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MORGAN STANLEY FIXED INCOME RESEARCH

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Europe

Investment Grade Credit

European Banks

Icelandic Banks: Chill Out

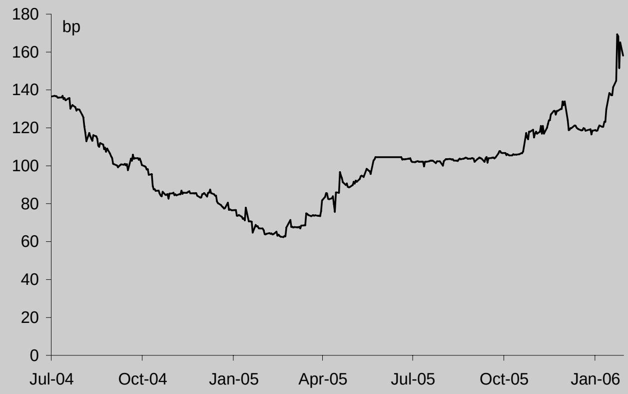
The market has overreacted, in our view. Icelandic bank stock price gains contrast neatly with the fixed income markets' sharp widening over the last six months. Certainly, the Icelandic banks are more of a positive equity story (Icelandic GDP is expected to rise by 5.5% in 2006) than a fixed income one, with their aggressive growth (Kaupthing and Landsbanki) in the capital markets arena. Who is right?

Hold the Icelandics up to the light. The banks are building up a riskier profile that exposes them to a number of exogenous factors. We stress-test these factors – Icelandic equity holdings, a reliance on capital markets, wholesale funding dependence, devaluation of the Icelandic krona. We find that the fixed income markets have overreacted to the risks the Icelandic banks face – and should start distinguishing them.

We recommend Islandsbanki (Glitnir) and Landsbanki. These banks seem to us to be trading on rumour and innuendo rather than fundamentals at the moment. We recommend selling 5-year senior protection on the names we are most comfortable with – Islandsbanki and Landsbanki – prior to moving to more subordinated parts of the capital structure. These banks are riskier, yes – but it is priced in at current levels, in our view. In 5-year senior CDS, we see well over 30bp of tightening potential for Islandsbanki and Landsbanki.

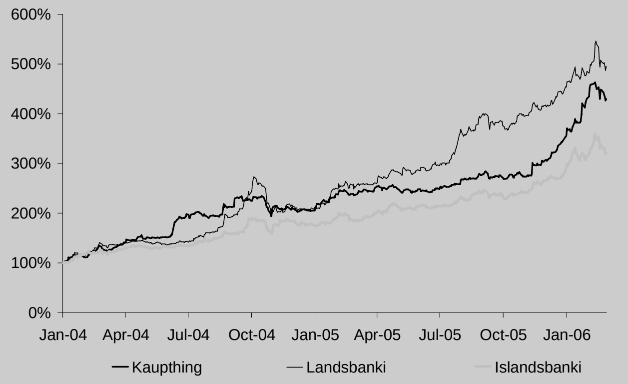
We just can't get comfortable with Kaupthing. We would have liked to recommend Kaupthing as well, as it does look cheap for its rating. However, its unproven private equity strategy, sizeable unhedged equity investments and low capital targets make us cautious. We do note that while we can't see a company-specific trigger for tightening, it may very well benefit from any tightening at its peers.

Kaupthing € Tier 1 14s



Source: Morgan Stanley, MSCI

Icelandic Banks' Stock Market Performance



Source: Morgan Stanley, MSCI

European Banks

Icelandic Banks: Chill Out

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Icelandic Banks – Fears Overdone For Some Names

It was only two years ago that the Icelandic banks were quietly providing banking (ex-mortgage, for the most part) services to their Icelandic customers, with little presence on the European stage. Well-capitalised and with low risk profiles, the worst criticism one could make about them was an over-dependence on the Icelandic fisheries sector. The once-government-controlled Icelandic mortgage market has since opened up, but the banks have already ventured further afield in order to develop their franchises.

What a difference the past year makes. Since then, the Icelandic banks have made their presence felt in our fixed income markets as they have been borrowing aggressively to fund a sharp uptick in growth. All three banks – **Kaupthing Bank** (Kaupthing, A1/A Fitch; € Tier 1 and CDS: Equal-weight (V)), **Landsbanki Islands** (Landsbanki, A2/A Fitch; CDS: Overweight (V)) and **Islandsbanki** (A1/A Fitch; CDS: Overweight (V)) – are engaging in expansion strategies of varying risk in an effort to diversify outside Iceland (population under 300,000). Islandsbanki recently changed its name to **Glitnir**; we refer to the bank by its old name throughout this report. We show their acquisitions and strategies below.

Exhibit 1

Icelandic Banks – Recent Acquisitions

Bank	Acquisition	Business line
Kaupthing	FIH	Corporate lending in Denmark
	Singer & Friedlander	UK capital markets/investment banking
	JP Nordiska	Swedish brokerage
Landsbanki	Teather & Greenwood	UK securities broker
	Kepler Equities	Securities broker
	Merrion Capital	Irish securities broker
Islandsbanki	BN Bank	Norwegian commercial bank
	Kredittbank	Norwegian retail bank

Source: Morgan Stanley

We cover the individual credits in more detail from page 10 onwards; we view the Icelandic banks' strategies to be as follows:

- **Kaupthing:** To be a full-service middle-market capital markets firm lending and investing alongside its clients. Focus is on the UK market and Scandinavia.
- **Landsbanki:** To remain an Icelandic retail bank with growth coming from a securities brokerage arm, with Teather & Greenwood as a base for growth.
- **Islandsbanki:** To be a leading Nordic retail bank in Norway and Iceland, building on expertise in the seafood and geothermal (a key Icelandic industry that uses the heat of the earth to generate electric power) sectors.

The banks' new strategies are fraught with greater difficulty than their previous incarnation as Icelandic retail banks. While the risk of their business mix has increased, we note that capital bases in some cases have gone down to support desired growth as well. Yet, over the last year, earned income (PBT) has increased dramatically – 176% at Kaupthing and 132% at Landsbanki (less so at Islandsbanki with 66%) – and the banks, on the face of it, appear to be doing quite well. Certainly, their stock prices would seem to indicate so, as shown by the second chart on the front page.

The stock price gains contrast neatly with the fixed income markets' sharp widening in the same period, where we show spread levels for Kaupthing's € Tier 1 14s on the front page. Certainly, the Icelandic banks are more of a positive equity story than a fixed income one, with their aggressive growth (Kaupthing and Landsbanki) in the capital markets arena.

Who is right? The banks are building up a riskier profile that exposes them to a number of exogenous factors. We discuss these factors in turn, and run stress tests on the banks for them in this report:

- Equity holdings;
- Reliance on capital markets;
- Wholesale funding dependence;
- Forex; devaluation of the Icelandic krona ('krona').

We find that the fixed income markets have overreacted to the risks the Icelandic banks face. However, we continue to have concerns surrounding Kaupthing Bank, particularly over its capital market activities and aggressive strategy. We initiate coverage at Overweight on Islandsbanki and Landsbanki, and Equal-weight on Kaupthing Bank.

We understand that there are reports in the market arguing that investors are simply not compensated for the systemic risks the banks face in Iceland, even while favouring the bank that remains the most exposed to Iceland in terms of its loan portfolio, Islandsbanki. We have met with the companies, and considering how far from Icelandic retail banks these companies have become, our concerns would centre more so on what they are getting up to outside the country. Further, running the numbers allows us to conclude that while severe corrections would impact the banks, they would be manageable. **We acknowledge Iceland and its banks' problems: we simply believe that it is more than priced in at these levels.**

Exhibit 2

Comparable Financial Metrics – 2005*

	Kaupthing	Landsbanki	Islandsbanki
Assets (€m)	30,697	16,980	17,787
Total loans (€m)	21,014	12,946	14,193
Operating income (€m)	1,231	737	440
% financial income	35	29	10
RoE (%)	29	33	28
NPL ratio (%)	1.0	0.6	0.8
Tier 1 (%)	9.4	11.9	9.9
Loan book split (%)	Does not split out; 70% op. income ex-Iceland	Iceland 40, UK 42, other 18	Iceland 45, Norway 40, other 15
Exposure to equities (€m)	1,301	704	359
~ % ICEX	45	47	50

Source: Company reports; *Exchange rate used throughout report: 82.77 krona/1€.

