CreditSights

Icelandic Banks: Round Table Summary

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- We held a round table discussion in London with a group of investors, traders and credit analysts
- Consensus was that funding is the banks' most pressing problem, and that they face a long haul to restore investor confidence
- Glitnir was regarded as the least risky credit, but all agreed that the concerns are over systemic rather than individual bank risk
- Default risk was seen as low, but the majority expected credit spreads to remain volatile, with further widening in the short term

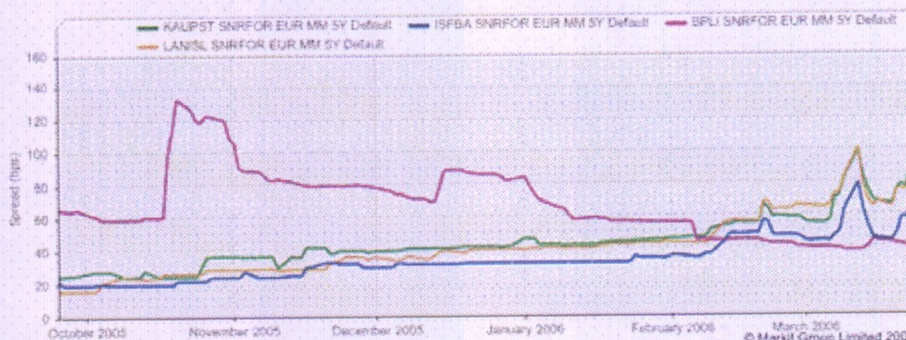
On 23 March, we hosted a round table discussion on the Icelandic banks and invited a selection of investors, traders and analysts closely involved with the credits (see the table for a list of participants). **In view of the high volatility in credit spreads, which remain at unusually wide levels, together with widespread concerns over risks in the banking system and the economy, we asked the question: where to now for the Icelandic banks?**

Icelandic Banks Round Table	
Company	**Participant**
Banquo	Matthew Rees
Barclays	Paul Fenner-Leitao
Barclays	Matthew Hegarty
BNP Paribas	Fabrizio Capanna
BNP Paribas	Rumit Mehta
Cairn Capital	Duncan Needham
MLIM	Ioana Cornisteanu
RBS	Tom Jenkins

Framework

We began with a short introduction to provide a framework for the discussion, summarising recent events. Even allowing for the spike in credit spreads on 13 March, the trend has been for spreads to steadily widen over the past few months. To put current levels in perspective, we compared 5 Year Senior CDS spreads with those of **Banca Popolare Italiana** (BPI - see chart). The difference is that BPI had tangible and clearly identifiable problems, whereas the spread widening for the Icelandic banks has occurred despite strong profitability, asset quality and capitalisation.

5Y Senior CDS: Icelandic Banks & BPI



Source: Markit Portal

Background

Next we summarised the financial condition of **Kaupthing Bank** (LB), **Glitnir** (the new name for Islandsbanki) and **Landsbanki Islands** (LBI). The three banks have mid to high single-A ratings from Moody's and Fitch. While we think these ratings are generous, we do not think the rating agencies have any plans to change them. We do note, however, that

2005: EUR millions	Kaupthing	Glitnir	Landsbanki
Moody's/Fitch	A1/A	A1/A	A2/A
Branches Iceland	37	25	46
Group employees	2,368	1,153	1,725
Total assets	34,059	19,735	18,840
Equity	2,603	1,136	1,475

Moody's assigns debt ratings that are one notch higher than those implied by its Financial Strength Ratings, presumably factoring in the banks' importance to the Icelandic economy and strong state support. KB is roughly twice the size of its peers, but despite rapid expansion, the banks' balance sheets are small in a European context. To put them in perspective, KB is, by market capitalisation, around the 50th largest European bank, a little smaller than **Northern Rock**, while Glitnir and LBI are around two-thirds the size of **Banco Espirito Santo**.

