High Grade Credit | Europe | Banks
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Merrill Lynch

Distress and default

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Is default the endgame for the Icelandic banks?

With Kaupthing and Glitnir CDS quoted at +1,000bps for the second time in four or so months, the market has returned to the idea that default is where we are headed with the Icelandic banks. It is not surprising. Since we had the promising agreement with other Nordic Central Banks in mid-May that gave access to a credit line of €1.5bn equivalent, we have had a virtual information vacuum out of Iceland. The markets hate a vacuum and generally consider (and price securities) for the worst scenario when confronted with one. That is what we are seeing now.

Micro: the banks (say they) can handle it

Immediate worries about liquidity can be somewhat addressed by the banks' liquidity profiles which generally show that they can meet obligations a year out. With €11.5bn of redemptions due in 2009, however, and the institutional markets virtually shut, it is not surprising that the market is taking Icelandic CDS wider. We expect the banks to give guidance on this with their 2Q08 results: a combination of their new deposit platforms, little new business and asset shrinkage will take them most of the way, we suspect. But we do wonder for how much longer they can continue to do this, especially if asset quality starts to deteriorate. That said, our base case is that the banks continue to muddle through for the foreseeable future.

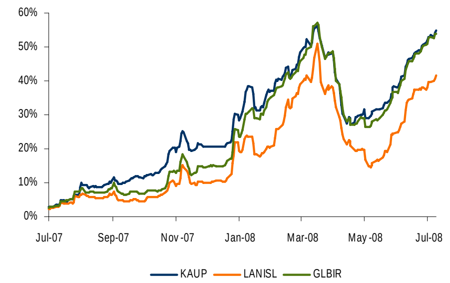
Macro: how are the Icelandic authorities helping?

With total bank debt in the $70bn+ level and GDP a quarter of that, the market is also focusing on the macro imbalances in Iceland. The Icelandic authorities' steps to address this have so far been inadequate in our view and the apparent inaction has merely fanned the flames of speculation. Though there is no evidence that we are heading in this direction, it is true that default is actually a macroeconomic tool peculiarly well suited to dealing with situations of over-indebtedness. We think that the market is envisaging renationalisation of the banks, a debt moratorium and a generalised restructuring of debt, where the bondholders feel significant pain (or at least share the pain with Iceland's taxpayers). This is not our central scenario – hence our unchanged recommendations on the banks. Some reassurance that we are not headed in this direction would however be quite welcome.

2Q08 numbers next week

The Icelandic banks all report their 2Q08 numbers next week. They will be boosted by inflation and FX effects which likely will make the headlines reassuring. We will be looking for signs of business shrinkage, corporate deposit flight, retail deposit inflows, deteriorating asset quality and guidance on 2009 bond redemptions.

Chart 1: Icelandic banks – market implied default probabilities (40% recovery rate)



Source: Merrill Lynch

Table 1: Our recommendations

Landsbanki	Senior/T1 Step	UW-30%
Kaupthing	Senior/T1 Step	UW-30%
Glitnir	Senior	UW-30%

Source: Merrill Lynch

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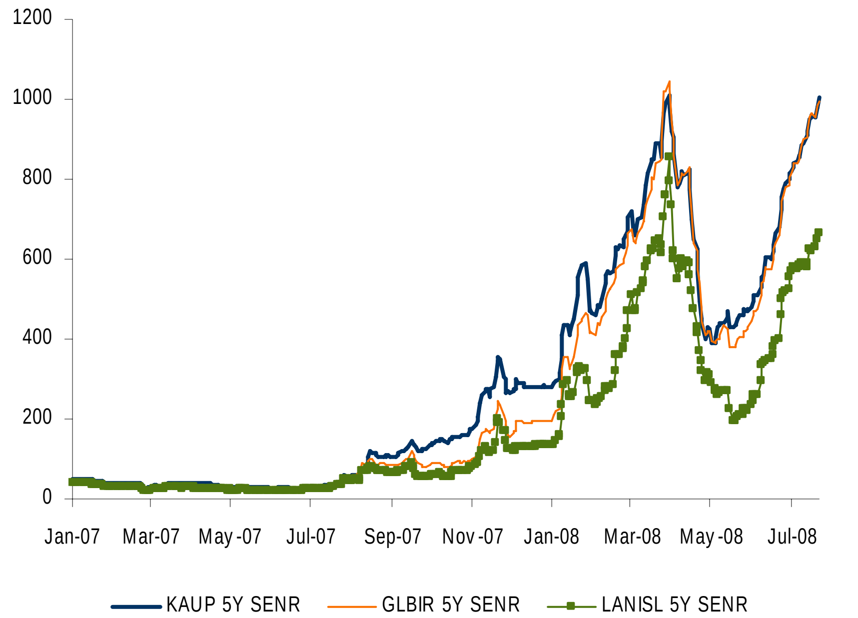
Distress and default

