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Icelandic Banks: No Sign Of A Thaw
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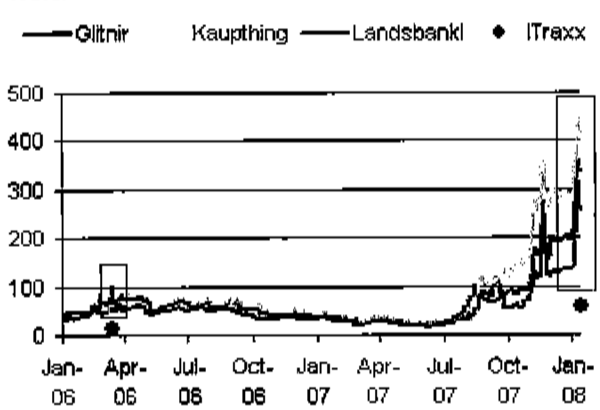
- The demise of small investment company Gnupur has intensified the perennial concerns about Icelandic banks and pushed spreads to new wides
- There are still reasons to be cautious about the banking sector, not least its exposure to falling equity markets
- But the recent widening in Icelandic bank CDS spreads smacks of panic and overstates their weaknesses

Relative value summary
We have already commented this year that CDS spreads on Icelandic banks have widened too far compared with those of other European banks (see **European Financials 2008 Outlook: The Camel and the Grief Cycle**). While we have consistently highlighted the risks in the Icelandic banking system that, in our view, justify a spread premium over other similarly rated European banks, current levels are disproportionately wide. As the chart shows, 5-year senior CDS have continued to widen and stand at unprecedented levels, significantly wider than in the mini-crisis they experienced in mid-2006. **While we think the CDS market has the hierarchy correct – from Landsbanki (Aa3/NR/A) through Glitnir (Aa3/A-/A) to Kaupthing (Aa3▾/NR/A) – we think spreads overstate the fundamental risks.** And we continue to see better relative value in Landsbanki and Glitnir than in Kaupthing.

Icelandic Banks: 5-Year Senior CDS



	Mar-06	Jan-08
Kaupthing		
CDS	102	413
iTraxx	11	57
Gap	91	356
Glitnir		
CDS	49	335
iTraxx	11	57
Gap	38	278
Landsbanki		
CDS	103	257
iTraxx	11	57
Gap	92	200

Source: CMA data, Bloomberg

Fundamental summary
We are expecting fourth quarter earnings to be depressed by mark-to-market losses, especially on equity holdings, but full year profitability should remain good. **The demise of investment company Gnupur (see below) should not itself have a significant financial impact on the banks, but we would not be surprised to see other investment companies having difficulties, and margin calls from the banks are increasing.** Capital ratios are higher than average for European banks - as they need to be, given the banks' risk profiles. Liquidity does not seem to be a problem, largely because the banks strengthened their balance sheets and restructured their funding profiles in the wake of their problems accessing the markets in 2006. Funding remains an issue, although deposit/loan ratios have been rising, particularly at Landsbanki, which tells us that balances at its Icesave UK on-line account continued to grow in the fourth quarter. Concerns remain about the banks' appetite for growth, particularly through acquisition, although our impression is that organic balance sheet growth will be low in 2008 in recognition of the market turbulence. We think investors are right to be cautious about Kaupthing's acquisition of **NIBC** (see **(WW) NIBC: What Awaits Kaupthing?**). Landsbanki is discussing an offer for the banking business of **Close Brothers** in the UK (see **(WW) Landsbanki Islands: Possible Close Brothers Takeover**),

which we estimate will cost it around £500 million. We see this as a relatively low risk acquisition – Close's balance sheet is liquid, credit quality appears good, and it has a strong deposit base. This would create goodwill of around £200 million and increase Landsbanki's balance sheet by around 15-20%, but after talking to management, we think the bank would seek to maintain its capital ratios at around the level of 30 September 2007, helped by its $400 million Tier 1 issue in October, i.e. with a Tier 1 ratio of close to 10%.

Gnupur affair hurts spreads

The latest spread widening seems to have been caused by headlines over the demise of a small investment company, Gnupur. Founded in 2006 and owned by three individuals and their families, Gnupur is typical of the proliferation of Icelandic investment companies that underpin the equity market. It appears to have been relatively undiversified, having bought sizeable holdings in **FL Group** (another, larger, investment company) and **Kaupthing**. In common with other investment companies in Iceland, Gnupur was highly leveraged and has now been forced to sell these holdings and most of its other assets to repay its banks and other creditors. We understand that unsecured bondholders will receive 60% of their holdings, but our impression from speaking to the banks is that their losses will be insignificant. We assume their loans were well collateralised, and that the asset sales have covered the bulk of the loans. Gnupur has not been put into liquidation, and we understand it might be able to recover tax losses that could repay the small remaining amount of bank loans.