Financial ratios look strong

Key financial ratios appear to paint a strong picture. In 2005, Iceland had the most profitable banking sector in Europe (as measured by reported ROE), as well as being among the best capitalised (as measured by Tier 1 ratios). **However, we also identified three ratios that partly explain why concerns have grown this year:** a) stripping out trading gains (almost all on equities), profitability would be much lower (at least for KB and LBI), b) deposits/loans ratios are exceptionally low, meaning the banks are unusually reliant on wholesale funding, and c) asset growth has been higher than anywhere else in Europe as the banks expand outside Iceland.

2005: EUR millions	Kaupthing	Glitnir	Landsbanki
Return on equity	34.0%	30.3%	45.8%
Adjusted ROE	12.0%	24.5%	10.5%
Cost/income ratio	34.1%	37.9%	34.4%
Loan loss impairments	0.2%	0.2%	0.8%
Deposits/loans	31.5%	28.2%	33.9%
Tier 1 ratio	9.4%	9.9%	11.9%
Total ratio	12.2%	12.6%	13.1%
Core tier 1 ratio	7.2%	7.8%	9.8%
2Y asset growth	+355%	+232%	+214%
2Y pre-tax profit	+563%	+263%	+866%
Market capitalisation	6,199	2,757	3,124
Price/earnings	10.91x	10.76x	9.67x
Price/book	2.80x	2.62x	2.52x

Source: Annual Reports, Bloomberg, CreditSights

Spread widening: the reasons

We briefly discussed the reasons for the spread widening, identifying four factors: a) **market indigestion** (the banks issued around €17 billion of debt in more than 200 transactions in 2005), b) **technical factors** (especially in CDS), c) concerns over the **economy** (rising and high interest rates, increasing current account deficit, depreciating currency, possible price bubbles in housing and the stock market), and d) fears over **systemic risk** in the banking sector.

The main risks

We then highlighted six areas of risk in the financial sector. The three primary risks are: a) the web of **interconnected shareholding** structures, b) **funding** and liquidity, and c) **equities** exposure. The three secondary risks are: a) massive **asset growth**, b) the impact of **krona depreciation**, and c) to what extent the state has sufficient resources to **support the banks** if necessary. Of these, we regard the most pressing issue currently as funding, which we covered in our most recent report on the sector, **Icelandic Banks: The Funding Debate**. In particular, we highlighted some of the discrepancies between the funding requirements and liquid assets shown in recent press releases by the banks, and the data provided in their 2005 Annual Reports.

Round table: main conclusions

- The majority of participants were bearish on credit spreads even from the current inflated levels.
- An important question for most participants was: what would be the catalyst for the banking sector running into serious difficulties? Participants agreed that it would probably need a major credit event, such as a stock market crash. However, the risk of default for one or more of the banks was seen as remote.
- Glitnir was unanimously regarded as the least risky credit among the Icelandic banks. Most thought it would continue to trade at tighter spreads

than KB or LBI, and some that the gap could widen, but participants were doubtful that the market will differentiate significantly between the three banks, given that concerns are mostly over systemic risk.

- Almost all participants felt that poor communication with bond investors has been a contributory factor to the banks' problems, including the release of data that is sometimes difficult to reconcile with other information provided by the banks.
- The funding situation was generally agreed to be the most pressing problem facing the banks, but it was felt that restoring confidence to the market would be a long-term project.

Most of the discussion centred on the main risks highlighted in the introduction, and what the implications were for credit spreads.

Credit spreads: where now?
The general view was that spread volatility will continue in the short term. While some participants thought that spreads would tighten in the longer term as confidence was restored, the majority felt unable to forecast spreads with any certainty. **A straw poll showed that a strong majority would be buyers of protection even at the current, inflated spread levels, and no-one predicted spreads would return to 2005 levels over the next few months.**

The senior CDS market for Icelandic banks is liquid and is heavily traded, but subordinated CDS trades were described as much rarer. While there was some disagreement over the level of liquidity offered by the cash market, one participant's observation that the funding strategy of the banks has been poor – no benchmark deals, small illiquid issues – met with general agreement. **One concern expressed by several participants was that, if spreads have weakened to this extent in benign market conditions, they could prove especially vulnerable if we see a general market downturn.**