In this report, we consider the options that could be on the table to resolve the Icelandic “banking crisis” and in general terms, the outlook for the Icelandic banks’ 2Q08 results.

Chart 2: Icelandic banks – 5 Year CDS levels



Source: Markit

What’s new?

A preponderance of sellers of Icelandic bank bonds on the one side and a preponderance of buyers of protection on the other side

Glitnir and Kaupthing CDS are more or less back at their wides. Landsbanki’s too have continued to climb. This is in spite of the fact that over the last few weeks we have seen a bit of a rally in the iTraxx Financials Index. Again, we have a situation where the Icelandic banks have continued to go in the opposite direction. This reflects a preponderance of sellers of Icelandic bank bonds on the one side and a preponderance of buyers of protection on the other side.

As a rule of thumb, when the CDS of a company trades north of +1,000bps, the market is stating it expects a default

How sustainable are the business models of banks that are dependent on market funds and that are forced to borrow at spreads in excess of 150-200bps for an extended period? Not very, we suspect is the answer. If the credit market remains tricky for the recognised “high yield” banks over an extended period, one would have to question what kind of business they have – at best, a shrunken one. But for banks that trade really wide – in excess of 1,000bps? We have a rule of thumb. It is that as the CDS of a company trades north of +1,000bps, the market is stating that it expects a default. Both Kaupthing and Glitnir are currently trading in that area. This is the second time that this has happened this year. We think that this reflects inertia on the part of the Icelandic authorities which we think is quite telling. It is time to consider whether or not we will see a default from these banks.

Micro: the banks (say that they) can handle it

On the micro level, we know that the banks would all be horrified at the suggestion: they would point to their high levels of liquidity; the fact that they have generally planned to pay all obligations a year out; and that they have other sources for funding in addition to the Euromarkets. They have done a good job to date.

Perhaps they will muddle through – our central scenario and why we are not changing our recommendations as yet. Against this, of course, the market is fearing that the longer the banks are shut out from the markets, the narrower the margin for error becomes. There are some concerns that with the asset quality cycle turning, creating unexpected non-repayment of loans from risky borrowers and deposit flight a real possibility, the banks' liquidity will actually be very tested at a time when the usual contingencies are also increasingly difficult. Though we don't really have immediate concerns for the banks, we think this is a valid view. In such a scenario, the banks may well look outside for liquidity – either from the Central Bank of Iceland or the ECB. Indeed, they are already doing that: Kaupthing's Pledged Assets for example rose to ISK 405bn in 1Q08 (+27% compared to the year end).

Macro: we have a problem…

We calculate that, in USD terms, the Icelandic banks have a total of $71.6bn outstanding

However, at a macro level the extraordinarily high level of indebtedness remains a policy problem for the Icelandic authorities that is impossible to (continue to) ignore. We calculate that, in USD terms, the Icelandic banks have a total of $71.6bn outstanding (Source: Bloomberg). This compares with Iceland's GDP of a projected $17bn in 2008F (according to Moody's). Therefore, the banks' indebtedness is about 4.2x the size of the total economy and many multiples of the Central Bank's foreign exchange reserves which are variously quoted as being between $2-4bn equivalent. We know that the banks hate this comparison, but in our view, given that they have clear difficulties in refinancing, it is a comparison that does matter. With markets more or less shut to the banks and spreads indicating distress, it is actually this level of imbalance that, from a policy perspective, can no longer be ignored and indeed must be addressed.

