Medium-Term Debt Management Strategy

2012 - 2015

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1 Executive Summary

The Medium-Term Debt Management Strategy (MTDS) for 2012 – 2015 sets forth the Government’s plans for debt financing for the specified period. The principal objective in the strategy is 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. Also, to promote the maintenance and further development of efficient primary and secondary markets for domestic Treasury securities.

Benchmark issues of Treasury bonds are structured so that each series is large enough to ensure effective price formation in the secondary market. The benchmark Treasury bond series will be issued each year with maturities of 2, 5 and 10 years. In order to reduce refinancing risk, it is intended to keep the redemption profile of Treasury securities as smooth as possible over time. The average time to maturity should equal or exceed 4 years.

The Government's foreign currency borrowings are carried out primarily to strengthen 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 2011 was equivalent to 89% of GDP. Government debt will gradually be reduced below 75% of GDP by year-end 2015. The net debt was 43% of GDP at the end of 2011 and is expected to be reduced to approximately 36% of GDP by year-end 2015.

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 is responsible for the central government's debt management, sets the strategy and makes all decisions regarding debt issues. A special section within the Central Bank, Government Debt Unit, is responsible for the implementation of the Treasury's debt management policies. Finally, the MTDS includes a description of communication with market participants.

The Medium Term Debt Management Strategy will be updated and revised annually.

2 Debt Management Objectives

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

1. 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;
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 period 2012-2015. It is intended to be a working policy document that will be updated and revised annually.

The strategy has been formulated to establish clear debt management guidelines and quantitative targets, as well as to support the creation of analytical tools to identify, monitor, and mitigate potential risk factors inherent in the 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 section 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 benchmark series, endeavours will be made to exchange non-marketable Treasury debt with benchmark securities as market conditions permit. A precondition for paying off non-marketable Treasury debt with benchmark securities is to ensure that it remains 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 exchange reserves. These loans are not actively managed in the same portfolio, but they are included in the discussion on refinancing of foreign borrowing (see Chapter 5).

The composition of the debt portfolio is designed to address the above-defined debt management objectives, namely to minimise overall risk and to promote the development of a well-functioning market that appeals to a broad range of investors and to establish pricing benchmark for financial markets.

The Government will mainly issue nominal debt, as nominal Treasury bonds form the basis for an efficient bond market. Treasury issuance will also include inflation-linked bonds targeted towards long-term investors, who have traditionally invested in such assets. There is also flexibility to borrow in foreign currencies. The proportion of foreign currency debt will be low, however, so that management of the debt portfolio responds effectively to volatility in foreign exchange markets.

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

Nominal	60-80%
Inflation-linked	10-40%
Foreign currency	0-20%

Chart 1 shows the composition of the debt portfolio in December 2011, excluding the loans taken to expand the foreign exchange reserves.

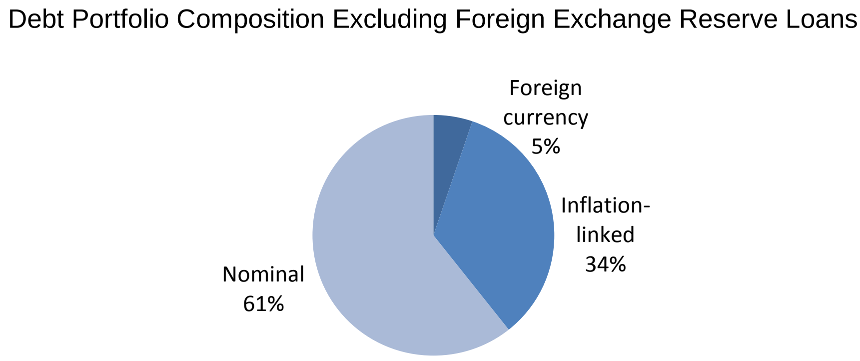

Chart 1

3.2 Guidelines for Borrowing

Based on the provisions contained in the Act on Government Debt Management, the Ministry of Finance has set the guidelines to be applied to debt management. The main guidelines for the debt portfolio are as follows:

1. *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*
   To establish liquid benchmark issues of Treasury bonds by taking into account the Treasury's outstanding domestic liabilities when determining the number and size of new issues.
3. *Proportion of short-term financing*
   To limit the proportion of short-term Treasury debt, (i.e., debt maturing within twelve months), less any undrawn credit facilities, to a maximum of 30% of the entire Treasury's total outstanding debt.
4. *Average time to maturity*
   The average time to maturity of the debt portfolio should be at least 4 years.

3.3 Quantitative Targets

The Government recognises the importance of clear and measurable quantitative targets by which it can evaluate its debt sustainability. The targets are based on Iceland's economic programme and macroeconomic assumptions. The medium-term baseline projections show that, between 2012 and 2015:

1. Total debt as a share of GDP will be below 75% by 2015 and below 60% in the long term;
2. Redemption as a share of GDP will be below 6%;
3. The deposit on the Treasury Single Account will amount to at least ISK 80 billion.

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 reduction in the Treasury's deposits at the Central Bank of Iceland. This chapter discusses the Treasury's financing needs, the Treasury's deposits, and the structure of Government securities, including strategy regarding structure, issuance, redemption profile and average time to maturity.

