the payments was ISK 163 bn. These loans are used to strengthen the Central Bank's foreign exchange reserves and are not part of central government debt.

6.1.4 Debt portfolio

Figure 5 shows marketable and non-marketable debt, including loans to reinforce the foreign exchange reserves. The loans fall into three categories: nominal debt, inflation-linked debt, and foreign-denominated debt.

¹ Exchange rates of 31 December 2012: EUR/ISK 170.27 and SDR/ISK 198.58

Debt portfolio

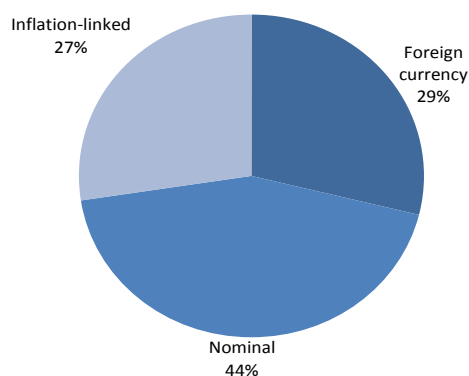


Figure 5

6.1.5 Redemption profile

Figure 6 shows the redemption profile for Treasury debt as of year-end 2012. The largest maturity dates are in 2014, 2016, 2018, and 2022.

Redemption profile, Government loans

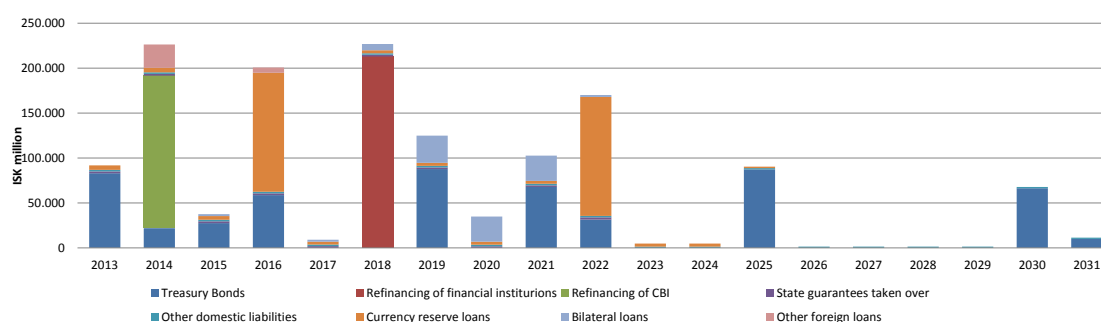


Figure 6

The Government bond issued to recapitalise the Central Bank of Iceland matures in 2014. The bond is inflation-linked, in the nominal amount of ISK 170 bn. It has been decided to extend it and amend the terms of the loan so that, from 1 January 2013 onwards, it will be a nominal amortisation bond. More information on the amended terms and conditions will be made public at a later date.

The foreign bonds issued in 2011 and 2012 (each in the amount of USD 1 bn) are scheduled to mature in 2016 and 2022, respectively.

The Government bond that was issued to recapitalise the new banks matures in October 2018. The nominal value of the bond was ISK 213 bn at end-2012. Assets against the bond are shares in financial institutions and loans to financial institutions.

6.2 Investor base

The Treasury endeavours to offer a broad range of securities with varying maturities. The objective is to appeal to a broad base of investors and limit financing costs. Figures 7 and 8 give a breakdown of the holders of domestic Treasury bonds and bills as of year-end 2012.

Owners of Treasury securities

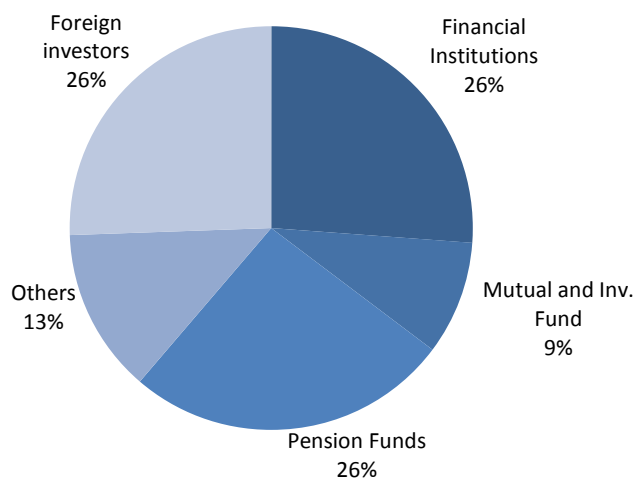


Figure 7

Financial institutions are the largest investors of domestic Treasury securities, with about 26% of outstanding bonds. The financial institutions' large position is mainly due to their having been capitalised with the special Treasury bond issue, RIKH 18 1009.

