

Glacier bonds: the icing on the cake?

Certain issues of Glacier bonds carry about 100 bp premium over the comparable Icelandic T-notes despite more favorable credit ratings. Glacier bonds constitute the best opportunity for those willing to take 1-2 year position in Icelandic nominal rates with a top credit rating.

Eurobond issues in ISK began in August 2005 and outstanding bonds are now in the excess of ISK 300 bn, with single series ranging up to ISK 60 bn. The Glacier bonds which normally have a 1-2 year duration are usually issued with AAA credit rating. An active secondary market has developed with approximately five major international banks quoting Glacier bonds. There are certain issues of Glacier bonds that carry about 100 bp premium over the comparable Icelandic T-notes despite the fact the issuers of Glacier bonds usually have a higher credit rating than the Icelandic government and that total outstanding series of T-notes are a mere ISK 73 bn. Kaupthing Research maintains that such a high premium is not warranted despite the spread for the Icelandic T-notes being lower and active market making sponsored by the Icelandic government. Thus, Glacier bonds constitute the best opportunity for those willing to take 1-2 year position in Icelandic nominal rates with a top credit rating.

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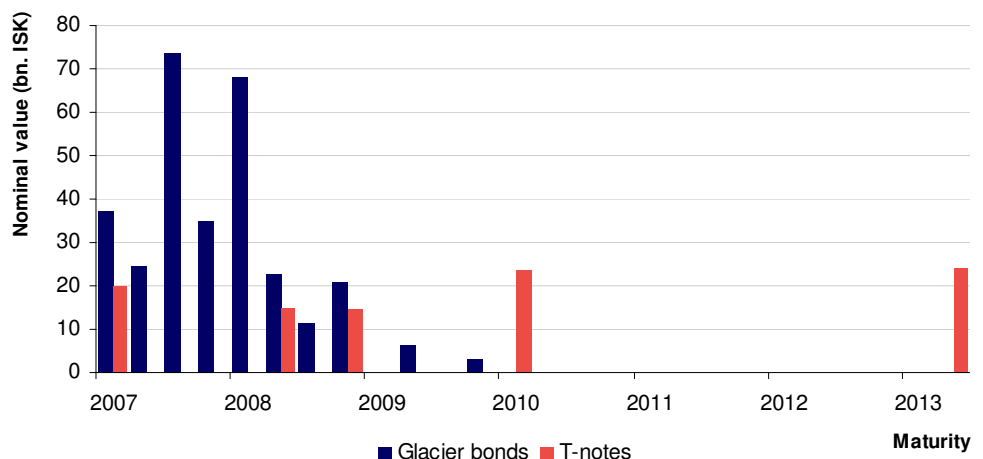
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General facts about Glaciers bonds

The outstanding issues of Glacier bonds now amount to ISK 301 bn (nominal value) with the largest single issue hitherto, ISK 40 bn, issued in January 2007. In comparison, the market value of the Icelandic T-notes series amounts to ISK 73 bn. These bonds have usually been issued by AAA parties with maturity heavily concentrated in the 1-2 year horizon although some issues reach 4 years.

Glacier bonds dwarf the T-notes issues

- Maturities and value of Glacier bonds and Icelandic T-notes (01/07)



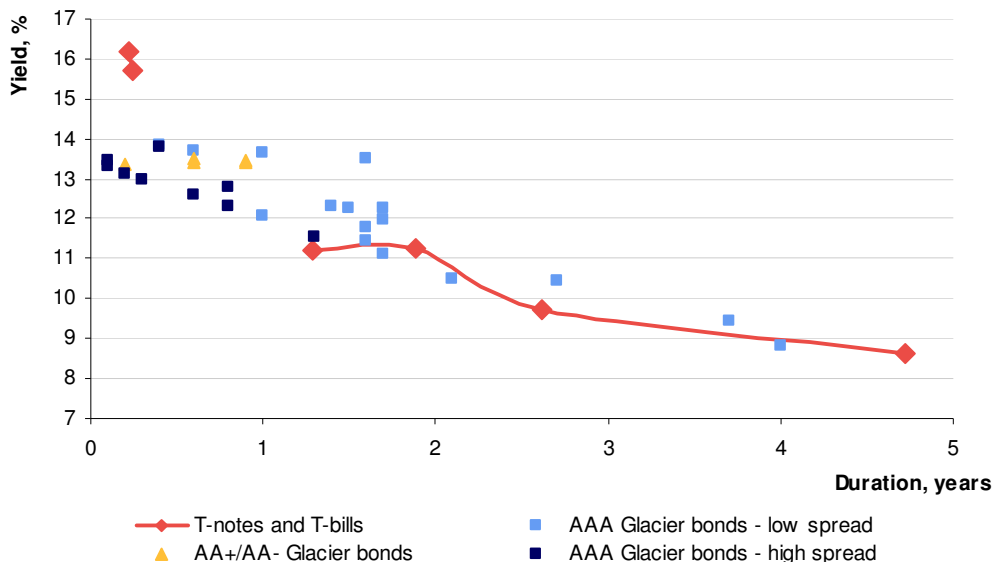
Source: Bloomberg, National Debt Management Agency