4.1 Financing needs

The Treasury's financing needs are based on budget assumptions made by the Ministry of Finance in a report on the fiscal plan for 2012-2015. The net borrowing requirement is the sum of net cash provided by operating activities and financial transactions.

Table 1 presents the net borrowing requirement according to the fiscal budget for 2012-2015. The aim is to achieve 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 requirements (ISK million)

2012	2013	2014	2015
-43.200	-23.900	-2.600	18.600

Table 1

4.2 Deposits

The Treasury's deposits at the Central Bank of Iceland amounted to approximately ISK 144 billion at year-end 2011. The present stock is sufficient to cover maturities of Treasury bonds and bills in 2012. At any given time, the Treasury aims to hold deposits amounting to at least ISK 80 billion in its account at the Central Bank.

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 bond series

The structure of benchmark bonds will be designed so that each series is large enough to ensure effective price formation in the secondary market. The aim is to issue a relatively stable amount of Treasury bonds through the year and to tap a number of benchmark points on the yield curve. To fulfil these aims, the benchmark Treasury bond series will be issued each year with maturities of 2, 5 and 10 years.

The 10-year series will be offered first with 11 years to maturity and subsequently re-offered the following two years, with 10 and 9 years to maturity. The bond will be reopened at 6 years to maturity and reoffered with 5 and 4 years to maturity. Finally, the bond will be reopened at 2 years to maturity.

Longer-term nominal bonds and medium- to long-term inflation-linked bonds will be issued on an irregular basis, depending on the Treasury's financing needs at any given time.

The objective is for the final size of each series to be in the range of ISK 40-100 billion, except that when a bond is issued for only two years, the final size of the series will be a minimum of ISK 15 billion. Initially, the series will be built up, relatively rapidly, to a sufficient size to facilitate effective price formation in the secondary market.

Table 2 shows the series that are scheduled for issuance.

Series	**Maturity**	**Amount issued**	**Frequency of issue**
Treasury bills	3 and 6 months	ISK 5-30 billion	Monthly
Treasury bonds	2 years	ISK 40-100 billion if initially issued with a longer maturity; ISK 15-100 billion if issued for only 2 years	Annually
Treasury bonds	5 years	ISK 40-100 billion	Annually
Treasury bonds	10 years	ISK 40-100 billion	Annually
Treasury bonds	>10 years	ISK 40-100 billion	Irregular
Inflation-linked Treasury bonds	Medium and long-term	ISK 40-100 billion	Irregular

Table 2

Treasury bills will be offered with maturities of 3 and 6 months. The 6-month Treasury bills will be offered first 6 months before maturity and then reoffered 3 months before maturity. The amount issued will be flexible, in order to meet the Treasury's financing requirements.

4.3.2 Treasury bond issuance as of 2012

Issuance of Treasury bonds peaked at ISK 190 billion in 2010. Total issuance amounted to 120 billion in 2011 and is expected to be ISK 75 billion in 2012. Issuance is expected to be below ISK 100 billion during the period 2013-2015.

An indication of issuance of Treasury bonds for the next years is given in Table 3. The table is only for demonstrative purposes. In the table, the Government securities that have already been issued are marked with their identification number; i.e., RB 12 0824 (nominal bond maturing 24 August 2012). For Treasury bonds that have not been issued, the numbers before 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.

Year	2012 RB	2013 RB	2014 RB	2015 RB	2016 RB	2017 RB	2018 RB	2019 RB	2020 RB	2021 RB
0	**12 0824**	**13 0517**	**14 0314**	15-2 Yr	**16 1013**	17-2 Yr	18-2 Yr	**19 0226**	20-2 Yr	21-2 Yr
1	**13 0517**	**14 0314**	15-2 Yr	**16 1013**	17-2 Yr	18-2 Yr	**19 0226**	20-2 Yr	21-2 Yr	**22 1026**
2	**14 0314**	15-2 Yr	**16 1013**	17-2 Yr	18-2 Yr	**19 0226**	20-2 Yr	21-2 Yr	**22 1026**	23-2 Yr
3		**16 1013**	17-5 Yr		**19 0226**			**22 1026**		
4	**16 1013**			**19 0226**			**22 1026**			**25 0612**
5			**19 0226**			**22 1026**			**25 0612**	
6		**19 0226**			**22 1026**			**25 0612**		
7	**19 0226**			**22 1026**			**25 0612**			28-10 Yr
8			**22 1026**			**25 0612**			28-10Yr	
9		**22 1026**			**25 0612**			28-10 Yr		
10	**22 1026**			**25 0612**			28-10 Yr			**31 0124**
11			**25 0612**			28-10 Yr			**31 0124**	

Treasury bond 2Y *Treasury bond 5Y* *Treasury bond 10Y*

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 over the long term. The target range for domestic Treasury bond maturities each year is ISK 40-100 billion, except that when a bond is issued for only two years, the final size of the series will be a minimum of ISK 15 billion. This reduces repayment risk while supporting liquidity in each series. Chart 2 shows the redemption profile of domestic liabilities at year-end 2011, excluding Treasury bills. For years where redemptions exceed the target range, measures will be taken to reduce the redemption amount. If necessary, the Treasury will engage in buyouts and hold exchange auctions so as to bring annual redemptions to a level within the target range.