Foreign investors² hold about 26% of domestic Treasury securities. Pension funds own about 26%, mutual and investment funds own 9%, and other investors hold about 13%.

Owners of Treasury securities

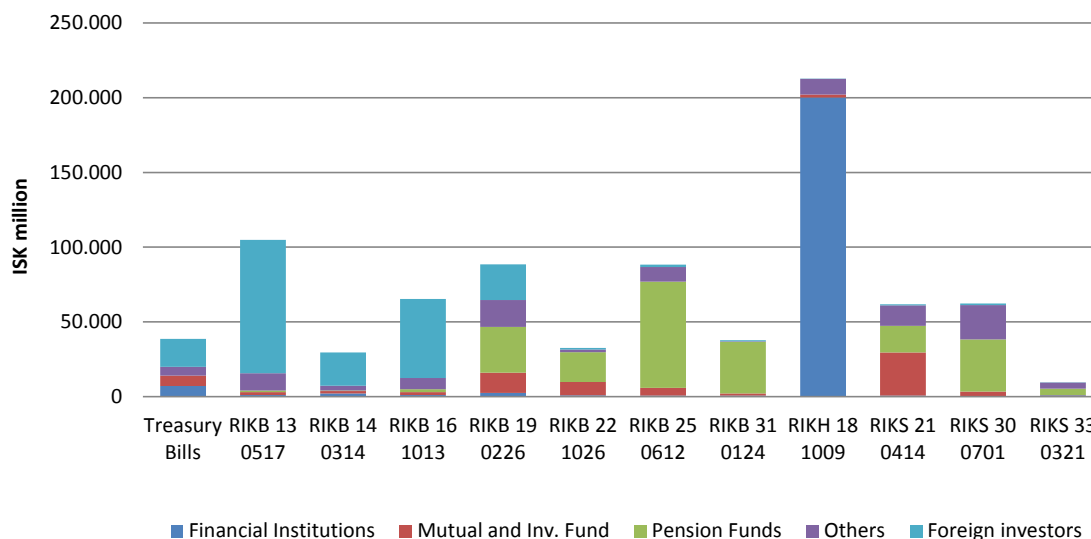


Figure 8

² In the Icelandic Securities Depository system, 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

The debt portfolio has certain inherent risks related to market volatility, such as changes in the interest rate, foreign exchange rate and inflation, and additional risks related to contingent liabilities. The management of these various risks is covered in this section.

7.1 Market risk

Financial market volatility — whether due to fluctuations in interest rates, exchange rate movements, or changes in inflation — leads to fluctuations in the market value of the debt portfolio. These risks, generally termed "market risks", are discussed in greater detail in the sections below.

Effective risk management aims to reduce risk while simultaneously minimising costs. These goals can be achieved through effective Treasury debt management, partly through the targeted use of derivative products.

7.1.1 Interest rate risk

Interest rate risk is the risk that the Treasury's financing costs will rise due to changes in interest rate terms. Interest rate risk is dependent on the composition of the debt portfolio. In cases involving variable interest rates, the risk is that interest rates will rise, thus increasing the Treasury's interest expense.

Figure 9 shows the interest rate composition of the debt portfolio. Approximately 24% of the total debt portfolio bears variable rates; therefore, payment flows will change in line with changes in the base interest rate on the loans concerned. Another 44% of the debt is non-indexed and bears fixed interest, and 27% is indexed, fixed-rate debt. Some 57% of issued Treasury bonds therefore bear fixed interest, and payment flows are a known quantity. It is possible to conclude interest swap agreements in order to manage the Treasury's interest rate risk and, for instance, increase the weight of variable-rate debt.