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A secondary market for Glacier bonds has evolved although it is quite segmented. Commonly, the spread on top rated (AAA by S&P) Glacier bonds over T-notes issued by the Icelandic state (AA by S&P) but with similar duration is often 100 bp. The yield spread over the yield curve for T-notes can go considerably higher in some cases.

Glacier bonds offer higher yields

- Ask yields and maturities on Icelandic T-notes and Glacier bonds (09.02.07)



Source: Bloomberg, National Debt Management Agency

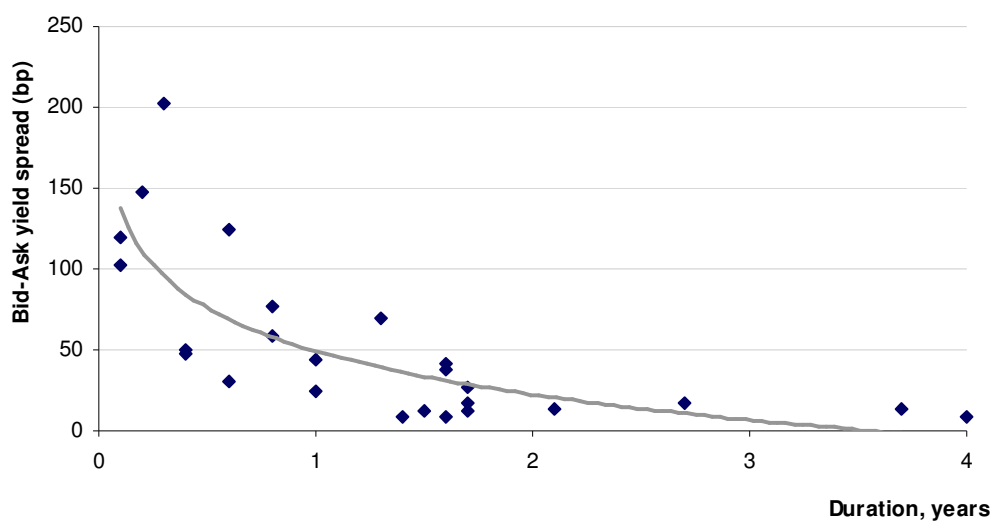
Spreads and duration

In terms of the default premium, Glacier bonds generally have an advantage over Icelandic T-notes. Some of those are even guaranteed by supranational authorities, e.g. EIB which is covered by member states of the EU. Furthermore, measured on outstanding series size the Glacier bonds are clearly larger than comparable T-notes issues. However, the picture concerning liquidity is more blurred. Trading volumes on the secondary market for Glacier bonds are probably more volatile than on the T-notes market, although a lack of data complicates the comparison. However, the Glacier bond market has been receiving more and more attention recently and now there are around five major international banks quoting Glacier bonds. AAA rated Glacier bonds such as those issued by EIB and KFW tend to be the most liquid.

In terms of the bid-ask spread the Icelandic T-notes have a clear advantage trading at a yield spread around 5 bp. This can be compared to the yield spread for the Glacier bonds which generally ranges from 10 to 50 bp although the spread can go higher in some cases. The difference in spread can probably be explained by the fact that the T-notes have about 5-6 active market makers that are compensated by the Icelandic government, whereas the Glacier bonds are usually not traded with an active market making agreement. As shown on the graph below, spreads are higher for Glacier bonds which are closest to maturity.

Spread and duration

- Bid-Ask yield spread and duration of AAA Glacier bonds



Source: Bloomberg

Liquidity and depth

The maximum offer amount which can be submitted without altering prices on the Glacier bond secondary market is generally around ISK 500 million for bigger issues which is relatively robust although not on par with the T-notes market.

There is more uncertainty regarding liquidity on the Glacier bond market than the T-notes market if unfavorable market conditions arise. This uncertainty probably explains why investors have not shown greater interest in Glacier bonds with longer durations than 2 years and therefore investors with a longer time horizon often choose T-notes instead. Some illiquid Glacier bond issues probably deserve a considerable liquidity premium, especially smaller issues with below AAA ratings. These bonds may nevertheless be of interest to investors who wish to hold the bonds until maturity.