Relative Value

Yes, these banks are riskier than the average European retail bank. We go through all the risks and our stress tests in the report. However, are they 400+% riskier than the other banks, as shown in Exhibit 3? Not to us, they aren't. The Icelandic banks look cheap, and we would be buyers of Islandsbanki and Landsbanki risk at these levels.

We hold Kaupthing out as an exception. The bank's strategy to be a middle-market investment bank investing alongside its clients in leveraged transactions concerns us both in terms of the risk of write-down and lack of track record, but also considering the bank's rapidly falling capital ratios and its poor performance on our stress tests.

Where Should the Icelandic Banks Trade?

Current CDS trading levels are shown in Exhibit 3, and we recommend selling protection on Islandsbanki and Landsbanki. There should be a premium attached to these banks as Icelandic banks, as we shall discuss in the report; we'd assign a conservative 20bp of Icelandic premium to the 5-year senior CDS. Landsbanki should trade wide to Islandsbanki, due to its greater reliance on volatile capital markets income streams, and both banks should trade through Kaupthing, in our view.

Exhibit 3

5-Year Senior CDS Levels

Bank	Rating	Mar 13 Mkt Open	Six months ago
Kaupthing	A1/A	90/100	35 level
Landsbanki	A2/A	75/105	34 level
Islandsbanki	A1/A	65/80	20 level
Comps			
Capitalia	A2/NR	14/16	Wider
BP Italiana	Baa2/BBB+	37/43	Wider
BNL	A2/A-	11/14	Wider
ESPSAN	A1/A-	12/14	Wider

Source: Morgan Stanley

We think the banks are trading on rumour and innuendo rather than fundamentals at the moment; the technicals (cash being driven wider by CDS, little actual trading going on) support this. We recommend selling protection on the names we are most comfortable with, Islandsbanki and Landsbanki, in 5-year senior CDS, prior to moving to more subordinated parts of the capital structure.

- Applying a 20bp Icelandic premium to the Nordic retail bank Islandsbanki, a fair level ought to be at least in the mid-30s in 5-year senior CDS; therefore, **we see well over 30bp of tightening potential for Islandsbanki.**
- Placing Landsbanki wide to Islandsbanki, fair value is in the mid-50s in 5-year senior CDS; therefore, **we see well over 30bp of tightening potential for Landsbanki.**

In our view, Landsbanki has been unfairly penalised due to its lower Moody's rating relative to Kaupthing, but we cover why these ratings seem out of date now that both banks have changed their profiles so much. As we discuss further in the report, although an update for Kaupthing is forthcoming from Moody's, we are not convinced a change in outlook will result, although the rating appears generous. We also do not anticipate ratings/outlook changes for the other banks.

We would have liked to recommend Kaupthing as well, as it does look cheap to us considering the rating. However, its unproven private equity strategy, sizeable unhedged equity investments and low capital targets make us uncertain about its prospects, and would wait for a lengthier track record. We do note that while we can't see a trigger for tightening, (and indeed, as we note later, a change in ratings outlook, which would make sense to us, could be the trigger for widening) it may very well benefit from any tightening at its peers. Its Tier 1 is offered at swaps+225bp, over 100bp behind similarly rated Tier 1 comparables.

Reality Check

What are you risking at the 5-year senior CDS level?
Volatility, certainly, but say we are terribly wrong on our call with the Icelandic banks and they do collapse. In our view,

these banks will not be physically wound down over this period; they would either be rescued by the government or acquired by another entity. Further, consider:

- The banks are trading wider than **Banca Popolare Italiana** (Baa2/BBB+; not rated), which is about to produce its first fully audited yearly accounts under new management and whose ex-CEO has been imprisoned following fraud;
- A CDO bid for these highly rated bank CDS could emerge;
- These banks are not particularly small; Kaupthing is more or less the same size as **Banco Espirito Santo** (A1/A-; € Tier 1: Underweight).

Systemic Risk? No

We conclude that, at this juncture, the banks deserve to be treated as the individual credits they are and not all painted with the same 'Icelandic scare' brush, since we do not believe that problems at one will mean problems at another. Further, we do not believe that we are on the cusp of a banking crisis in Iceland; we detail our thoughts on the economy further in the report and would encourage some calm in the midst of the 'Icelandic hysteria'. Consider if the perfect storm occurred in Iceland and the ICEX fell 50%, the krona dropped 30% and the banks ceased to make any money from capital markets activities.

The banks remain adequately capitalised and continue to make income from their retail banking activities, as shown in Exhibit 4 (we go through more detail of each test further on in the report). We do recognise that the economy would look very different on a number of fronts under such a scenario, not all of which we have captured here; however, the banks would still have interesting franchises from an M&A perspective. The banks' NPLs, under a quick test, could increase fourfold in this scenario prior to any capitalisation issues (about an NPL ratio of 5%). We have already noted the different directions the banks have gone in diversifying outside Iceland.

Exhibit 4

Stress-Testing the Banks – Summary

%	T1	ICEX falls 50%	Krona falls 30%*	Tier 1 result	Drop in income ex-cap. markets	PBT ex-cap. markets (€m)
Kaupthing	9.36%	-1.25%	-1.50%	6.61%	-80.5%	147
Landsbanki	11.90%	-1.41%	-1.50%	8.99%	-80.1%	81
Islandsbanki	9.88%	-0.79%	-1.50%	7.59%	-26.2%	208

Source: Morgan Stanley; *Worst case according to Fitch's recent report.

The web of cross-shareholdings for which the banks have become infamous is more of a threat to the share price; we stress-test falls in their stock portfolios and the banks are fine. Our biggest concern regarding the Icelandic banks is their capital markets activity which, as Kaupthing's Baugur relationship illustrates, can be obscure and discomforting to us as analysts. This prevents us from initiating at a wholesale Overweight on the Icelandic banks.

Retail Banking in Iceland – Yesterday's Business

We detail where the banks make their money on page 10 onwards; retail banking is increasingly less of an important business for the Icelandic banks as they pursue their various expansion strategies. However, retail banking in Iceland is a fairly stable business, when one looks at the historical asset quality and interest margins the banks have enjoyed, and the fact that the Icelandic economy, while small and concentrated, is a strong one. (GDP growth is expected to be 5.5% in 2006 – we cover economic expectations later on.)

Landsbanki has the greatest Icelandic market share at 31% of deposits, and the largest branch network at 46 branches. In general, the banks split the Icelandic retail market fairly evenly.

Exhibit 5

Market Shares – Icelandic Retail

%	Deposits	Consumer loans	Corporate loans
Kaupthing	21	24	25
Landsbanki	31	35	35
Islandsbanki	25	20	30

Source: Morgan Stanley

Until 2004, the state-owned Housing Financing Fund (HFF) dominated the mortgage market in Iceland through state-backed bond issues that were sold to private investors, so the retail banks had trouble competing with their cost advantage. However, restrictions on the types of loans the HFF could offer and the low interest rate environment have allowed the banks to begin to compete in the residential mortgage market on a small scale.

In terms of corporate loans, Icelandic corporates, buoyed by the stock market gains we will discuss later in the report, are investing heavily in European companies, particularly consumer/retail-oriented ones. Witness this list of recent transactions, all of which the Icelandic banks were the primary lenders to (Kaupthing in particular); from our read of the loan participations:

- Bakkavor's £490 million acquisition of Geest (along with Kaupthing);
- Baugur's £326 million acquisition of Iceland (along with Kaupthing), its £120 million acquisition of Karen Millen and its 13.7% stake in French Connection;
- FL Group's 16.2% investment in EasyJet and 10.1% investment in Bang & Olufsen.