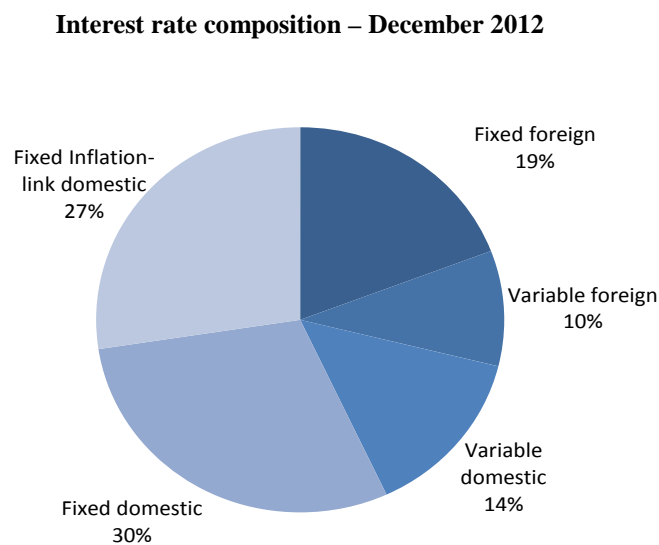


Figure 9

7.1.2 Exchange rate risk

Exchange rate risk is the risk that the Treasury's debt position will deteriorate due to changes in the exchange rate of the Icelandic króna versus other currencies. The Treasury's direct exchange rate risk is limited because foreign currency holdings and foreign-denominated bonds offset foreign Treasury debt. The reserves are actively managed according to set currency composition guidelines. The Central Bank attempts to minimise the exchange rate risk attached to the reserves.

7.1.3 Inflation risk

Inflation risk is the risk that indexation on index-linked Treasury bonds will raise the Treasury's financing costs as a result of increased inflation. As of year-end 2012, the Treasury's indexed loans totalled ISK 412 bn, about 40% of the domestic debt portfolio.

Inflation risk can also be managed with derivatives; however, the Icelandic derivative market is not functional at present. The Treasury will be able to manage its inflation risk more effectively once the derivative market has normalised. 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. This mitigates inflation risk to some extent.

7.2 Refinancing risk

One of the greatest risks to the debt portfolio centres on refinancing. To reduce refinancing risk, the Ministry of Finance and Economic Affairs aims to keep the redemption profile of Government securities as smooth as possible over the long term, with individual bond series of generally uniform size.

The following summarises the largest maturities, and therefore the potential risks, in the portfolio:

(a) 2014	ISK 170 bn	Recapitalisation of Central Bank
(b) 2016	ISK 129 bn	Expansion of reserves
(c) 2018	ISK 213 bn	Capital contribution to financial institutions
(d) 2022	ISK 129 bn	Expansion of reserves

(a) In December 2008, the Treasury issued an inflation-linked bond of ISK 170 bn, maturing in 2014, to the Central Bank of Iceland to strengthen its capital position. The loan matures in 2014, but it has been decided to extend it and amend the terms so that, from 1 January 2013 onwards, it will be a nominal amortisation bond. More information on the amended terms and conditions will be made public at a later date. It is planned to prepay ISK 5 bn of the principal during the year.

(b) In June 2011, the Treasury issued a bond in the amount of USD 1 bn (ISK 129 bn at the year-end 2012 exchange rate) at a yield of 4.993%. It is planned to refinance the debt prior to its 2016 maturity with another foreign market issue.

(c) In 2008, the Treasury issued a special 10-year Government bond to finance capital contributions and subordinated loans to financial institutions. The outstanding balance of the bond peaked at just over ISK 226 bn in 2010 but declined by ISK 32.5 bn in 2011 as a result of a bond swap between the Treasury and the Housing Financing Fund. The balance rose again in

2012, by ISK 19 bn, due to remuneration to Landsbankinn for the takeover of SpKef savings bank. The end-2013 balance is therefore ISK 213 bn. The net refinancing risk of this bond is lower than its face value, however, as ISK 58 bn will be repaid with the subordinated loans to the banks.

(d) In May 2012, the Treasury issued a bond in the amount of USD 1 bn (ISK 129 bn at the year-end 2012 exchange rate) at a yield of 6.0%. It is planned to refinance the debt prior to its 2022 maturity with another foreign market issue.

One of the uncertainties related to refinancing centres on whether non-residents choose to continue investing in Government securities once the capital controls have been lifted. It is the Treasury's task to minimise the impact of capital account liberalisation on the central government's debt management.

The Treasury's domestic balance with the Central Bank of Iceland totalled ISK 135 bn at year-end 2012, and its foreign balances amounted to just over ISK 338 bn. It is planned to reduce the domestic balance by about ISK 30 bn in 2013. As a result of this strong cash position, the deposits can be used to service Treasury debt during the year if the issuance plans for 2013 do not materialise in full. Consequently, Treasury deposits reduce refinancing risk.