All in all, even the most liquid Glacier bonds probably deserve a somewhat higher liquidity premium than the Icelandic T-notes. However, the question remains whether the 100 bp premium over T-notes more than compensates the difference, not least when a smaller default premium is taken into account.

Glacier bonds: Spread and credit

- Sorted by credit rating and bid-ask yield spread (9 February 2007)

| Issuer | Bid-ask yield spread (bp) | Yield (ask) | Coupon | S & P Rating | Nominal value (bn. ISK) | Duration | Maturity |
|------------------|---------------------------|-------------|--------|--------------|-------------------------|----------|------------|
| KFW | 9 | 11,81 | 10,75 | AAA | 5 | 1,6 | 22.09.2008 |
| EUROPEAN INVT BK | 9 | 12,32 | 11,5 | AAA | 3 | 1,4 | 24.07.2008 |
| EUROPEAN INVT BK | 9 | 8,84 | 7 | AAA | 3 | 4 | 14.02.2011 |
| KFW | 12 | 12,27 | 11,75 | AAA | 3 | 1,5 | 08.08.2008 |
| EUROPEAN INVT BK | 12 | 11,11 | 7 | AAA | 29 | 1,7 | 06.10.2008 |
| KFW | 13 | 9,45 | 8,5 | AAA | 3 | 3,7 | 27.10.2010 |
| EUROPEAN INVT BK | 13 | 10,51 | 9,5 | AAA | 8,5 | 2,1 | 02.06.2009 |
| KFW | 17 | 10,43 | 9 | AAA | 3 | 2,7 | 27.10.2009 |
| KFW | 17 | 12,28 | 10 | AAA | 3 | 1,7 | 27.10.2008 |
| RABOBANK | 25 | 13,66 | 13,5 | AAA | 45 | 1 | 28.01.2008 |
| EUROFIMA | 27 | 11,96 | 10 | AAA | 3 | 1,7 | 03.11.2008 |
| KFW | 31 | 13,72 | 8,25 | AAA | 60 | 0,6 | 20.09.2007 |
| REPUBLIC OF AUST | 38 | 11,46 | 10 | AAA | 2 | 1,6 | 15.09.2008 |
| RENTENBANK | 41 | 13,49 | 12 | AAA | 3 | 1,6 | 01.10.2007 |
| KFW | 44 | 12,05 | 11 | AAA | 5 | 1 | 23.02.2008 |
| TOYOTA MTR CRED | 47 | 13,85 | 8,75 | AAA | 5 | 0,4 | 20.06.2007 |
| EUROPEAN INVT BK | 50 | 13,80 | 8 | AAA | 7,5 | 0,4 | 12.07.2007 |
| NORDIC INVST BNK | 58 | 12,80 | 12,75 | AAA | 3 | 0,8 | 18.12.2007 |
| RENTENBANK | 70 | 11,55 | 9 | AAA | 2 | 1,3 | 08.05.2008 |
| TOYOTA MTR CRED | 77 | 12,31 | 12,5 | AAA | 3 | 0,8 | 19.11.2007 |
| RABOBANK | 103 | 13,46 | 8,625 | AAA | 15 | 0,1 | 22.03.2007 |
| RABOBANK | 120 | 13,30 | 9,25 | AAA | 5 | 0,1 | 15.03.2007 |
| NORDIC INVST BNK | 124 | 12,61 | 11,5 | AAA | 3 | 0,6 | 06.09.2007 |
| KFW | 147 | 13,13 | 8,25 | AAA | 7,5 | 0,2 | 10.04.2007 |
| RENTENBANK | 202 | 12,99 | 8 | AAA | 3 | 0,3 | 08.05.2007 |
| ABN AMRO BANK NV | 21 | 13,45 | 14 | AA- | 3 | 0,9 | 11.01.2008 |
| DEUTSCHE BANK AG | 80 | 13,39 | 11,25 | AA- | 7,5 | 0,6 | 07.09.2007 |
| DEUTSCHE BANK AG | 38 | 13,40 | 12,5 | AA- | 3 | 0,9 | 18.01.2008 |
| DEPFA BANK PLC | 144 | 13,34 | 8,25 | AA- | 3 | 0,2 | 16.04.2007 |
| EKSPORTFINANS | 92 | 13,49 | 8,5 | AA+ | 9 | 0,6 | 07.09.2007 |

Source: Bloomberg

Provisional release:

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