Asset quality is strong for all the banks, with NPLs/total loans at 1.0% for Kaupthing, 0.6% for Landsbanki and 0.8% for Islandsbanki. Asset quality has historically been very good for the Icelandic banks, with low charge-offs a particular characteristic. Certainly, the banks are engaging in a different sort of lending nowadays, where the recent transactions as laid out above are likely more highly leveraged and riskier than earlier retail activities in Iceland. Data on the leverage of the transactions are not available, however, so all we have to go on are historical asset quality results, which are strong and have been improving.

Overall, we have left the banks' retail activities, including their participation in LBOs, aside in this report. Considering the banks' extremely strong asset quality, it seems unfair to fault them for lending to what seem like riskier projects. We would watch asset quality closely for any uptick, but at the moment **it seems appropriate to assume that the banks' lending procedures are sound, given past performance.**

Equity Exposure: Cross-Shareholdings

In Exhibit 7, we show the cross-shareholdings of the banks, with the names that appear most frequently in bold.

The banks are within regulatory requirements with regards to the cross-shareholdings. The firms themselves cannot control where their own shareholders choose to invest their money and, in a small, fast-developing economy, it is easy to see how such a situation has arisen. However, seeing the level of cross-shareholdings the banks share is a concern, as it calls into question the banks' independence, particularly given the limited free float (listed below). Further, shareholders are often borrowers as well (in the case of FL Group and Iceland Telecom) and such a degree of inter-connectedness could theoretically beg the question of how arm's length the bank's transactions are, for instance:

- **Kaupthing:** Free float: 28.73% (although company informs us that 100% of shares are free floating). Owns 19% of Exista, its largest shareholder. Owns 29.1% of Iceland Telecom, who is a client. Kaupthing also owns 24.7% of its fifth-largest shareholder, Vatryggingafelag Islands.
- **Landsbanki:** Free float: 31.33%. Owns 29.9% of FL Group, its second-largest shareholder; however, hedging means that its direct holding is only 1%, according to the company.
- **Islandsbanki:** Free float: 22%. No shareholdings in any of its largest shareholders.

The banks tell us that the Icelandic FSA monitors their transactions to ensure they are at arm's length and that they deduct own shareholdings from Tier 1 as required by BIS rules.

Unusually, the banks are invested in each other, as summarised below. The banks tell us that many of these shares are held for third parties so the figures below are not representative of their true exposures. However, this does bring up the spectre of systemic risk; still, we note that the investment levels are not overwhelming at this time, and one bank's failure would be manageable at the other – not that we are remotely suggesting such a scenario.

Exhibit 6

Investments in Each Other

Bank	Invested In	€ millions	Tier 1 %
Kaupthing* in	Landsbanki	42	1.9
	Islandsbanki	39	1.8
Landsbanki in	Kaupthing	133	8.7
	Islandsbanki	162	10.6
Islandsbanki in	Kaupthing	132	11.7
	Landsbanki	43	3.8

Source: Morgan Stanley; *This is all through Kaupthing's asset management unit.

Exhibit 7

Icelandic Banks – Cross-Shareholdings

Kaupthing		€ amt	Landsbanki Islands hf		€ amt	Islandsbanki-FBA hf		€ amt
Bakkabraeaur Sarl (Exista)*	21.1	1,526	Samson Eignarhaldsfelag ehf	40.37	1,467	Wernersson Family	21.68	707
Egla ehf	10.82	783	**Landsbanki Islands hf**	6.62	241	**FL Group hf**	15.21	496
FL Group hf	5.14	372	Fjarfestingarfelagia Grettir hf	2.22	81	**Islandsbanki-FBA hf**	11.67	381
Arion hf	4.4	318	Proteus Global Holding SA	1.98	72	**Landsbanki Islands hf**	4.96	162
Vatryggingafelag Islands hf	4.03	292	Arion hf	1.95	71	Straumur Fjarfestingarbanki hf	4.54	148
Lifeyrissjoaur verslunarmanna	3.4	246	LB Holding Ltd	1.93	70	Sveinsson Einar	3.4	111
Gildi - Lifeyrissjoaur	3.32	240	Tryggingamiastoain hf	1.92	70	RedSquare Invest	2.66	87
Lifeyrissjoair Bankastraeti 7	3.19	231	**Lifeyrissjoaur verslunarmanna**	1.87	68	Smarason Hannes	1.77	58
Eignarhaldsfelagid Sveipur ehf	1.99	144	Lifeyrissjoair Bankastraeti 7	1.81	66	**Gildi - Lifeyrissjoaur**	1.65	54
Gudmundsson, JH	1.85	134	**Gildi - Lifeyrissjoaur**	1.77	64	Lifeyrissjoair Bankastraeti 7	1.48	48
Landsbanki Islands hf	1.84	133	**Islandsbanki-FBA hf**	1.19	43	Melax Robert	1.06	35
Islandsbanki-FBA hf	1.82	132	Lifeyrissjoaur Noraurlands	1.16	42	**Kaupthing Asset Management**	1.06	35
Kaupthing Asset Management	1.09	79	Saxholl Ehf	1.03	37	**Kaupthing Investment Funds - Icelandic Equity**	0.13	4
Kaupthing Investment Funds	0.35	25	**Kaupthing Asset Management**	0.92	33	Sveinsson Benedikt	1.05	34
Everest Equities Ltd	0.95	69	**Kaupthing Investment Funds - Icelandic Equity**	0.24	9	Armannsson Bjarni	0.93	30

Source: Morgan Stanley; *Kaupthing owns 19.2% of Exista.

An issue that cross-shareholdings represent, for us, is the multiplier factor. Everything is fine in a rising market, but let's assume that the Icelandic stock market takes a turn for the worse. As the value of one company's shares decrease, the holders of those shares will also suffer write-downs to their stake, which will drive their own shares lower still.

Considering the large gains made in the past, the overriding concern is the banks' overall investments in listed and unlisted shares in the Icelandic stock market, investment levels they have in common with their borrowers. **Therefore, the risk is more of a drop in overall market value rather than a blow-up at any one investment,** which is where we turn to next.

Equity Exposure: Equity Holdings

Since the start of 2000, the ICEX is up 304%, whereas the DJ Stoxx is down, and the Icelandic exchange capitalisation is now over 160% of GDP. There is little to indicate that the economy is heading for a downturn – on the contrary, on March 3, the *WSJ* reported that Alcoa was considering building a second aluminium smelter in Iceland at a cost of at least $1 billion and could announce a preliminary agreement soon with officials from Iceland. Yet, the fact that the banks have sizeable holdings of Icelandic stocks (including their holdings of each other's shares as discussed), which may be headed for a correction, is a concern.

Here at Morgan Stanley we do not have a published view on the direction of the Icelandic stock market. However, speaking to our equity analysts, a valuation correction of 50% in any given exchange in a year is as good a guess as any to apply to the Icelandic sector, considering the growth in the past three years (and the fact that the ICEX fell 10% on the date of Fitch's change to a negative outlook on Iceland). The biggest drop in recent history was 44% from April 2000 to August 2001. The majority of the banks' equity holdings are in Icelandic stocks, as shown in Exhibit 8. We therefore assume a rough 50% fall in the value of their equity holdings in Iceland only, and give credit where the banks have hedged their exposures (Islandsbanki and Landsbanki do utilise hedges, where Kaupthing largely does not, we understand). We show the impact on the Tier 1 of the banks on page 10 onwards, which we summarise here.