Domestic Redemption Profile

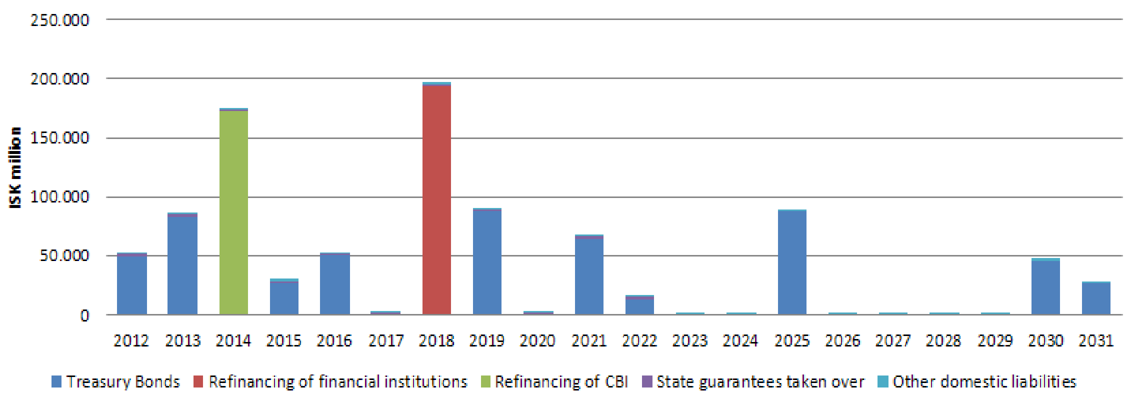

Chart 2

4.3.4 Average time to maturity

The average time to maturity of domestic Treasury securities is set at a minimum of 4 years. In recent years, the Treasury has made targeted efforts to lengthen the average time to maturity of its portfolio. The average time to maturity of the debt portfolio is managed through issuance of Treasury securities with various maturities. If domestic market conditions permit, the Treasury will also use interest rate swap agreements, engage in buyouts, and/or hold exchange auctions to keep the average time to maturity within the defined guidelines.

5 Foreign Borrowing

The Government's foreign currency borrowings are carried out primarily to strengthen foreign reserves, not to fund fiscal operations. Going forward, the foreign currency borrowing strategy is aimed at securing regular access to international capital markets and maintaining a well-diversified investor base. In order to do so, the Government aims at 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 instruments (i.e., those related to the IMF-supported economic programme) with marketable instruments. Regular issuance of marketable instruments in international capital markets is further intended to ensure recognition of the Republic of Iceland as an attractive investment option.

The Central Bank manages the foreign exchange reserves and uses the profile of foreign currency Treasury debt as a benchmark for the 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 according to which the balance sheets of the Government and the Central Bank are viewed on a consolidated basis.

Chart 3 shows all of the Treasury's outstanding foreign currency obligations at end-March 2012. Loans from supporting nations are related to the IMF-supported economic programme. Programme-related debt can be prepaid without a prepayment penalty.

Foreign currency debt redemption profile

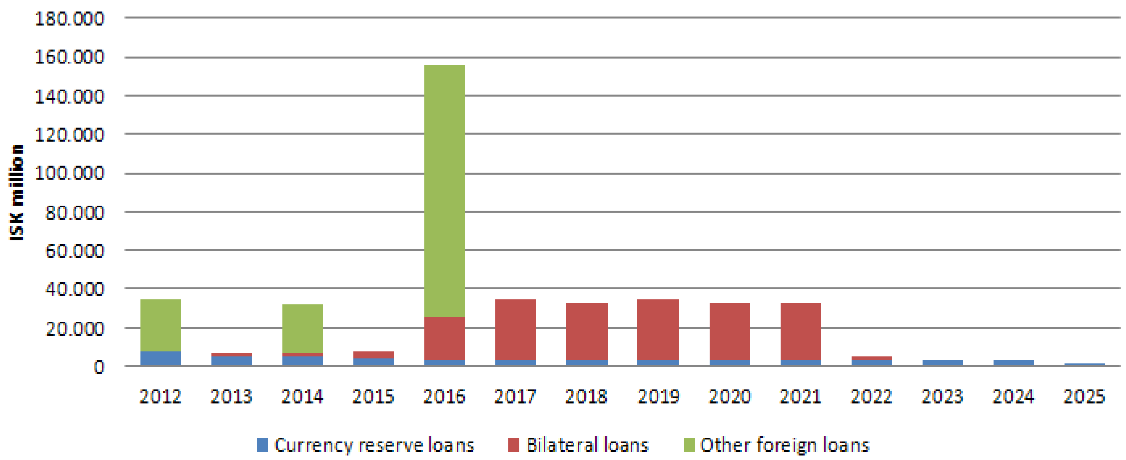

Chart 3

6 Debt portfolio

This section describes the total Government debt portfolio, including loans to expand the foreign exchange reserves, the composition, repayment profile and the investor base of Government securities. It also includes information on the Central Bank's borrowing to strengthen the reserves. Chart 4 shows the development of Government debt from 2005-2011 and expected development until 2015.