7.3 Contingent liabilities

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 that are of key importance in Icelandic society. A discussion of the magnitude of this risk can be found in Sections 7.3.1 - 7.3.4.

7.3.1 State guarantees

State guarantees represent the Treasury's greatest contingent liabilities. State guarantees are governed by Act no. 121/1997. The Parliament of Iceland grants State guarantees upon receiving requests from the Ministry of Finance and Economic Affairs.

State guarantees are administered by the State Guarantee Fund, which compiles information on the position of the companies concerned and assesses the risk attached to the guarantees. The Central Bank oversees State guarantees according to an agreement with the Ministry of Finance and Economic Affairs. The State Guarantee Fund notifies the Ministry of Finance and Economic Affairs if a guarantee is likely to fall on the Treasury. Table 5 shows the status of State guarantees at the end of December 2012.

State guarantees

Position Dec. 31 2012	Amount in ISK millions	%
Housing Finance Fund (HFF)	942.169	71%
Landsvirkjun	342.231	26%
Others	35.226	3%
Total	1.319.626	

Table 5

As of 31 December 2012, State guarantees amounted to ISK 1,320 bn, or 77% of GDP. The largest entities enjoying State guarantees of their borrowings are the Housing Financing Fund, with 71% of the total, and Landsvirkjun, with 26%.

7.3.1.1 Housing Financing Fund

In accordance with the Housing Act, no. 44/1998, the role of the Housing Financing Fund is to provide loans for the purchase of housing in Iceland. The Fund is supervised by the Financial Supervisory Authority.

The Fund's operating results for 2012 were negative by ISK 7.9 bn, as opposed to a profit of ISK 1.0 bn in 2011. The Fund's capital at the end of the period was ISK 14.7 bn, taking into account the capital contribution in the amount of 13 bn that will be paid to the fund in the form of Treasury bond as of 1 January 2013. The Fund's capital was ISK 9.6 bn at end-2011. Its capital ratio, calculated in accordance with the Regulation on the Housing Financing Fund, no. 544/2004, was 3.2% in 2012, as opposed to 2.3% at end-2011.

The Government obtained authorisation in the 2013 fiscal budget supplement for a capital contribution of up to ISK 13 bn so that the Fund's capital ratio would not be below 3% at the beginning of 2013. Nevertheless, it remains the Government's aim that the Fund's capital ratio shall be 5%, as is set forth in the pertinent Regulation.

On 7 December 2010, Parliament had approved a contribution of ISK 33 bn to the Housing Financing Fund to improve its capital position. Other things being equal, further capital contributions will probably be necessary in coming years.

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 the most prominent by far, which is reflected in the fact that the Fund's operational losses in recent years stem primarily from loan impairment and increased debt prepayment.

Interest rate risk is also an important risk factor, as net interest income is a prominent part of the Housing Financing Fund's profit and loss account. The low equity ratio makes it difficult for the Fund to protect itself against risks in its operations, and the financial risk to the Treasury is greater as a result.

Currently there is a committee on behalf of the Ministry of Welfare, viewing the prospects and future of the fund. The committee will schedule an interim report in the spring.

7.3.1.2 Landsvirkjun

Landsvirkjun's financial position is acceptable, with EBITDA amounting to USD 319.6 m and an equity ratio of 37.6% at year-end 2012. At year-end 2011, EBITDA was USD 345 m and the equity ratio 35.9%. The company's liquidity is sound because of its strong cash position and undrawn revolving credit facilities, and the group is well prepared to service its debt in coming years. It has reduced its debt in recent years and aims to reduce it still further.

Landsvirkjun has signed agreements with the Nordic Investment Bank for the conversion of two loans from floating-rate euro-denominated loans to dollar-denominated fixed-rate loans. The loans were taken in 2004 (maturing in 2019) and 2006 (maturing in 2028), in the amount of

EUR 70 m each, for a total of EUR 140 m, but after the conversion they will be USD 92 m each, or a total of USD 184 m.

The advantages to Landsvirkjun of the debt restructuring are twofold. First of all, financial risk due to changes in the exchange rate of the euro against the company's functional currency, the US dollar, is reduced. Second, the share of variable-rate loans in the debt portfolio is reduced, thereby reducing the company's interest rate risk. In order to reduce market risk still further, the company concluded a currency swap agreement of the underlying loan, where a EUR 60 m variable-rate loan was converted to a USD loan bearing fixed interest.