Exhibit 8

Impact of a 50% Fall in ICEX Stock Market Values

%	Net equity holdings (€m)	ICEX	Tier 1 falls to	From
Kaupthing	1,301	45	8.11	9.36
Landsbanki	704	47	10.49	11.90
Islandsbanki	359	50	9.09	9.88

Source: Morgan Stanley

Key Take-Aways

- **Kaupthing** is the most exposed to the equity markets, given its sizeable equity holdings. It is also only a small portion of the bank's total markets portfolio (including fixed income), detailed on page 10 onwards. We are concerned about the bank's target to hold 2-3% of total assets in unlisted securities (equates to €614 million to €921 million; currently stands at 1.1%).
- **Landsbanki** comes out the best of the banks, considering its higher Tier 1 ratio.
- **Islandsbanki's** equity exposure is the smallest, and the bank tells us that its strategy is to refocus on banking and rely less on capital markets gains

We note that potential stock market devaluation and subsequent write-downs is a key issue for us and a driver of our relative recommendation on the CDS.

Balance Sheets – Funding Not an Issue for Now

We detail and analyse the banks' balance sheets on page 10 onwards. Our two main credit issues with the Icelandic banks' balance sheets are the reliance on wholesale funding and equity holdings. We address wholesale funding here, where we show the banks' repayment schedules in Exhibit 9.

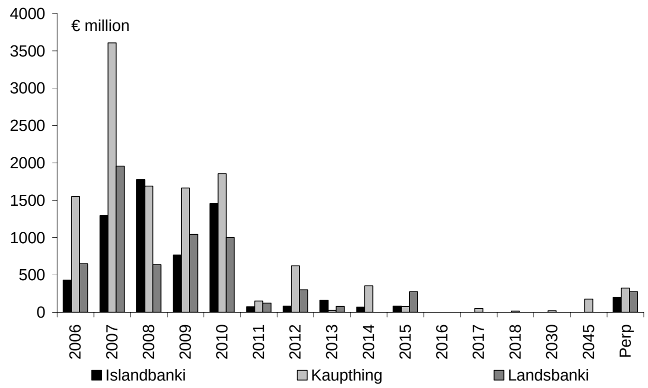
Kaupthing appears to have the biggest looming issue, with €1.5 billion maturing this year and €3.6 billion in 2007 (all senior). The fear is that the banks, considering their increasing financing costs as reflected in the CDS, will have trouble refinancing maturing issues. This could be problematic for the banks in terms of growth, but we do not see anything to suggest a true liquidity crisis at the banks yet.

After all, let's consider that spreads have widened, but the cost of refinancing isn't approaching impractical levels. Even a 100bp widening in senior funding levels would cost Kaupthing an extra €15 million a year in interest if it refinances the whole amount coming due this year at a higher cost. Spreads have only widened less than half this amount. Even considering the reduced NIM, we encourage investors to look at exactly how much the banks suffer under a higher refinancing cost.

What if the markets closed completely? **Islandsbanki tells us that it has already refinanced half of its debt coming due this year and has the liquidity to sit the next 12 months out of the capital markets if it chooses, as can Landsbanki.**

Exhibit 9

Icelandic Banks – Repayment Schedule



Source: Bondware

We do note that the banks have a diverse set of funding avenues, including the possibility to tap the equity markets, considering their strong share price gains. All banks have issued in various fixed income markets in the past year, with Kaupthing issuing in €, £, US$ and ¥, Islandsbanki issuing in €, US$, C$, A$, £ and ¥ and Landsbanki issuing in €, C$, £ and ¥. The banks point to these numerous currencies as evidence of diversification of funding source, and these markets are up and running for the banks when debt refinancing needs come around. We address the banks' currency exposures overleaf.

We also refer readers to Fitch's recent report, Icelandic Banks: Assessment of Resilience to Systemic Shocks, March 2, where the agency comes to the same conclusion we do on the banks' funding risks. Fitch points out the Icelandic regulator's monitoring of liquidity positions, where daily penalties can be levied, and the possibility for the banks to raise money through securitisation.

Income Statements – Reliance on Capital Markets

In Exhibit 10, we detail the banks' income statements, with capital markets-related income streams stripped out. We identify capital-markets related income as the 'financial' line item on the income statement, which is made up of trading gains, and the fee and commission income attributable to capital markets-type activities (see the company profiles on page 10 onwards for a full breakout of the sources of fee and commission income). As shown in Exhibit 10, the banks cover their operating expenses without needing to rely on capital markets activities.

However, witness how little money both Kaupthing and Landsbanki make without such activities, and how much profit before tax (PBT) falls for Kaupthing. At least Landsbanki has the equity cushion that we allude to earlier. This is somewhat of a conservative test, since we do not take out any of the associated operating expenses from running the capital markets businesses.

Exhibit 10

Income Statement Analysis

ISK million	Kaupthing	Landsbanki	Islandsbanki
Interest	32,710	22,996	23,390
Fee and commission	22,428	16,726	8,773
Financial*	35,875	17,813	3,567
Other	10,872	3,444	681
Total	101,885	60,979	36,411
Fee and commission income – securities	8,263	9,261	2,563
Fee and commission income – derivatives	1,680	-	-
Income ex-capital markets	51,771	33,905	30,281
Operating expenses	34,729	20,967	11,146
Operating income ex-capital markets	17,042	12,938	19,135
Impairment	4,872	6,197	1,900
PBT ex-capital markets	12,170	6,741	17,235
In € million	147	81	208
PBT as reported	62,284	33,815	23,365
In € million	752	409	282
Decrease (%)	-80.5	-80.1	-26.2

Source: Morgan Stanley; *Financial income includes gains on financial assets and dividend income

Icelandic Economy

Given how sensitive Icelandic banking spreads proved to be post the Fitch sovereign outlook change on February 24, a short discussion of the country's impact on the credit is worthwhile. As Fitch's report pointed out, macro imbalances are deteriorating at a faster clip than one would like.

Seeing as our Morgan Stanley economists do not formally cover Iceland, we refer instead to the Economist Intelligence Unit (EIU) report from January 2006 for data and forecasts for the country. They project the following for 2006:

- GDP will increase by 5.5% in 2006, driven by a 7.3% increase in private consumption;
- The short-term interbank rate will move to 11.3% from 9.8% in 2005;
- The ruling Independence Party will continue in office over the outlook period;
- Several large-scale, foreign investment-led projects will continue to have a significant stimulatory impact on the economy in 2006, before a sharp slowdown in 2007.

Undoubtedly, however, Iceland's economy is building up some distressing signals, forthrightly pointed out by the Fitch report. Net external indebtedness has risen sharply, and is largely bank-related. The banks have grown their balance sheets very quickly, with households and corporates highly indebted. We agree with Fitch that the risks of a hard landing have increased. We think that the banks are likely to suffer sharp turndowns in income this year as equity gains made this year evaporate, and asset quality will deteriorate from current very low levels. **Our argument is that, considering our recommended banks' strong balance sheets and diversity away from Iceland, this slowdown will be manageable for them, and is more than priced in at 5-year senior CDS levels.**

Speaking to the Fitch sovereign analyst, the purpose of its impactful move to a negative outlook on Iceland's AA- ratings (Aaa/AA- S&P and Moody's, stable since 2002 at Moody's; upgraded last year by S&P) was driven by a desire to flag up some macro imbalances in the economy. On the ensuing conference call, the banks analyst made clear that he is comforted by their capital bases, currency hedges and diversity outside Iceland. We would agree, but as we have laid out in the report, our concerns lie with the riskier business lines the banks have become involved in outside Iceland rather than their domestic retail business. The banks analyst also made clear that these risks are factored into the ratings.

Exposure to Currencies – Banks Generally Hedged

The krona devaluing would be a problem for the banks since their equity is held, for the most part, in krona, and their assets are held outside the country in foreign currencies. The price action of the krona on February 24, when it dropped 4.6% against the dollar at a time when the benchmark interest rate was 10.75%, showed how volatile this factor can be for the banks.