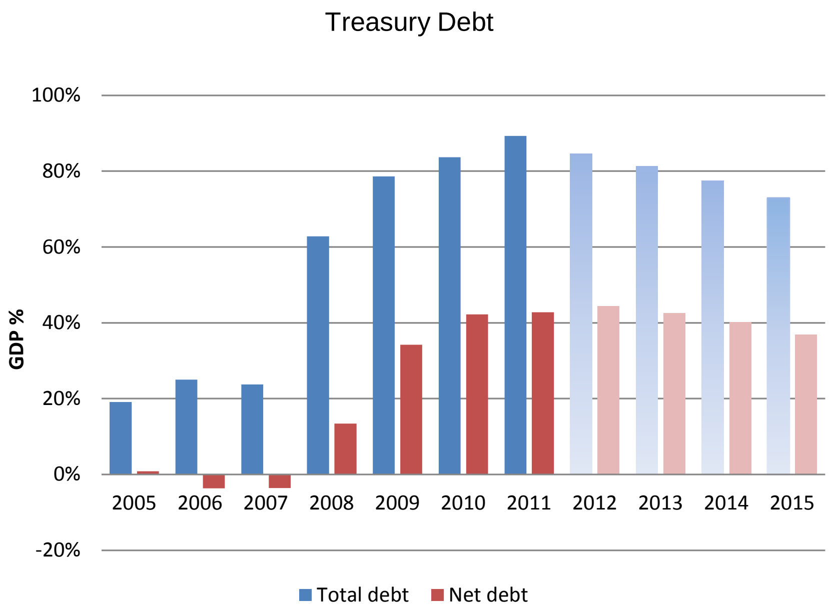

Chart 4

6.1 Government debt

Government debt has increased substantially since the banks collapsed and has risen from approximately ISK 311 billion in 2007 to about ISK 1,465 billion at end-2011. This is equivalent to 89% of GDP. Government debt will gradually be reduced to below 75% of GDP by year-end 2015. Table 4 shows the composition of Treasury debt at year-end 2011.

Net debt totals 43% of GDP at the end of 2011 and is expected to be reduced to approximately 36% of GDP by year-end 2015. Cash in hand and receivables are subtracted from gross debt to calculate net debt. Cash and receivables amounted to ISK 761 billion at the end of 2011.

Treasury debt at the end of December 2011

Central Government				*ISK million*
Domestic				
	Marketable securities			
		Treasury bills		58.900
		Treasury bonds inflation-linked		136.600
		Treasury bonds nominal		399.200
		Refinancing of financial institutions		193.700
	Non-Marketable debt			
		Refinancing of CBI		172.000
		State guarantees taken over		19.400
		Other domestic liabilities		37.900
			Total	1.017.700
External borrowing				
	Currency reserve loans			
		Bilateral loans		220.000
		Other currency reserve loans		172.500
	Other loans			
		Foreign loans		56.200
			Total	448.700
			Total	1.466.400

Table 4

6.1.1 Domestic borrowing

Marketable securities comprise Treasury bonds, Treasury bills, and marketable bonds to recapitalise financial institutions. At the end of 2011, total outstanding marketable securities amounted to approximately ISK 789 billion, having increased from ISK 126 billion since 2007.

The Treasury issued a special Government bond to finance capital contributions and subordinated loans to financial institutions. The series matures in 2018. As of year-end 2011, the outstanding amount is ISK 194 billion. This series carries a variable interest rate in order to hedge some of the interest risk on the liabilities side of the banks' balance sheets. This series is a benchmark bond and is listed on the NASDAQ OMX Nordic Stock Exchange.

Non-marketable debt consists of bond issued to recapitalise the Central Bank of Iceland and cover other domestic liabilities. In 2008, the Government issued a 5-year inflation-linked bond to recapitalise the Central Bank of Iceland after the collapse of the banks. At year-end 2011, the outstanding amount is ISK 172 billion. Other non-marketable debt is attributable primarily to the Treasury's acquisition of stakes in Landsvirkjun from the City of Reykjavík and the town of Akureyri. These are inflation-linked annuity loans maturing in 2034.

6.1.2 Foreign borrowing

Loans contracted within the framework of the Government's IMF-supported economic programme, will be used to strengthen the Central Bank's foreign exchange reserves. The bilateral loans, which are from Denmark, the Faroe Islands, Finland, Poland and Sweden, amount to ISK 235 billion (EUR 1,480 million) and were disbursed directly to the Central Bank of Iceland.[1] The Nordic loans and the Faroese loan have been fully drawn, together with approximately one-third of the loan from Poland. At year-end 2011, the Treasury's borrowings in relation to the economic programme amounted to ISK 220 billion.

Other foreign currency loans to strengthen the reserves amount to ISK 173 billion. These loans are a USD 1 billion Eurobond issued in mid-2011 and a Eurobond of EUR 311 million.

The Treasury has contracted other foreign loans to finance its activities in previous years; these currently amount to approximately ISK 56 billion. Their proportion of the total debt portfolio has been steadily decreasing.

6.1.3 The IMF and bilateral loans to the Central Bank

The loans from the IMF, in the amount of ISK 264 billion (SDR 1,400 million), are part of Government's economic programme and are disbursed directly to the Central Bank of Iceland. The bilateral loan from Norway, amounting to ISK 76 billion (EUR 480 million), is also disbursed to the Central Bank. These loans are used to expand the Bank's foreign exchange reserves and are not part of central government debt.