Landsvirkjun's financial risk consists of market risk, liquidity risk, and counterparty risk. Landsvirkjun has systematically reduced its market risk. With an agreement negotiated in 2010 between Landsvirkjun and Alcan Iceland, the aluminium price linkage in the previous contract was revoked and all sale of electricity to Alcan linked to the US consumer price index. The proportion of Landsvirkjun's electricity sales linked to the price of aluminium has therefore declined sharply in recent years, from 70% to about 45%.

The company's operations will continue to be vulnerable to changes in interest rates and aluminium prices. Its refinancing risk is reduced with equal distribution of instalments and interest and with long residual maturities of outstanding debt. The weighted average time to maturity of the debt portfolio was 6.5 years as of end-2012, as opposed to 7.6 years at the end of 2011. It is therefore considered unlikely that the State guarantee will be activated in the near future.

7.3.2 Municipalities

While there is no legally mandated State guarantee on local government debt, municipalities' financial position could pose a general risk to the economy and the Treasury, as well as to the municipalities concerned. Some municipalities are heavily leveraged, and their weak financial position is cause for concern.

Parliament passed legislation on municipal in 2011 affairs that provides for increased discipline and clearer rules for local government finances, as well as increased supervision and information disclosure. First of all, it is stipulated that combined Part A and Part B revenues must be in balance each three-year period. Second, total debt and obligations of Parts A and B shall not exceed 150% of regular revenues. It is clear that many municipalities will need several years to adjust their debt position to this maximum. The adaptation period according to the Act is 10 years. It is important that the municipalities use this time well and return their finances to a sustainable position as soon as possible. The Act stipulates that decisions on municipal investment, development, or other contractual obligations exceeding 20% of the current year's tax revenues shall be subject to an impartial appraisal of the impact on the municipality's financial position.

During the period 2002-2007, total municipal debt and obligations, Parts A and B, increased steadily in ISK terms but remained broadly unchanged relative to total revenues. During that period, revenues grew rapidly, as did foreign borrowings, and total debt as a share of total revenues averaged 160%. The ratio of total debt to total revenues was lower than it would have been otherwise, owing to increased economic activity and the appreciation of the króna. Icelandic municipalities' debt has been relatively high since 2008, in the wake of the ISK depreciation that year, and the contraction in revenues increased the ratio quickly to almost 229% and then 256% by 2010. By year-end 2011, it had fallen back to 230%. It should be noted, however, that the liabilities of Reykjavík Energy (OR) skew the picture considerably, as they constitute 40% of total municipal debt and obligations. Without OR, municipal debt as a share of total revenues would have been 165% at year-end 2011. An examination of Part A of

the municipal accounts reveals that total debt and obligations amounted to 135% of total revenues at year-end 2011.

In order for municipalities with a high debt ratio to reduce their debt in coming years, it is important that net cash from operations is enough to cover both investments and loan instalments. Municipalities' need for domestic and foreign refinancing in coming years underscores the importance of maintaining strong operating results. The sooner the municipalities show that their debt is moving towards sustainable levels, the sooner their refinancing risk will be reduced. In the next few years, refinancing agreements for foreign loans will be made with domestic and foreign lenders. It is important that targets for operational streamlining and debt reduction be established so that each municipality's debt and obligations will be below 150% of defined revenues within a realistic time frame.

7.3.3 Public-private partnership

Public-private partnerships can entail financial risk for the Treasury, even in the absence of a State guarantee. Such partnerships usually represent little direct financial risk in and of themselves, but circumstances can develop where the projects need capital in excess of current budget allocations. The main public-private partnerships currently in preparation are the operation of the Harpa Concert and Conference Centre and the Vaðlaheiðargöng tunnel.

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 entities that manage long-term projects for individual ministries and public institutions.

Agreements are prepared in three stages. The first stage involves a preliminary examination of the cost-effectiveness and premises of the project, which must be approved by the Ministry of Finance and Economic Affairs. In the following stage, contractual agreements are drafted with a more detailed definition of the project concerned. In the third stage, the parties to the agreement are selected in compliance with the rules on public procurement.