From 2006, the economists at the EIU expect the krona to start to weaken in response to the large external deficit, with a further period of depreciation projected to occur in 2007. They point out that the krona's exchange rate path is subject to major uncertainties and represents one of the main risks to their own baseline forecast. A sharper-than-expected weakening could have serious economic repercussions, given the surge in foreign currency borrowing over the past year and the high level of private-sector external debt.

We refer readers to Fitch's report, mentioned earlier, on the banks' exposure to systemic shocks, for a full discussion of their exposure to a devaluation of the krona. The agency notes that the banks are vulnerable in two ways: through any asset/liability currency mismatch and through the fact that, on average, the banks' Tier 1 is 80%+ krona-denominated.

The banks are subject to central bank regulations stipulating that the FX position in all currencies may not exceed 30% of equity. The banks have stricter limits and the net combined FX positions at end-2005 were respectively 0.1%, 1.7% and 3.1% of Kaupthing, Landsbanki and Islandsbanki's equity bases, according to the Fitch report. The report also mentions the banks' own stress tests that show that a 30% depreciation in the krona would cause total capital ratios to decrease by 0.7-1.5%. **With such results, and considering strong ratios to start with, we are comforted that the banks are appropriately hedged in terms of currency risk.**

Rating Agency Issues

Why Can't We Go on the Ratings?

As evaluating the Icelandic banks is reasonably complex, it is tempting to let the agencies' ratings determine where the names should trade. The banks all started to trade well away from their A1/A ratings in October 2005, and have stayed as some of the widest names in our universe since then. True, it may not have made sense to see a high single A bank trade like a BBB bank; however, in this case, we believe the market got it partially right though overshot a bit with 'Icelandic hysteria'. These banks were high single A credits last year. **That Moody's has not seen to change the outlook on, for instance, Kaupthing, now that it has a vastly different risk profile coupled with lower capitalisation, is a mystery to us.** Speaking to the agency, we are not convinced that a negative outlook on any of the banks is forthcoming, where Moody's will be publishing an update soon (in the next three weeks, we imagine). Moody's stated that it has a different view to the market. Fitch's mid-single A ratings seem more reasonable, in our view, although both agencies factor in government support as their senior ratings are a notch higher than their individual ratings would seem to support.

Government Support

There is no legal obligation for the Icelandic government to support the Icelandic banks should they run into difficulty. However, both Moody's and Fitch state it as a factor in their ratings and, indeed, we believe that the government would be willing to step in to support the banks since they are such an important part of the economy (three banks constitute over 90% of banking assets and over 60% of the ICEX).

However, to what degree is in question – banking assets loom large over Icelandic GDP at 5.5x the ISK 970 billion GDP in 2005 (according to the EIU), and while support may be forthcoming for the ISK 1,369 billion (€16.5 billion) collective deposits of the banks, the impact on debtholders is less clear. However, we believe some solution would be found for the banks in case of difficulty.

Capital

Capital has been strong at the banks but it is increasingly ceasing to be so. That Kaupthing's Tier 1 ratio has dropped from 11.4% to 9.4% over the year, with an increasingly risky business profile, and that this did not even prompt a negative outlook on the A1 rating, seems unusual to us.

We detail the banks' capital position on the following pages. Islandsbanki and Landsbanki have improved their Tier 1 ratios this year – from 9.4% to 9.9% for Islandsbanki and from 7.8% to 11.9% for Landsbanki. Further, the banks have targets that are below current levels, with an 8% target at both Landsbanki and Kaupthing (8%+ target at Islandsbanki). Considering these two banks' capital markets activities, we believe that these targets are too low, where we'd prefer a 10+% Tier 1 level for these banks, as at Landsbanki.

Basel II

Landsbanki aims to implement the standardised approach, while Kaupthing and Islandsbanki will be implementing the IRB approaches. Considering the low retail activity level at the banks, these banks will not necessarily be 'winners' under Basel II, in our view.

Kaupthing Bank (A1/A Fitch; € Tier 1 and CDS: Equal-weight)

Recommendation

We concede that Kaupthing looks cheap at these levels, considering its rating. However, this is not an improving credit and the bank's risk profile, along with its willingness to put its own capital towards investments whose details are not disclosed and where the shares are often unlisted, concerns us. We are uncertain about its prospects, and would wait for a lengthier track record. We do note that while we can't see a company-related trigger for tightening, it very well may benefit from any tightening at its peers.

Issuer Description

Kaupthing is Iceland's largest bank by assets (€30.7 billion). Primarily a capital markets bank in Iceland, in the past 15 months it has dramatically changed its business mix via two acquisitions – FIH in Denmark and Singer & Friedlander in the UK. Now, it makes well over a third of its income through trading gains, primarily by taking proprietary positions in companies prior to their IPO or other exit-type opportunity. The bank's capital base has been eroding towards management's target of 8% Tier 1, which is appropriate for a bank but not a diversified financial group, focused on capital markets.

Credit Strengths and Concerns

Strengths	Concerns
Well diversified geographically in terms of business mix	Willingness to commit own funds, invest in own shareholders, hold unlisted shares
Close client relationships with dynamic set of companies, currently actively expanding its business portfolios in the UK	Aggressive strategy in areas/geographies (UK) with limited prior expertise
Strong asset quality – NPLs 1.0% of loans	Large market investments and sizeable equity exposure
Strong past operating performance – earnings increased threefold y/y in 2005	Largest shareholder in Exista (19%), its own largest shareholder (21%)
Over target capitalisation at 9.4%	Target for investment in unlisted equities: 2-3% total assets (sizeable, currently 1.1%)
Low cost/income ratio at 34.1%	Capital target of 8% is too low for type of business company is targeting
Reasonable currency hedging	Large upcoming funding needs

Key Credit Points

Strong Operating Performance

Kaupthing's operating performance in the past year is very impressive and its metrics are good. Asset quality, costs, capitalisation and income growth all point towards a company that is performing well at the present time. However, risks loom.

Funding Difficulties Possible

Kaupthing's financing costs have deteriorated dramatically in the past year due to the end-2005 'Icelandic scare'. Kaupthing has €1.5 billion maturing this year and €3.6 billion in 2007 (all senior). The fear is that Kaupthing will have trouble refinancing maturing issues – we believe it will be more expensive, but doubt that Kaupthing will not be able to source the funds, given the diverse set of currencies it funds itself in.

Overall Strategy Unfavourable to Credit

Kaupthing's management has a clear strategy with investment banking and corporate banking at its core. Kaupthing aims to be an "integrated service provider – providing senior and mezzanine loans and also private equity" (presentation, September 2005). This type of strategy can have high margins, but the taking on of proprietary equity risk while slimming Tier 1 ratios concerns us.

Less a Bank, More a Private Equity Investor

As Kaupthing grows in its chosen growth area, retail banking activities will become a smaller part of the business mix. Kaupthing has little track record in the private equity arena and nor have its main clients, Icelandic holding companies buoyed by ICEX gains. The risk exists for Kaupthing to suffer extreme losses if equity markets falter, as well as to suffer from further negative headlines.

Balance Sheet Analysis

Like the other Icelandic banks, Kaupthing's sizeable loan book is funded by an overwhelming amount of wholesale funding versus deposits (25% deposits/deposits + wholesale funding; the norm for Nordic banks is closer to 50%). It further has a sizeable portfolio of financial assets, broken out on the next page; most bonds and shares held as financial instruments for customers, but also comprising €1,301 million of unhedged equity exposure, 45% of which we assume is to the ICEX according to company statements. A 50% ICEX hit would thus result in a €293 million write-down, representing 125bp off the current 9.36% Tier 1 ratio.