6.1.4 Composition of Treasury borrowing

Chart 5 shows the Treasury's marketable and the non-marketable debt, including reserve loans, divided into three main categories: nominal debt, inflation-linked debt, and foreign-denominated debt.

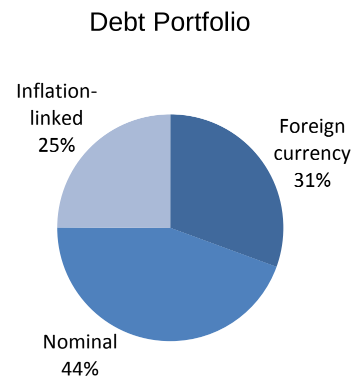

Chart 5

[1] Exchange rate on 31 December 2011: EUR/ISK 159.28.

6.1.5 Redemption profile

Chart 6 shows the redemption profile of Treasury debt as of year-end 2011. The largest maturity dates are in 2014, 2016 and 2018:

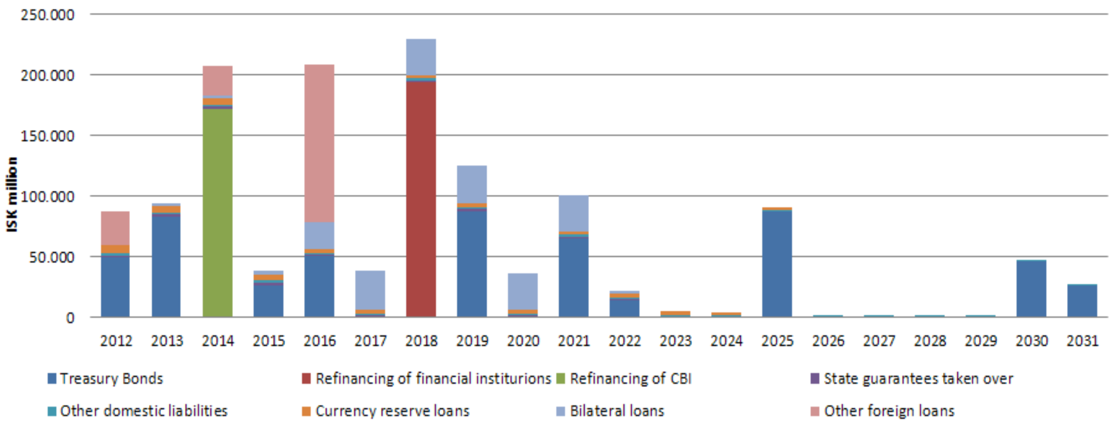

Chart 6

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 172 billion.

Bilateral loans from Denmark, Finland, and Sweden to the Treasury are re-lent to the Central Bank. Repayment will begin at the end of 2014, and the debt will be paid in equal instalments over a period of 7 years. The loan from the Faroe Islands will be repaid in three instalments in 2014-2016.

The Government bond issued to recapitalise the new banks matures in October 2018. The value of the bond is ISK 194 billion as of year-end 2011, but the amount is expected to increase to ISK 214 billion. Assets against the bond are shares in financial institutions and loans to financial institutions.

The summary of the redemption profile does not take into account obligations that may fall on the State as a result of Icesave; these are discussed in greater detail in Section 7.3.2.

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. Chart 7 and chart 8 give a breakdown of the holders of domestic Treasury bonds and bills as of year-end 2011.

Owners of Treasury Securities

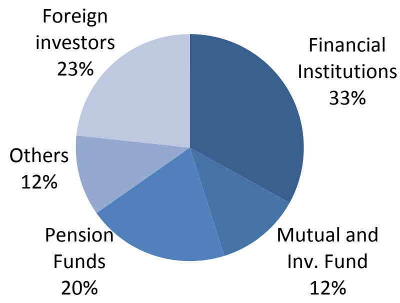

Chart 7

Financial institutions are the largest investors in domestic Treasury securities. They hold 33% of outstanding Treasury securities. The large holdings of financial institutions are mainly due to the special Treasury bond issue, RIKH 18 1009, undertaken to recapitalise the banks.

Non-resident investors hold approximately 23% of domestic Treasury securities. Pension funds hold approximately 20% of outstanding securities. Mutual and investment funds hold 12% of outstanding securities, and other investors hold 12%.