However, what have the Icelandic authorities actually done? Pious words and wishful thinking are not going to result in this problem going away

However, what have the Icelandic authorities actually done? We have been very disappointed. In April, Icelandic bank CDS rallied following several reassuring comments from the Icelandic political establishment. However, there has been very little (apparent) follow-through. As we have stated previously: pious words and wishful thinking are not going to result in this problem going away. Several solutions were apparently on the table: FX reserve build; help from the IMF; help from other friendly Central Banks were all mooted. We did see an agreement with the other Nordic Central Banks in terms of possible liquidity lines but that was about it (and the total liquidity lines are 'only' €1.5bn which doesn't get us too far). There was also apparently a sovereign bond in the market but for whatever reason it did not proceed. With almost a complete information vacuum, the market has inevitably called the bluff of the Icelandic authorities and sent CDS sky high again. It is perfectly understandable, in our view. Markets hate a vacuum and generally assume the worst when they see one.

The crisis toolkit

Are the Icelandic authorities really weighing up the options? Should we expect an announcement any day of how they propose to assist the Icelandic banks which would result in CDS compression? In the past, we have suggested that a possible solution was for the Government to buy back (at least part of) the banks' bonds for cash, reducing the overhang of securities and setting a floor for valuations (see Money in the Bank, *Resolving Iceland's banking "crisis",* 31st March 2008). However, we haven't actually seen anything tangible from the Government in this respect. It is probably still an option. There is the potential cash from the Nordic Central Bank agreement which was a step in the right direction; there was no follow through however on that promising start. Moreover, the Government did not build its FX reserves which are dwarfed by the extent of the banks' debt and has said nothing about ways in which it could help; it must know of the tools in the toolkit. They only need to ask the IMF how to handle a banking crisis.

There are of course other permutations for the authorities (our list of ideas is by no means exhaustive):

- **Asset sales**: most of the Icelandic banks have made many acquisitions in recent years. These could be sold. We are less keen on this option because (a) these subsidiaries can often be self funding, so getting rid of them (deconsolidation) doesn't necessarily reduce the mountain of refinancing at the parent (Icelandic) bank[1] (though of course the proceeds could be used to pay down debt) and (b) these assets were bought at a time when asset values were far more generous than they were today suggesting large goodwill write-offs which will impact capitalisation, turning liquidity issues into solvency ones. We'd rather that didn't happen.

Sooner or later all banking crises end in a Government bailout of some sort or another. Why should Iceland be any different?

- **Bailout**: We know that this crisis is somewhat atypical – caused by liquidity issues (closure of the markets) rather than the (classic) asset quality problems. Sooner or later though all banking crises end in a Government bailout of some sort or another. We are already seeing this unfold in the UK and the US and we don't expect it to be any different elsewhere either.

- **Nationalisation**: many of the more unpalatable solutions probably entail the banks being nationalised in one form or another. This may not necessarily be a good thing for bondholders.

- **Debt swaps**: this would mean that as bank debt matured, it was repaid with Icelandic Government debt of a given maturity – that could be in any form. Iceland wouldn't need to issue debt up front for this because it would just issue paper to the holder of bank debt. This would be in any case a de facto nationalisation of the *debt* of the Icelandic banks. We believe it would constitute a default too under most rating agency definitions.

When high levels of debt reach an impasse, we would be foolish not to consider the solution that we have seen many times before: default and restructuring

- **Default and moratorium**: default is actually a macroeconomic tool peculiarly well suited to dealing with situations of over-indebtedness. If it is the case that there is a lot of debt and there are questions as to how will it all be paid back when no one has the means to do so, then non-payment, or perhaps part-payment, is obviously a particularly appropriate and effective solution. We think that this is now the market's central scenario and we wonder what can be done to convince the market otherwise.

  If for whatever reason, therefore, the banks find themselves unable to pay their obligations, the market's view is that Iceland itself has only limited flexibility to meet them and stave off a default. Only the Icelandic authorities can challenge this view. We can however think about the possible scenarios that the market is implying will happen. If one or more of the banks went illiquid, one could see a situation arising where one or more of the banks is nationalised and a general moratorium declared on payment of the banks' obligations (with the exception of deposits naturally).