The State Trading Centre is the agency that handles procurement for public institutions and provides assistance and guidelines on agreements of this kind. The financial objective of this arrangement is to enhance the cost-effectiveness of procurement in such a way that it strengthens and maintains competition in the market and builds up markets where they did not previously exist.

According to the Government Financial Reporting Act, agreements of this kind must be approved by Parliament. The Ministry of Finance and Economic Affairs has also issued guidelines on the preparation of service contracts and public-private partnership agreements.

7.3.4 Icesave

The EFTA Court ruling in the Icesave case acquitted Iceland of ESA's demand that Iceland be declared in violation of the EEA Agreement. The Court rejects the claim that the Icelandic authorities violated the EU Deposit Guarantee Directive or discriminated among depositors. It is extremely satisfying that Iceland's cause prevailed, and the EFTA Court decision closes an important chapter in a very long story.

From the outset, Iceland has drawn attention to the legal uncertainty about whether the state is liable for payment of minimum deposit guarantee amounts to depositors, and it has emphasised the importance of subjecting this issue to a court ruling. There were no realistic opportunities to

do this, however, before the EFTA Surveillance Authority decided to file the case with the EFTA Court.

The ruling concludes Iceland's dealings with the EFTA Surveillance Authority on the Icesave case. A legal decision has been made, and there is no reason for any further action by ESA. The case has been particularly difficult, both domestically and in international relations, and it caused significant delays in the Government-IMF economic programme. Now, however, the Icesave dispute is no longer a hindrance to the revitalisation of the Icelandic economy.

It is important to emphasise that payments from the Landsbanki estate will continue, irrespective of the EFTA Court ruling. The assets of the estate are now assessed at ISK 1,542 bn, which is about ISK 200 bn in excess of the priority claims, which are estimated at ISK 1,318 bn. Of these priority claims, ISK 1,167 bn are due to Icesave accounts and another ISK 150 are due to wholesale deposits from municipalities, charitable organisations, etc., which have also been paid. To date, ISK 661 bn have been paid towards priority claims, or about 50% of the total amount. Of that amount ISK 585 bn have been used for payment of claims related to Icesave accounts. This amount corresponds to over 90% of the minimum deposit insurance amount paid out by the British and Dutch authorities.

It is assumed that the Icesave claims will be paid in full by the actual debtor, the Landsbanki estate. The passage of the Emergency Act in 2008, which granted deposits priority over general claims, led to this result.

8 Institutional Structure

Parliament authorises the Ministry of Finance and Economic Affairs to borrow and issue State guarantees each year, according to the National Budget. The Act on Government Debt Management stipulates that the Ministry is responsible for and implements debt management and State guarantees. The Ministry of Finance and Economic Affairs has also concluded an agreement with the Central Bank of Iceland on the provision of advice and execution of the Treasury debt management strategy. The agreement contains explicit provisions on division of tasks and responsibilities so as to ensure that debt management decisions are taken independent of monetary policy conduct.

8.1 Ministry of Finance and Economic Affairs

The Financial Management Department of the Ministry of Finance and Economic Affairs handles Treasury debt management. The Ministry takes decisions on issuance volume, proposed bond auctions, and liquidity management. It also determines yields and amounts of accepted bids in Treasury auctions. Moreover, the Ministry of Finance and Economic Affairs decides on the structure, maturity, and characteristics of new issues, as well as buybacks and/or swap agreements.

8.2 Agreement with the Central Bank of Iceland

The Ministry of Finance and Economic Affairs has made an agreement with the Central Bank of Iceland on the provision of advice and the implementation of Treasury debt management.³ The purpose of the agreement is to promote 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, administers Treasury debt affairs with the authorisation of the Ministry of Finance and Economic Affairs and in accordance with guidelines set by the Ministry. Government Debt Management is responsible for ensuring that borrowing and debt management are in harmony with the policies set by the Ministry.

Government Debt Management also administers State guarantees and assesses the Treasury's risk due to such guarantees. It provides the Ministry with opinions on State guarantees and grants the guarantees on the basis of parliamentary decisions.

On behalf of the Ministry of Finance and Economic Affairs, Government Debt Management handles the regular disclosure of information on the Treasury's domestic and foreign loan stock to market participants, and publishes information on auction days and planned volume of issuance for the year on the basis of the Government's estimated borrowing requirement. It also issues press releases on debt management on behalf of the Ministry of Finance and Economic Affairs.

³ The Government Debt Management Agreement of 18 October 2010, based on the agreement of 4 September 2007.