It is clear that a small number of particularly bearish investors have been pushing CDS spreads wider. One participant stated that Nordic banks and financial institutions seem particularly negative. Another noted that the Icelandic banks have been active in buying back their own bonds, and another that buyers in the cash market tend to be "fast money" rather than "real money" accounts, with the latter stepping back for now. CDS spreads were also pushed wider earlier in the year by LBI's Tier 1 issue. **There could, however, be some positive technical influences in the near term.** One participant felt that the CDO bid would underpin spreads, while another pointed out that bonds are now trading on a negative basis, i.e. wider than CDS.

Funding and liquidity: a matter of confidence
It was generally accepted that the higher cost of funds that will presumably be a consequence of the current spread widening would have a relatively minor impact on the banks' income statements. **The much more serious worry expressed by participants was the banks' ability to access funding at all.** Some thought that the banks' moves to diversify their funding outside Europe, and KB's recent announcement of a syndicated loan at favourable rates, were indications that the fears have been overblown. Most, however, thought that the problems the banks have had this year accessing the Euro market would inevitably spread to other markets. The view of one participant that the banks have made themselves a hostage to market sentiment because of their unusually high reliance on wholesale funding met general agreement. There was some discussion as to how much the banks could fund via their foreign subsidiaries such as FIH and BNbank, which for now have been relatively unaffected by the market turbulence.

Most participants agreed that confidence was the key, but there were few suggestions as to how the banks can restore confidence. One point noted by several participants was that investor communication has been poor. In particular, it was felt that the banks have not been open enough, and that they have a tendency to issue data that is incomplete or difficult to reconcile with other information they have provided. It is clear that one way to restore confidence is by being more open with, and more responsive to, investors. There was general

agreement that the banks have failed to understand or realise the extent of investors' concerns, although more than one participant felt Glitnir was better in this respect than its peers. Several participants were concerned that the banks were still targeting expansion and potential acquisitions in 2006, seeing this as evidence that they do not appreciate the depth of concern in the market.

Ownership structures and stock market exposure: confusion
Most participants cited interconnected and cross-ownership structures in Iceland as a major concern. One participant felt that the recent announcement by KB regarding its cross-shareholding with Exista was a sign that the banks are beginning to address the problem. The overall sentiment, however, was that this is an opaque area, and that it raises questions over banks' relationships with connected parties, the amount of leverage in the system, and the sustainability of the strong rises in the Icelandic Stock Exchange.

The possibility of a stock market crash was mentioned by several participants as a major risk to the banks, especially given the interconnected ownership structures. There was, however, no consensus on how realistic this possibility is, although some participants considered that stock prices could have been artificially inflated by the lack of foreign investors in Icelandic equities and the inability to short stocks. One participant was surprised that there had not been more of a sell-off in the equities market given the problems in the fixed income market, and several participants commented on the disconnect between the equities and other markets. Some mentioned the difficulty of gauging banks' exposure to the stock market and of assessing real shareholdings because of the extensive use of forward contracts, attributed by one participant to the activity of a small group of investment companies. There was also uncertainty among participants about the real risk on these contracts.

The Icelandic economy: overheating concern
The banks' arguments that their international diversification makes them less exposed than in the past to the domestic economy was widely accepted. However, some participants were puzzled by the wide range of economic forecasts, and most were worried by the overheating recently identified by Fitch.

Ratings: too high, but no sign of downgrades
There was little opposition among participants to the view that Icelandic bank ratings, particularly those of Moody's, are too high, but no-one expected the rating agencies to take negative actions. Given the spread reaction to Fitch's change of outlook on the sovereign rating, any such rating action on the banks would presumably cause a severe reaction. There was disagreement over whether the banks' problems in the debt market would be eased if they applied for S&P ratings – most participants though not, given they would certainly be lower than those assigned by Moody's or Fitch.

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