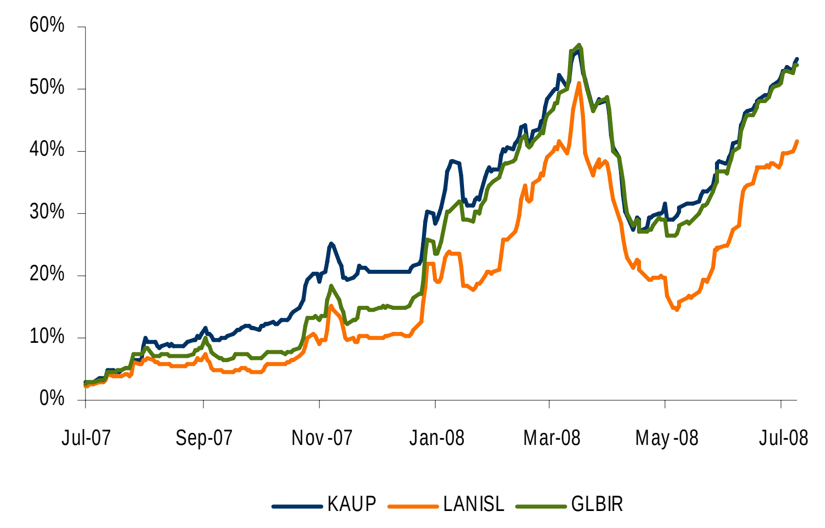
  Then, in due course, the Government could offer creditors whatever the Government thought was appropriate, probably at a discount to par. Iceland itself has not really needed to borrow much in recent years – its only real contingency is the banks themselves. Would Iceland really trash its credit rating and disregard any worries about "reputational risk"? We are not certain

[1] We estimate, for example, that even excluding its major subsidiaries, Kaupthing could still have as much as €20bn of borrowings at the parent company.

about that and we are not of course suggesting that this is what Iceland will do. However, when high levels of debt reach such an impasse, we cannot believe that all scenarios have not been considered by the authorities, including default and restructuring – even if they are immediately dismissed. Default and restructuring also have the benefit of transferring the pain away from the Icelandic taxpayer and onto the credit markets. Given that the Icelandic authorities must live with their taxpayers on a daily basis, but have made only occasional visits to the international markets in recent years, it is clear that, from a domestic policy perspective, the transfer of pain onto the international markets is much to be preferred.

Is default really the endgame here? The market is currently implying a 55% chance of default at Kaupthing, 54% at Glitnir and 41% at Landsbanki (40% recovery rate). This rises to 61% for Kaupthing with a 50% recovery rate. Perhaps the 2Q08 numbers, which we certainly don't expect to be disastrous, are a catalyst here for some spread retracement. However, ultimately we believe the key to all this does not lie with the banks themselves. The banks are indeed generally sound, as we have been continually reminded – but not if they can't pay back their debt. We would welcome some clarification from the Icelandic authorities as to what role they expect to play in resolving the issues here and improving the perception that the market has of the banks' inability to manage their debt burden.

Chart 3: Icelandic banks: default probability (40% recovery rate)



Source: Merrill Lynch

Icelandic banks report 2Q08 next week

The Icelandic banks report their 2Q08 numbers next week. In our view, this will be an important landmark in terms of analysing where these banks go next. There has been a virtual information vacuum in the last few months. The only major news was that Kaupthing was taking over the Reykjavik savings bank, SPRON, which in our view itself was a bank in distress, having lost half of its shareholders' equity in six months owing to soured equity investments.

Table 2: Icelandic bank reporting dates

Landsbanki	29th July
Kaupthing	31st July
Glitnir	1st August

Source: Companies

What are we expecting from the 2Q08 results?

Investors expecting significant red ink across the results are likely to be disappointed. Market expectations currently see net profits as follows: ISK 7,308m for Glitnir, ISK 17,281m for Kaupthing and ISK 10,765m for Landsbanki. These compare to ISK 5,867m, ISK18,748m and ISK 17,307m in the first quarter respectively – so a real mixed bag in terms of whether the numbers go up or down. In 1Q08, we were of the view that Glitnir's results were the most resilient and of the greatest quality. However, its funding is the most vulnerable to market sentiment, as its loan-to-deposit ratio is still the highest.