Kaupthing Bank (A1/A Fitch; € Tier 1 and CDS: Equal-weight)

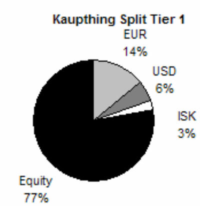
Balance Sheet

		ISK millions	EUR millions
Assets			
Cash		34,877	421
Loans		1,739,294	21,014
Financials assets at fair value		612,366	7,398
Financial assets AFS		167	2
Investments in asssociates		13,888	168
Intangibles		54,943	664
Investment property		24,156	292
PP&E		22,433	271
Tax assets		5,004	60
Non-current assets		2,302	28
Other		31,380	379
	Total assets	**2,540,810**	**30,697**
Liabilities			
Deposits		69,643	841
Other deposits		486,176	5,874
Borrowings		1,556,567	18,806
Sub debt		102,688	1,241
Financial liabilities at fair value		60,273	728
Provisions		3,271	40
Tax liabilities		18,458	223
Liabilities included in disposal groups		1,161	14
Other deposits		40,062	484
	Total liabilities	**2,338,299**	**28,251**
Equity			
Share capital		6,638	80
Share premium		114,606	1,385
Reserves		- 1,540	- 19
Retained earnings		74,479	900
		194,183	2,346
Minority interest		8,329	101
	Total liabilities and equity	**2,540,811**	**30,697**

Fall in stock market values		50%
%age invested in Iceland	ICEX	45%
Effect on portfolio		23%

Financial Assets Breakdown - Fair Value

		ISK millions	EUR millions		Stress Test
Trading					
	Bonds	197,116	2,381		
	Other debt	1,286	16		
	Futures	18	0		
	OTC derivatives	12,644	153		
	Other trading derivatives	8,385	101		
	Shares	114,463	1,383		
	Other equity	3,245	39		
Total trading assets		*337,157*	*4,073*		
Derivatives against equity		53,388	645		
			-		
Net equity exposures		61,075	**738**		**166**
Financial	Bonds	88,730	1,072		
	Debt	120,098	1,451		
	Shares	46,583	**563**		**127**
	Other equity	3,306	40		
Total financial assets		*258,717*	*3,126*		
Mortgage loans		12,033	145		
Derivatives		4,429	54		
Total trading/financial assets		*612,336*	*7,398*	*Total loss*	**293**



	ISK millions	EUR millions		
			Stress test	
Tier 1	182,029	2,199	Tier 1	1,907
RWAs	1,945,271	23,502		
			Stress test	
Tier 1 ratio		9.36%	Tier 1 ratio	8.11%

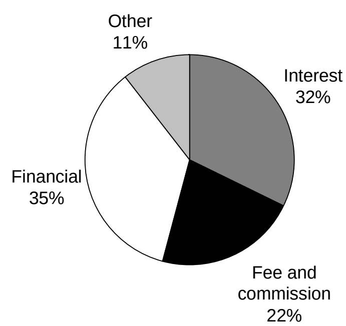
Kaupthing's target for investment unlisted equities:
2-3% total assets

614 to 921 m €

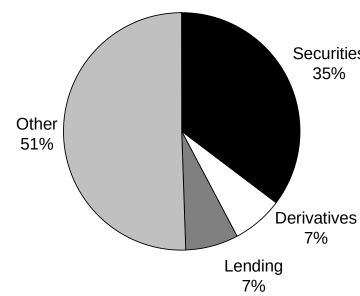
Source: Morgan Stanley

Kaupthing Bank (A1/A Fitch; € Tier 1 and CDS: Equal-weight)

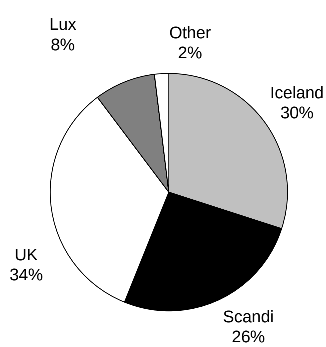
Split of Income



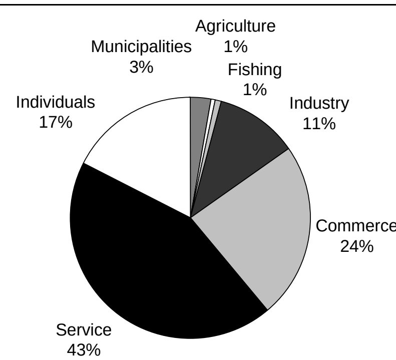
Split of Fees and Commissions Income



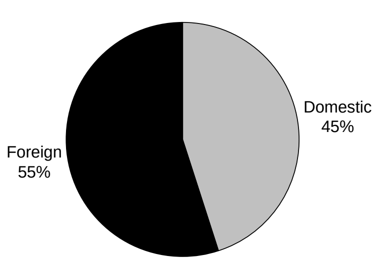
Operating Income by Geography



Loan Book by Industry



Split of Equity Investments



Source: Company reports

Landsbanki Islands (A2/A Fitch; CDS: Overweight)

Recommendation

With 5-year senior CDS levels at 75/105, Landsbanki looks very good value, in our view. We believe that the market may have looked at Landsbanki's lower Moody's rating and pushed it wider than Kaupthing, when really Landsbanki's more retail banking-oriented profile is superior from a credit perspective, in our view. Further, Landsbanki is not as exposed to equities on the balance sheet (acts as agent rather than principal), is better capitalised, and is less reliant on wholesale funding. Landsbanki should trade through Kaupthing, in our view.

Issuer Description

Landsbanki is the smallest of the three Icelandic banks in terms of assets, but holds the dominant retail banking share in Iceland (31% of deposits). In choosing its expansion strategy, Landsbanki targeted equities brokers in Europe (Kepler), Ireland (Merrion) and the UK (Teather & Greenwood) and as such has experienced rapid growth in the past two years. Landsbanki's income growth has been driven by capital markets activities, yet it still has a sizeable presence in the Icelandic banking market.

Credit Strengths and Concerns

Strengths	Concerns
Good record of smaller acquisitions of well-regarded securities brokers	Makes a significant percentage (80%) of income from capital markets activities
Generally serves as an agent not principal	Landsbanki has a large shareholder – Thor Bjorgolfsson of Samson (40%)
Well-capitalised at current Tier 1 of 11.9%, with Tier 1 improving last year	Equity exposures partially hedged
Less reliant on wholesale funding than others	Tier 1 is expected to fall; target is low at 8%
Reasonable currency hedging	Compared to Kaupthing, asset quality is weaker but still strong at NPLs 0.6% of total
Low cost/income ratio of 34%	Is lowest-rated Icelandic bank on Moody's side
Reducing net equity exposure from 2004	Smallest Icelandic bank

Key Credit Points

Expansion in Equity Brokerage

Landsbanki's acquisitions have been smaller and of well-regarded companies in their fields, for the most part. The bank is targeting a controlled expansion in the equity brokerage realm, where the bank will act as agent rather than principal. This is in contrast to Kaupthing's private equity ambitions, which expose the bank to a greater degree of market risk.

Most Exposed Bank to Icelandic Retail

Landsbanki's loan book is exposed (39%) to the Icelandic retail market, where its peers have managed to diversify away from this small economy. Reading Fitch's recent report on the macro imbalances in Iceland, it does not represent the ideal economy to be focused in due to the limited scope for economic development. However, the economy is expected to grow 5.5% next year and asset quality is strong in a European context.

Capitalisation Strong, Equity Exposures Hedged

Landsbanki does have a trading portfolio of Icelandic equities, but it is hedged and down from last year. We also note that Landsbanki has improved its Tier 1 ratio, from 7.8% in 2004 to 11.9% in 2005.

Funding Difficulties Possible

Landsbanki's financing costs have deteriorated dramatically in the past year due to the end-2005 'Icelandic scare'. The bank has €650 million maturing this year and €1.9 billion in 2007. Landsbanki does have sufficient liquidity for the next 12 months.