Owners of Treasury Securities

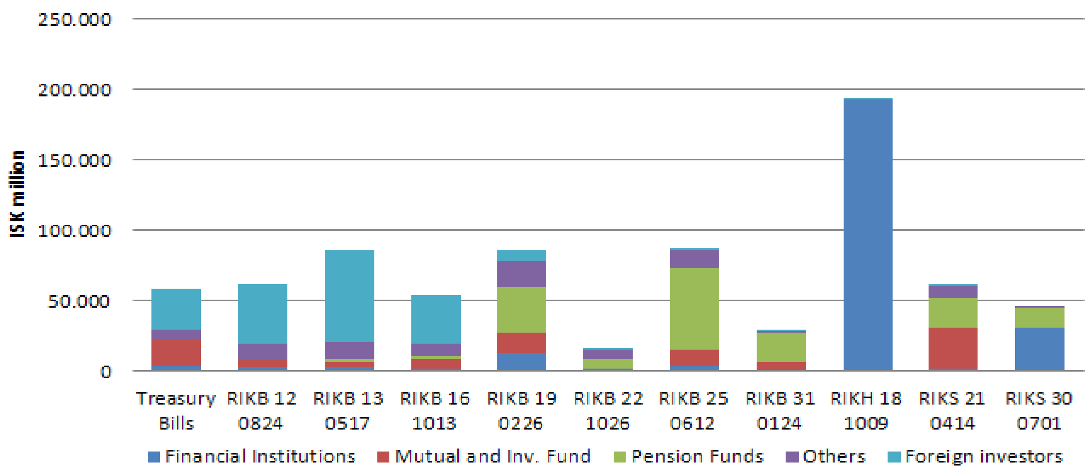

Chart 8

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. There is also substantial refinancing risk in the current portfolio. 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 rate, the risk is that interest rate will rise, thus increasing the Treasury's interest expense.

Chart 9 shows the interest rate composition of the debt portfolio. Approximately 32% 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 43% of the debt is non-indexed and bears fixed interest, and 25% is indexed, fixed-rate debt. Some 68% 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.

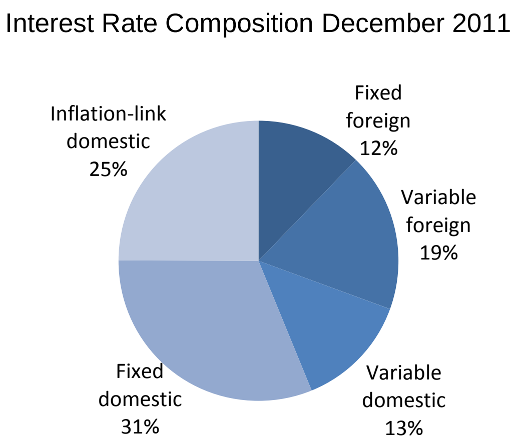

Chart 9

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 the Treasury relends the amount of its foreign loans to the Central Bank to expand the Bank's foreign exchange reserves. 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 2011, the Treasury's indexed loans totalled ISK 364 billion, just over one-third 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 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 largest maturities of Treasury debt, and therefore the sources of the greatest refinancing risk in the portfolio, are as follows:

(a) 2014	ISK 172 bn	Recapitalisation of Central Bank
(b) 2016	ISK 123 bn	Expansion of reserves
(c) 2018	ISK 194 bn	Capital contribution to financial institutions

(a) In December 2008, the Treasury issued an inflation-linked bond to the Central Bank of Iceland to strengthen its capital position. The bond matures in 2014, and the current amount outstanding is ISK 172 billion. It is planned to refinance the loan prior to maturity. The refinancing could take place through issuance of benchmark Treasury bonds and through issuance of a non-marketable debt instrument.

(b) In June 2011, the Treasury issued a bond in the amount of USD 1 billion (ISK 123 billion at the year-end 2011 exchange rate). The bond bears fixed interest and was issued for five years at a yield of 4.993%. It is planned to refinance the debt prior to its 2016 maturity with another foreign market issue.

(c) The Treasury issued a Government bond in the amount of ISK 226 billion to finance capital contributions and subordinated loans to financial institutions. The outstanding balance of the bond declined by ISK 32.5 billion in 2011 as a result of a bond swap between the Treasury and the Housing Financing Fund. The balance stood at ISK 194 billion at year-end 2011. The bond matures in 2018. The net refinancing risk of this bond is lower than its face value, however, as ISK 54 billion will be repaid with the subordinated loans to the banks.

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 deposit balance with the Central Bank of Iceland amounted to ISK 144 billion as of end-2011. It is planned to reduce that balance by about ISK 25 billion in 2012. 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 2012 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 issues State guarantees upon receiving requests from the Ministry of Finance.

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. The State Guarantee Fund notifies the Ministry of Finance if a guarantee is likely to fall on the Treasury. Table 5 shows the status of State guarantees at the end of December 2011.

State Guarantees

Position Dec. 31 2011	ISK millions	%
Housing Financing Fund	943.880	71%
Landsvirkjun	338.763	26%
Others	39.952	3%
Total	1.322.595	

Table 5

As of 31 December 2011, State guarantees amounted to ISK 1,323 billion, or 86% 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. According to the Housing Financing Fund's interim financial statements for the first half of 2011, the Fund's operations improved significantly in the first six months of the year, generating a profit of ISK 1.6 billion. The Fund's equity was ISK 10.1 billion at the end of June 2011, and its equity ratio as calculated in accordance with the provisions of the Regulation on the Housing Financing Fund, no. 544/2004. was 2.4%. The ISK 33 billion contribution from the Treasury in the 2010 budgetary supplement was allocated primarily to the planned write-down of individuals' mortgage loans to 110% of the property valuation or appraised value of the underlying asset; therefore, the Fund's equity ratio benefited very little from the transfer. Participation in the 110% option was considerably less than expected, however. Nonetheless, the Fund's equity ratio is below the required 5% minimum.