Impact of inflation and FX

Inflation and FX gains will dominate the banks' 2Q

The main feature that will help the numbers of the banks is, oddly, the impact of higher inflation (through indexation) and a plunging currency (ISK has depreciated ~30% versus the EUR in 1H08, though only about 3-4% in 2Q08). The impact of higher inflation will be visible in much higher accruals of interest income e.g. from the banks' domestic mortgage books. This is because the banks are 'long' inflation – they have more indexed assets sensitive to inflation than they have indexed liabilities. This is a contrast to mortgages in, say, Spain which are 95% linked to LIBOR. The banks were right to position themselves to benefit from this, just as they were right to position themselves to benefit from the devaluation of the currency, though the Icelandic authorities have moved to reduce the permitted open FX position of the banks to 10% versus the previous 30%. Still, the banks should be able to take some gains from the FX movements.

We have noted in the past that whilst higher net interest income is accrued, it does not mean that the banks have higher cash inflows. The improvement will be cashed out only over the long life of the mortgages. What we have in Iceland is effectively "reverse amortisation", since the extra income accrued largely is added to the principal amount of the loan – passing the risk essentially back to the banks from the mortgage customer. Equally, the FX effect will flatter both assets and income, though to a lesser extent (we believe) than we saw in 1Q08. But it will be these accounting effects that optically will cushion the results of the Icelandics in 2Q08.

Trading income

In terms of trading income, we also expect a mixed bag. For whilst the Icelandic stock market fell about 13% in the quarter, the Norwegian one was up a similar amount whilst the Swedish down by a similar magnitude. In Denmark the index was almost flat (-2.5%). On the other hand, the UK Small Caps were down just over 7% in the quarter. From this we conclude that it will be hard for the banks to make money if they are long equities, though it is difficult to make that call as the banks have used various hedges in the past to come up with extraordinary gains.

Costs

We would be expecting costs to fall on a like-for-like basis, given the efforts that many of the banks have put into cost reductions in recent months. However, the FX effect may cloud this story.

Provisions

The banks will not be rewarded by the market for having a decent bottom line, so why not do some extraordinary reserve strengthening to comfort the market with respect to asset quality?

These will be key. With the economy generally in decline across Europe – and asset markets generally in a mess (e.g. Danish real estate), we have seen a number of high profile names getting into trouble. We were aware, for example, that Kaupthing sold 94m shares of Dawnay Day's holding in F&C Asset Management on July 10th (obviously after the quarter end but the sale of the stake was widely reported to have led to losses for the stake holder). It was widely reported that this action was the result of margin calls, but we don't know which bank(s) were involved. In any case, the asset quality position of the banks must be continuing to deteriorate – at a time when their reserve coverage is undoubtedly still at a cyclical low. Kaupthing's loan book was 17% acquisition and leveraged finance at end-March 2008 (for example); we would expect the other banks to have similar levels of exposures to this sector. There have also been a few high profile corporate collapses in Iceland, though admittedly not in the second quarter. The extraordinary measures taken by the Icelandic Government to help the domestic real estate market also suggest a high degree of stress there. We will be looking to see whether there is any reserve build at the banks. They will not be rewarded by the market for having a decent bottom line, so – like Banco Sabadell in FY2007 – why not do some extraordinary reserve strengthening to comfort the market with respect to asset quality?

Liquidity

Deposit flow will also be an important factor in our considerations. It will be recalled that in 1Q08, Kaupthing's deposits declined some 20% in EUR terms. On the other hand, the quiet newsflow vis-à-vis the banks should have ensured that Kaupthing and Landsbanki have both enjoyed inflows into their retail deposit programs, Kaupthing Edge and Icesave. Both are increasingly their presence in Europe. Landsbanki has a deposit program in the Netherlands now and has successfully attracted in excess of 24,000 clients. These will be very helpful to the banks, given that institutional markets appear to be shut to them for now. The higher the level of balances in the deposit programs, the more comfortable will the market be with respect to the banks' redemption schedules for 2009, especially whilst the banks remain vulnerable to deposit flight in the institutional/corporate markets. The magnitude of deposits that have been raised will be key to our view on how the banks will redeem debt in 2009. According to Bloomberg, redemptions peak in 2009: €5.5bn from Kaupthing (with another €4.5bn the following year); a more manageable €2.7bn for Landsbanki (€2bn the following year) and €3.3bn for Glitnir (€3.6bn in 2010). Source: Bloomberg.