On this basis, the Gnupur affair should not have a significant impact on the banks' finances. So, have CDS spreads overreacted to the news? The answer is yes, although we do think investors are right to be wary about the wider implications. Falling share prices are not good news for Icelandic banks for two reasons: a) the banks have direct holdings of equities – in particular Kaupthing and Landsbanki - albeit smaller than in the past, and b) they lend to clients with shares as collateral. The table shows 4Q07 and year-to-date performance of the exchanges to which they are mainly exposed. Icelandic share prices are not alone in falling, but the decline has been more marked than in many other countries because of the dominance of financial stocks in the main index.

Stock Exchange Performance	4Q07	YTD
OMX Iceland 15	-21%	-14%
OMX Stockholm 30	-11%	-9%
FTSE 100	0%	-7%

Source: Bloomberg

Equity exposures

The table shows the three banks' equity holdings at 30 September 2007. Despite reductions in recent years, equity exposure remains quite sizeable, especially for Kaupthing and Landsbanki. Kaupthing's holdings are inflated by the inclusion of two unlisted holdings (in Phase Eight and ADP) that were being warehoused before a transfer in the fourth quarter to Kaupthing Capital Partners II, a €540 million private equity fund in which Kaupthing has a €200 million stake. The table shows gross and net equity holdings as a percentage of shareholders' equity. The net equity positions of the banks are much smaller than the gross positions (which are shown on the balance sheet) because they exclude forward contracts with clients that have the equities as collateral. **These are essentially a form of lending secured on shares and are therefore primarily counterparty rather than market risk – unless the client is unable to fulfil the contract.** It is possible, therefore, that the banks will be exposed to some of this equity risk if investors they have financed run into difficulty.

Equity Holdings EUR mln		--------Trading & Fair Value--------			
		Gross	% of equity	Net	% of equity
Kaupthing	31/12/06	1,697	83%	1,172	34%
	30/9/07	3,464	91%	1,889	50%
Glitnir	31/12/06	1,119	73%	403	26%
	30/9/07	1,182	63%	239	12%
Landsbanki	31/12/06	1,163	76%	526	34%
	30/9/07	2,117	105%	803	40%

Source: Company Reports, CreditSights

Kaupthing says that only 28% of its listed equity holdings are quoted on the Icelandic exchange, and we think this is typical of the banks, meaning that their direct exposure to Icelandic equities is fairly limited. 43% of Kaupthing's equity portfolio is listed on the Stockholm exchange. Nonetheless, we expect the banks' 4Q07 profitability to be dampened by mark-to-market write-downs, to a greater extent than 3Q07, when trading and investment income was well down on previous quarters.

The Central Bank of Iceland estimates that at end-2006, 12% of the banks' lending was against share collateral. Of this amount, 63% had a margining level (i.e. the market value of the shares relative to the loan) of over 150%, while 59% of the lending was to finance purchases on the Icelandic exchange. It also estimates that listed equities used as collateral account for 29% of stock market capitalisation, highlighting the high leverage. **The Icelandic Financial Supervisory Authority (FME) states that total loans with securities pledged as collateral, i.e. direct loans and forward contracts (see below), were 126% of equity at 30 June 2007 (i.e. around €9.5 billion), which we calculate is equivalent to 14% of total loans.** The over-collateralisation should provide a good cushion, even against the substantial stock market declines seen recently, and the FME says that banks made margin calls (i.e. demanded additional capital) in more than 700 cases in the period between 5 December 2007 and 4 January 2008. **It would be naïve to think that Gnupur will be the only investment company to run into difficulties, especially given the highly inter-related nature of investors in Iceland, but the banks all tell us they are comfortable with their exposure and levels of over-collateralisation, and that most investment companies are meeting collateral requirements in a timely way.**

The FME carries out regular stress testing of the banks and publishes the results. The stress test assumes a 25% depreciation of the ISK, a 20% increase in impaired loans, a 28% decrease in share prices (35% in Iceland, 25% foreign) and a 7% decrease in the value of bond holdings. **The latest test, as at 30 June 2007, showed that the potential impact on banks' regulatory capital ratios would be limited, ranging from 70 bps at Glitnir to 250 bps at Landsbanki.**

Finally, the **economic outlook** for Iceland does not make pleasant reading, although the banks are much less exposed to the domestic economy than they used to be. GDP growth was relatively high in 2007 at around 3% but is forecast to fall to 1% in 2008. However, future years should be boosted by the impact of large energy and aluminium projects. The Central Bank policy rate remains at an exceptionally high 13.75% and is not expected to be cut until the second half of the year, while inflation stands at 5.9%, although falling house prices should reduce this. Landsbanki is forecasting a 9% decline in real house prices in 2008.

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