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, credit risk is most prominent by far, which is reflected in the fact that the Fund's operational losses in recent years stem primarily from loan impairment. It should be borne in mind, however, that the Housing Financing Fund's general credit risk is less than that facing the banks because the Fund's lending requirements have been stricter. The ceiling on loans is set at ISK 20 million, and the loan-to-value ratio is 80% of the assessed value according to the Iceland Property Registry. All Housing Financing Fund loans are denominated in ISK.

Applicants for the Government's 110% option were about 4,400 fewer than expected; therefore, a portion of the precautionary write-down of last year will be reversed. On the other hand, closer analysis reveals more extensive debt and operational problems among legal entities than originally expected; therefore, an additional ISK 4 billion has been allocated as a precautionary contribution for them.

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.

7.3.1.2 Landsvirkjun

Landsvirkjun's financial position is strong. The group's operating revenues before depreciation totalled USD 345.2 million in 2011, and its equity ratio was 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.

At year-end 2011, Landsvirkjun negotiated a syndicated loan in the international banking market. The loan is a three-year multi-currency revolving credit facility in the amount of USD 200 million. With this loan, Landsvirkjun has completed refinancing a similar loan maturing in December 2012.

Landsvirkjun's financial risk consists of market risk, liquidity risk, and counterparty risk. Landsvirkjun has systematically reduced its market risk. With a new 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, from 76% to about 50% in 2011.

The company's operations will continue to be vulnerable to changes in the price of aluminium, but hedging and a broader revenue base will ensure strong cash flow in coming years. 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 7.6 years as of end-December 2011. It is therefore considered unlikely that the State guarantee will be activated in the near future.

7.3.2 Icesave

Since the Icesave agreement was rejected in the 9 April 2011 plebiscite on the validity of Act no. 13/2011, the authorities have been in contact with the EFTA Surveillance Authority (ESA) concerning the resolution of the matter. On 10 June 2011, ESA sent the Icelandic authorities a substantiated opinion on the Icesave matter and granted them three months to take the appropriate measures to comply with the opinion. The authorities replied to the ESA statement on 30 September, reiterating its demand that ESA conclude the matter without further action. On 14 December 2011, ESA referred the case to the EFTA Court on the grounds of Iceland's alleged violations of the deposit insurance directive.

Uncertainty about the conclusion of that case and other uncertainties make it impossible to estimate the cost that will fall on the Treasury. It can be said, however, that a given uncertainty has been eliminated with the Supreme Court's confirmation of the administrative validity of the Emergency Act in October.

According to the revised asset valuation prepared by the Landsbanki resolution committee on 17 November 2011, the prospects for asset recovery from the Landsbanki estate continue to improve. It can be said that there is an overwhelming likelihood that the estate's assets will cover all of the claims that the winding-up committee has defined as priority claims, including the claims of general depositors, most of which are in the hands of the British and Dutch deposit insurance funds. At the beginning of December 2011, about one-third of priority claims had been paid out. Payments from the Landsbanki estate will then be disbursed in coming years, as asset recovery payments are made to the estate.

7.3.3 Local governments

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. Some municipalities are heavily leveraged, and their weak financial position is cause for concern. Municipal debt has been relatively high in recent years. Their total debt and obligations amounted to an estimated 243% of total revenues in 2011. It should be noted, however, that the liabilities of Reykjavík Energy (OR) skew the picture considerably, as they constitute 42% of total municipal debt and obligations. An examination of Part A of the municipal accounts reveals that total debt and obligations amounted to 144% of total revenues in 2011.

The rules on local government finance recently passed by Parliament stipulate that the total debt and obligations of Parts A and B shall not exceed 150% of regular revenues. The municipalities are granted an adaptation period to bring their financial ratios into compliance with these guidelines, and it is important that they use this time well and return their finances to a sustainable position as soon as possible.

7.3.4 Public-private partnership

Public-private partnerships can entail financial risk for the Treasury, even in the absence of a State guarantee. Such partnerships represent little financial risk in and of themselves, but circumstances can develop where the projects need capital in excess of budget allocations. The main public-private partnerships currently in preparation are the Vaðlaheiðargöng tunnel and the construction of the new national hospital.

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. 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 has also issued guidelines on the preparation of service contracts and public-private partnership agreements.

8 Institutional Structure

The Althingi authorises the Ministry of Finance to borrow and issue State guarantees each year according to national budget. The Act on the National Debt Management stipulates that the Ministry of Finance is responsible for and implements debt management and State guarantees. The Act also gives the responsibility of liability management to the Ministry of Finance, which in turn has made an agreement with the Central Bank of Iceland on the provision of advice and the execution of the Treasury's debt management. The agreement ensures that the Central Bank of Iceland's monetary policy has no impact on the Treasury's debt management.

8.1 Ministry of Finance

The Financial Management Department of the Ministry of Finance deals with debt management. The Ministry of Finance decides on the volume of issuance, proposed bond auctions and liquidity management. Furthermore, the Ministry determines the yield and amounts on accepted bids in auctions of Treasury instruments, as well as the structure, maturity, and characteristics of individual debt issues, and approves any buybacks and/or swap agreements.