Table 3: Kaupthing: short-term maturity profile

ISKbn	Demand	Up to 3 months	3-12 months	Total
Cash	71			71
Banks	288	289	20	597
Loans	256	897	446	1599
Bonds	144	8	121	273
Total ISKbn	759	1195	587	
Total EURm	6170	9712	4772	

Source: Company report

We believe that the banks' near term asset liquidity is quite strong. For example, looking at the maturity profile of Kaupthing's assets as of end-March 2008 (Table 2), we can see that the bank had €6.2bn of on demand assets. That means that in theory as of 31st March, the bank *could have* called in the loans (ISK 256bn), liquidated the bonds and placed a total of €6.2bn with banks. In the three months to end-June (the up to 3 months bucket), a further €9.7bn matured. Of course, the bank would probably have rolled most of this – so we would see a similar profile to the above in the 1H08 numbers, we believe.

Of course, translating theoretical maturities into cash isn't always as easy as it may appear: borrowers may be reluctant to pay back their overdrafts and short-term borrowings; some may have defaulted; and whilst the cash and interbank and bonds are the bank's to do with as it wishes, in practice they represent its liquidity pool, which most Treasurers would like to preserve at almost any cost as a cushion. So *in practice* the *available* liquidity is lower than the table suggests. However, it does show that, even as of end-March, Kaupthing did have some elbow room to shrink its asset base and thereby pay off liabilities. We continue to believe that the short-term liquidity situation at the banks is acceptable. However, we would welcome guidance in the 2Q08 results about how the banks' propose to manage the 2009 redemption schedule (and beyond).

Credit Opinion History Table
Glitnir / GLBIR

Security	Date^	Action	Recommendation
Senior incl. CDS	07-Mar-06	Initiation	Underweight-30%
	05-Apr-07	Downgrade	Underweight-70%

As of 07-Mar-06. ^First date of recommendation within last 12 months. Please refer to text above "Important Disclosures" for the current opinion system.

Credit Opinion History Table
Kaupthing Bank / KAUP

Security	Date^	Action	Recommendation
Senior	07-Mar-06	New Opinion	Underweight-30%
Euro T1 Step	07-Mar-06	New Opinion	Underweight-70%
	22-Nov-07	Upgrade	Underweight-30%

As of 22-Nov-07. ^First date of recommendation within last 12 months. Please refer to text above "Important Disclosures" for the current opinion system.

Credit Opinion History Table
Landsbanki Islands HF/ LANISL

Security	Date^	Action	Recommendation
Senior	07-Mar-06	Initiation	Underweight-30%
EUR T1	07-Mar-06	Initiation	Underweight-70%
	08-Nov-06	Upgrade	Underweight-30%
	26-Jan-07	Upgrade	Overweight-30%
	21-Mar-07	Downgrade	Underweight-30%

As of 21-Mar-07. ^First date of recommendation within last 12 months. Please refer to text above "Important Disclosures" for the current opinion system.

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Recommendation	Investor Action Points (Cash and/or CDS)	Primary Investment Return Driver
Overweight-100%	Up to 100% Overweight of investor's guidelines	Compelling spread tightening potential
Overweight-70%	Up to 70% Overweight of investor's guidelines	Carry, plus some spread tightening expected
Overweight-30%	Up to 30% Overweight of investor's guidelines	Good carry, but little spread tightening expected
Underweight-30%	Down to 30% Underweight of investor's guidelines	Unattractive carry, but spreads unlikely to widen
Underweight-70%	Down to 70% Underweight of investor's guidelines	Expected spread underperformance
Underweight-100%	Down to 100% Underweight of investor's guidelines	Material spread widening expected

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