Balance Sheet Analysis

Landsbanki's continued presence in the retail banking market is illustrated by its relatively high level of deposits (39% deposits/deposits + wholesale funding, compared to Kaupthing's and Islandsbanki's 25%). Its portfolio of financial assets, broken out on the next page, is mostly bonds and shares held as trading assets, which is partially hedged. There is €704 million of unhedged equity exposure, 47% of which we assume is to the ICEX according to company statements. A 50% hit to the ICEX would therefore result in a €181 million write-down for the company, representing 141bp off the current 11.9% Tier 1 ratio.

Landsbanki Islands (A2/A Fitch; CDS: Overweight)

Balance Sheet

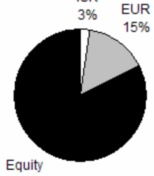
	ISK millions	EUR millions
Assets		
Cash	16,611	201
Loans	1,071,513	12,946
Trading assets	218,894	2,645
Financial assets AFS	34,483	417
Derivatives	4,689	57
Investments in associates	4,456	54
PP&E	4,260	51
Intangibles	10,461	126
Non-current assets	16,459	199
Other	23,636	286
Total assets	**1,405,462**	**16,980**
Liabilities		
Deposits from credit instit.	144,596	1,747
Deposits from customers	334,163	4,037
Borrowing	689,989	8,336
Sub debt	49,074	593
Trading liabilities	26,504	320
Derivatives	4,086	49
Tax liabilities	7,289	88
Liabilities included in disposal groups	4,475	54
Unsettled payments	20,428	
Other deposits	11,240	136
Total liabilities	**1,291,844**	**15,608**
Equity		
Share capital	10,614	128
Share premium	52,277	632
Reserves	1,790	22
Retained earnings	45,377	548
	110,058	1,330
Minority interest	3,557	43
Total liabilities and equity	**1,405,459**	**16,980**

Fall in stock market values	50%
%age invested in Iceland	47%
Effect on portfolio	24%

Financial Assets Breakdown - Fair Value

		ISK millions	EUR millions	Stress Test
Trading				
	Bonds	100,498	1,214	
	Equity	104,509	1,263	
	Derivatives	13,886	168	
Total trading assets		218,893	2,645	
Less: Forward contracts	Bonds	48,963	592	
	Equity	80,701	975	
Net trading assets	Bonds	51,535	623	
	Equity	23,808	**288**	**68**
Financial assets AFS (all equity)		34,483	**417**	**98**
Total trading/financial assets		*253,376*	*3,061*	*Total loss* **181**

Landsbanki Split Tier 1

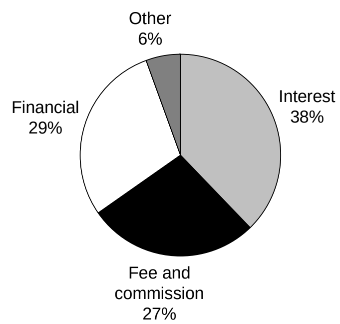


	ISK millions	EUR millions		
Tier 1	126,635	1,530	Stress test Tier 1	1,349
RWAs	1,064,160	12,857		
Tier 1 ratio		11.90%	Stress test Tier 1 ratio	10.49%

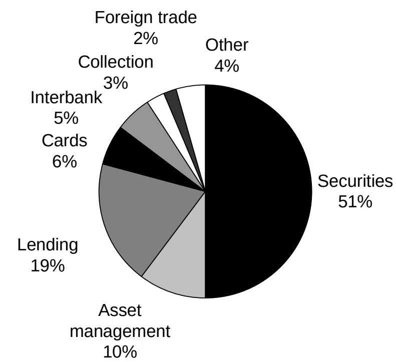
Source: Morgan Stanley

Landsbanki Islands (A2/A Fitch; CDS: Overweight)

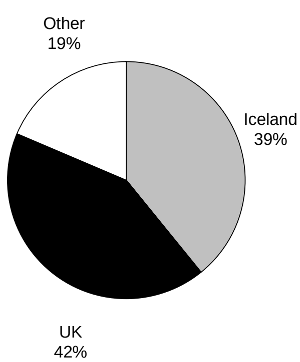
Split of Income



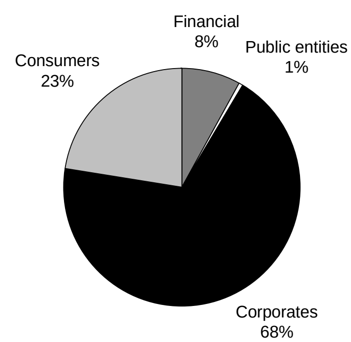
Split of Fees and Commissions Income



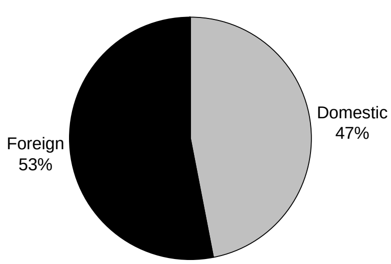
Loan Book by Geography



Loan Book by Industry



Split of Equity Investments



Source: Company reports

Islandsbanki (Glitnir, A1/A Fitch; CDS: Overweight)

Recommendation

Islandsbanki has pursued the least-risky expansion strategy of the Icelandic banks, in its move into retail banking in Norway. We ask ourselves, why should a solid little Nordic bank be trading at 65/80 in 5-year senior CDS? We think there is an element of Icelandic taint here, as fears about Kaupthing's rapid expansion and lending practices, along with a focus on Iceland's macro imbalances, have caused Islandsbanki to widen in sympathy. However, even adding on an Icelandic premium, we see well over 30bp of tightening potential for Islandsbanki.

Issuer Description

As a specialist Nordic bank that offers a comprehensive banking service, Islandsbanki focuses on its home markets of Norway and Iceland. It recognises its sustainable competitive advantage in lending to certain industries, among them the seafood and geothermal sectors. The bank offers retail and corporate banking services to its clients, and has lately pulled away from an earlier focus on both insurance and equity investments, refocusing on banking activities in chosen markets.

Credit Strengths and Concerns

Strengths	Concerns
Sound expansion strategy in Norway and, in the future, building on seafood expertise in additional markets	Growth story not a strong as at other banks – income only up 66%, compared with triple-digit increases at peers
Reducing equity trading exposure	Owner of a significant amount of Kaupthing stock (1.82% or ~€132 million worth)
Good growth in new markets – BNbank lending up 46%	Poor track record making equity gains; loss in 4Q05
Good asset quality – NPLs 0.6% of total loans	Isandsbanki has a large shareholder – Thattur (23%); FL Group also large shareholder
Improving capitalisation – 9.9% this year from 9.4%	Sold its insurance subsidiary Sjova to Thattur, its largest shareholder; plans to establish an investment company with Sjova and Thattur to invest in unlisted equities
Is not a shareholder in any of its shareholders	Plans long-term growth in dividend per share, generally 20-40% of profit
Well-diversified funding sources	

Key Credit Points

Less Risky Expansion Plan

We regard Islandsbanki's decision to expand into Norway's retail banking units as a more favourable plan from a credit perspective in comparison to Icelandic peers. Having met with the company, we also believe that it has a good plan to build on areas where it has proven a sustainable core competence; in this case it is lending to the seafood and geothermal industries.

Suffers from Icelandic Ills – i) Wholesale Funding Reliance

Islandsbanki is not immune from the low deposit levels and web of cross-shareholdings that characterise Icelandic banks. Deposits as a percentage of deposits + wholesale funding are a low 25%. However, Islandsbanki has made good progress in diversifying its funding sources and has a fairly well-diversified set of international debt investors.

Suffers from Icelandic Ills – ii) Cross-Shareholdings

Islandsbanki also has a set of shareholders who themselves are invested in the other banks or are Islandsbanki's customers, which is disconcerting to us. It is also an investor in other banks, in particular with a 1.82% investment in Kaupthing (not all at the bank's own risk). We take comfort that Islandsbanki, as opposed to the other banks, is not a shareholder in any of its shareholders.