8.2 Agreement with the Central Bank of Iceland

The Ministry of Finance has made an agreement with the Central Bank of Iceland on the provision of advice and the implementation of Treasury debt management.[2] The purpose of this Agreement is to promote a more economical, efficient and effective debt administration for the Treasury, based on the Ministry of Finance's debt management strategy. Under the terms of the agreement, the Central Bank is responsible for the provision of advice and execution of the Treasury's debt management.

A special section within the Central Bank of Iceland, administers debt affairs and debt implementation with the authorisation of the Ministry of Finance and in accordance with guidelines set by the Ministry. The Bank's Government Debt Unit is responsible for ensuring that borrowing and liability management are in harmony with the policies set by the Ministry.

The Government Debt Unit also handles the administration of State guarantees and assesses the Treasury's risk due to such guarantees. The Unit provides the Ministry with opinions on State guarantees and grants such guarantees, on the basis of parliamentary decisions.

The Unit, on behalf of the Ministry of Finance, 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 behalf of the Ministry of Finance.

8.3 Debt Management Consultative Committee

The Minister of Finance appoints a Consultative Committee on Debt Management, which comprises representatives from the Ministry and the Central Bank of Iceland.

[2] The initial agreement was made in September 2007 and renewed in October 2010.

The Consultative Committee acts as a forum for the exchange of opinions on the position and prospects of financial markets, and the Treasury's debt management and borrowing plans, both domestically and abroad. The committee is also intended to facilitate enhancements to the domestic credit market, where necessary.

The committee submits proposals to the Minister of Finance concerning the form of individual series of government securities, maturities, size, proposed market-making and auction arrangements. The committee also submits the proposed criteria for the risk management of the Treasury’s debt portfolio in domestic and international markets. The committee discusses and processes the proposed Treasury’s Issuance Calendar for the domestic and international markets. The calendar specifies the volume of issuance for the year, issuance dates and the measures that are being envisaged for the credit market that year. The calendar needs to be endorsed by the Ministry of Finance and is later announced to market participants. The committee meets monthly or more frequently if necessary.

9 Market Communication

The Ministry of Finance and the Government Debt Unit will increase communication with market participants through publication and meetings. Annual borrowing plan is presented to the market by the Ministry of Finance after the fiscal budget has been approved by Althingi. Furthermore, meetings will be held with primary dealers and end-investors.

The Ministry of Finance and Government Debt Unit will publish following documents regarding Government Debt Management:

- Medium-term Debt Strategy (MTDS)
- Annual Borrowing Plan (ABP)
- Quarterly Financing Announcement (QFA)
- Auction Preview (AP)

All press announcements are published on the NASDAQ OMX Icelandic Stock Exchange, Bloomberg and are distributed to the media and market participants. The NASDAQ OMX use GlobeNewsWire newswire distribution company to broadcast all the press announcements to the media and market participants globally.

9.1 Medium-term Debt Management Strategy

The Ministry of Finance produces the MTDS which is reviewed and published yearly. Presentation to the market participant will include following subjects:

- Government debt strategy
- Emphasis in issuing strategy
- Structure in government securities issuance
- Average time to maturity
- Composition of the debt portfolio

9.2 Annual Borrowing Plan

The ABP is published as soon as the fiscal budget has been approved by the Parliament and contains the following information:

- Total issuing amount for the year
- Emphasis in issuing strategy for the year
- Buybacks
- Exchange auctions

The ABP aims to give market participants general information about the Government debt for the coming year.

9.3 Quarterly Financing Announcement

At the end of each quarter the Government Debt Unit will publish QFA. The QFA will contain detailed information about issuance of individual Treasury securities in the quarter.

- Treasury bond issuance
- Treasury bill issuance

9.4 Auction announcements

Auction Preview (AP) is published few days before each auction. The results of the auction are published in a subsequent press announcement after the auction.

9.5 Auction calendar

In December each year auction calendar is published on the website of the Government Debt Unit and distributed to market participants. The auction calendar contains scheduled auctions for Treasury bonds and bills.

9.6 Market information

The Central Bank's Government Debt Unit publishes a monthly newsletter entitled Market Information. The bulletin provides the main information about Government debt and State guarantees. Market Information is distributed to the media and market participants. It is also available on the website of the Government Debt Unit. The bulletin contains the following information:

- Results of government auctions
- Government debt
- The position on marketable debt
- Composition of the debt portfolio
- Redemption profile
- Investors
- Securities lending
- State Guarantees

9.7 Government Debt Website

The Government Debt Unit has a website, www.lanamal.is, with information on Government debt. The website includes all publications regarding Government Debt Management, information about market price, yields and historical data on government securities and registration statements on government bonds and also:

- Medium-term Debt Management Strategy
- Annual Borrowing Plan
- Quarterly Financing Announcement
- Auction Preview
- Market Information
- Press announcements
- Credit rating

Information on government debt can also be attained on the Ministry of Finance website, www.ministryoffinance.is.

9.8 Primary dealers

The Government Debt Unit oversees the daily business of primary dealers and meets with them at least quarterly and more often if necessary. A representative from the Ministry of Finance attends also these meetings.

9.9 End investors

Communication channels with end investors will be enhanced. Representatives from the Government Debt Unit and the Ministry of Finance will have meetings with end investors to get their feedback on the issuing strategy.

Ministry of Finance