8.3 Consultative Committee on Debt Management

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

The Consultative Committee shall serve as a forum for the exchange of views on the position of and outlook for capital markets, and on the Treasury's domestic and foreign borrowing and borrowing plans. It is intended to promote reforms in the domestic credit market as it deems appropriate.

The committee presents proposals to the Ministry of Finance and Economic Affairs on the format and arrangements for individual bond issues and their maturity and volume, as well as arrangements for market making and auctions. Furthermore, the committee proposes risk management criteria for the Treasury's domestic and foreign debt portfolio. It discusses and passes proposals for Treasury issuance programmes in domestic and foreign markets. The calendar specifies the volume, dates of issuance, and planned borrowing actions for the year. The calendar must be approved by the Ministry of Finance and Economic Affairs and is then announced to market participants. The committee meets on a monthly basis or more often, as necessary.

9 Market communication

The Ministry of Finance and Economic Affairs and Government Debt Management communicate with market participants through publications and meetings. The Ministry of Finance and Economic Affairs publishes its annual borrowing plan after the National Budget has been approved by Parliament. Furthermore, meetings are held with primary dealers and investors.

Including information about debt management that The Ministry of Finance and Economic Affairs and Government Debt Management publish are:

- Medium-Term Debt Management Strategy
- Annual Government Debt Management Prospect
- Quarterly Government Debt Management Prospect
- Auction announcements
- Market Information

All press announcements are published on the NASDAQ OMX Nordic Exchange in Iceland and Bloomberg and are distributed to the media and market participants. The exchange uses GlobeNewsWire to broadcast press releases to foreign media and market participants.

9.1 Medium-Term Debt Management Strategy

The Ministry of Finance and Economic Affairs prepared the Medium-Term Debt Management Strategy (MTDS), which is revised and published annually. The MTDS discusses the following topics, among others:

- Government debt strategy
- Issuance strategy
- Structure and issuance of new Treasury bonds
- Average time to maturity
- Composition of the debt portfolio

9.2 Quarterly Government Debt Management Prospect

The Quarterly Government Debt Management Prospect is designed to provide market participants with general information on Treasury issuance for the upcoming year. It is published following parliamentary approval of the National Budget and includes the following information:

- Total issuance volume for the coming year
- Issuance policy for the coming years
- Buybacks
- Switch auctions

9.3 Quarterly Government Debt Management Prospect

At the end of each quarter, Government Debt Management issues a calendar for the upcoming quarter. The quarterly Prospect contains detailed information on issuance of individual series.

- Treasury bond issuance
- Treasury bill issuance

9.4 Auction announcements

Press releases on individual auctions are published a few days before each auction. The results are published after each auction.

9.5 Planned auction dates

In December of each year, planned Treasury bill and Treasury bond auction dates for the upcoming year are published on the Government Debt Management website, as is information on Treasury bond maturities and the Market Information newsletter. This information is also communicated directly to market participants.

9.6 Market Information

Government Debt Management publishes a monthly newsletter entitled Market Information. The newsletter contains important information on Treasury debt and State guarantees. Market Information is distributed to the media and to market participants and is published on the Government Debt Management website. It contains the following information, among other things:

- Results of Treasury bond auctions
- Government debt
- Position of Treasury benchmark securities
- Composition of the debt portfolio
- Redemption profile of Government debt
- Owners of Treasury securities
- Balance of securities loans
- State guarantees

9.7 Government Debt Management website

Government Debt Management publishes a website, www.lanamal.is, which includes information and publications related to Treasury debt management, information on market prices, yields, and historical information on Treasury securities, as well as their prospectuses. The following information can also be found there:

- Medium-Term Debt Management Strategy
- Annual Government Debt Management Prospect
- Quarterly Government Debt Management Prospect
- Auction announcements
- Market Information
- Press releases
- The Republic of Iceland's sovereign credit ratings

Information on Government debt can also be found on the Ministry of Finance and Economic Affairs website: www.fjarmalaraduneyti.is.

9.8 Primary dealers in Treasury securities

Government Debt Management oversees primary dealers to ensure that they fulfil their requirements for market making in the secondary market. Meetings are held with them on a quarterly basis, or more often if necessary. A representative from the Ministry of Finance and Economic Affairs also attends these meetings.

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 to them.



MINISTRY OF FINANCE AND ECONOMIC AFFAIRS