Not as Reliant on Capital Markets nor Equity Gains

Net financial income fell 56% in 2005, and the bank states that it does not intend to rely on such gains in future. That Islandsbanki was still able to post a reasonable annual result is comforting, along with our stress test that shows it only makes about 26.2% of PBT from capital markets-related sources.

Balance Sheet Analysis

A smaller bank than Kaupthing, about the size of Landsbanki, Islandsbanki is typical in that its assets are supported by mostly wholesale funding. However its portfolio of financial assets, broken out on the next page, is partially hedged. There is €359 million of unhedged equity exposure, 50% of which we assume is to the ICEX according to company statements. A 50% hit to the ICEX would therefore result in a €90 million write-down for the company, representing 79bp off the current 9.88% Tier 1 ratio.

Islandsbanki (A1/A Fitch; CDS: Overweight)

Balance Sheet

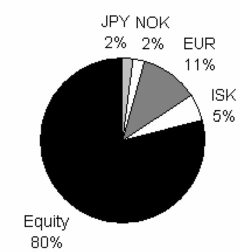
	ISK millions	EUR millions
Assets		
Cash	20,861	252
Loans	1,174,733	14,193
Financial assets - trading	151,897	1,835
Financial assets - fair value	96,438	1,165
Financial assets - AFS	3,611	44
Derivatives	2,352	28
Investments in associates	8,081	98
Investment property	-	-
PP&E	1,987	24
Intangibles	10,824	131
Tax assets	268	3
Non-current assets	551	7
Reinsurers' share	-	-
Other	647	8
Total assets	**1,472,250**	**17,787**
Liabilities		
Deposits	30,656	370
Other deposits	304,136	3,674
Borrowings	937,794	11,330
Sub debt	47,464	573
Insurance liabilities	-	
Financial liabilities at fair value	28,791	348
Derivatives	7,233	87
Post-employment oblgs.	418	5
Tax liabilities	5,178	63
Other liabilities	25,830	312
Total liabilities	**1,387,500**	**16,763**
Equity		
Share capital	13,112	158
Share premium	32,888	397
Reserves	- 465	- 6
Retained earnings	39,215	474
	84,750	1,024
Minority interest	-	-
Total liabilities and equity	**1,472,250**	**17,787**

Fall in stock market values	50%
%age invested in Iceland	50%
Effect on portfolio	25%

Financial Assets Breakdown - Fair Value

		ISK millions	EUR millions	Stress Test
Trading				
	Public bonds	59,161	715	
	Other bonds	1,901	23	
	Shares	74,335	898	
	Derivatives	16,500	199	
Total trading assets		*151,897*	*1,835*	
Less: Derivatives against equity		59,627	720	
Net equity exposures		14,708	**178**	**44**
Financial	Public bonds	1,824	22	
	Other bonds	73,587	889	
	Shares	15,027	**182**	**45**
Total financial assets		*90,438*	*1,093*	
Total trading/financial assets		*242,335*	*2,928*	*Total loss* **90**

Islandsbanki Split Tier 1

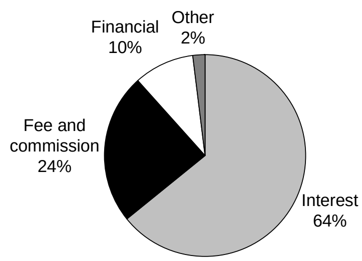


	ISK millions	EUR millions		
			Stress test	
Tier 1	93,503	1,130	Tier 1	1,040
RWAs	946,428	11,434		
			Stress test	
Tier 1 ratio		9.88%	Tier 1 ratio	9.09%

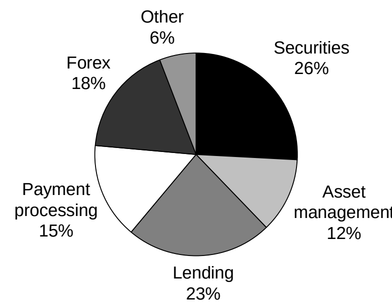
Source: Morgan Stanley

Islandsbanki (A1/A Fitch; CDS: Overweight)

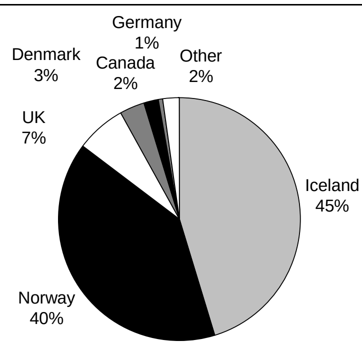
Split of Income



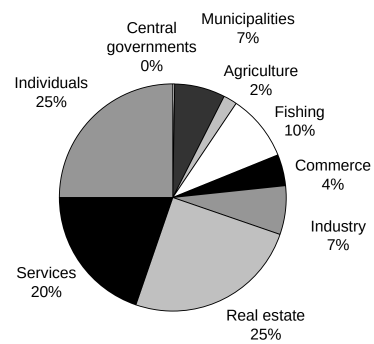
Split of Fees and Commissions Income



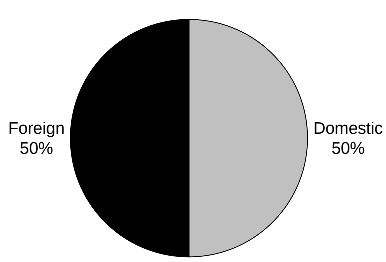
Loan Book by Geography



Loan Book by Industry



Split of Equity Investments



Source: Company reports

Credit Products Rating Distribution Table

(as of March 1, 2006)

	Coverage Universe		Investment Banking Clients (IBC)		
Rating	Count	% of Total	Count	% of Total IBC	% of Rating Category
Overweight	90	39%	48	37%	53%
Equal-weight	113	48%	69	53%	61%
Underweight	30	13%	13	10%	43%
Total	233		130		

Coverage includes all companies that we currently rate. Investment Banking Clients are companies from whom Morgan Stanley or an affiliate received investment banking compensation in the last 12 months.

Analyst Ratings Definitions

Overweight (O) Over the next 6 months, the fixed income instrument's total return is expected to exceed the average total return of the relevant benchmark, as described in this report, on a risk adjusted basis.

Equal-weight (E) Over the next 6 months, the fixed income instrument's total return is expected to be in line with the average total return of the relevant benchmark, as described in this report, on a risk adjusted basis.

Underweight (U) Over the next 6 months, the fixed income instrument's total return is expected to be below the average total return of the relevant benchmark, as described in this report, on a risk adjusted basis.

More volatile (V) The analyst anticipates that this fixed income instrument is likely to experience significant price or spread volatility in the short term.

Important Disclosures on Subject Companies

The information and opinions in this report were prepared by Morgan Stanley & Co. Incorporated and/or one or more of its affiliates (collectively, "Morgan Stanley") and the research analyst(s) named on page one of this report.

Issuer Name: Banco Espirito Santo
Fixed Income Research 12-Month History
Issue Type: EUR LT2
Current Rating: Equal-weight --as of 09/23/2005
Issue Type: EUR T1
Current Rating: Underweight --as of 02/09/2006
Issue Type: EUR UT2
Current Rating: Equal-weight (No Changes in Past 12 Months)

Issuer Name: Kaupthing Bank
Fixed Income Research 12-Month History
Issue Type: EUR T1
Current Rating: Equal-weight --as of 03/13/2006
Issue Type: CDS
Current Rating: Equal-weight --as of 03/13/2006

Issuer Name: Landsbanki Islands
Fixed Income Research 12-Month History
Issue Type: CDS
Current Rating: Overweight --as of 03/13/2006

Issuer Name: Islandsbanki
Fixed Income Research 12-Month History
Issue Type: CDS
Current Rating: Overweight --as of 03/13/2006

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Within the last 12 months, Morgan Stanley has received compensation for investment banking services from Banco Espirito Santo.

In the next 3 months, Morgan Stanley expects to receive or intends to seek compensation for investment banking services from Banco Espirito Santo, Banca Popolare Italiana.

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