JPMorgan

Icelandic banks

Typical investor Q&A, and our response

Financial Credit Research

Ben Ashby
(44-20) 7325-5749
Ben.Ashby@jpmorgan.com

Roberto Henriques,CFA
(44-20) 7777-4506
roberto.henriques@jpmorgan.com

- Since the Christmas period there has been an increasing amount of volatility around the bonds and CDS of the Icelandic banks. While we do not cover these banks, we believe further articulation of the logic behind our recent relative-value trade recommendation is required (see *Financial Institution Trade Ideas 17/02/06* and *Icelandic Banks 22/02/06*)

- We also attempt to answer some of the common investor questions that have arisen over the past few weeks with regards to some of the underlying fundamental issues, such as the state of the Icelandic economy.

- The financial signatures of these firms are unique compared to the majority of firms within our coverage universe and thus we do see them as relatively higher risk than other firms within our coverage universe. We attempt to give a market-based valuation to this risk. Hence as a relative value trade we would be buyers of risk at current levels and sellers of risk around 40bp.

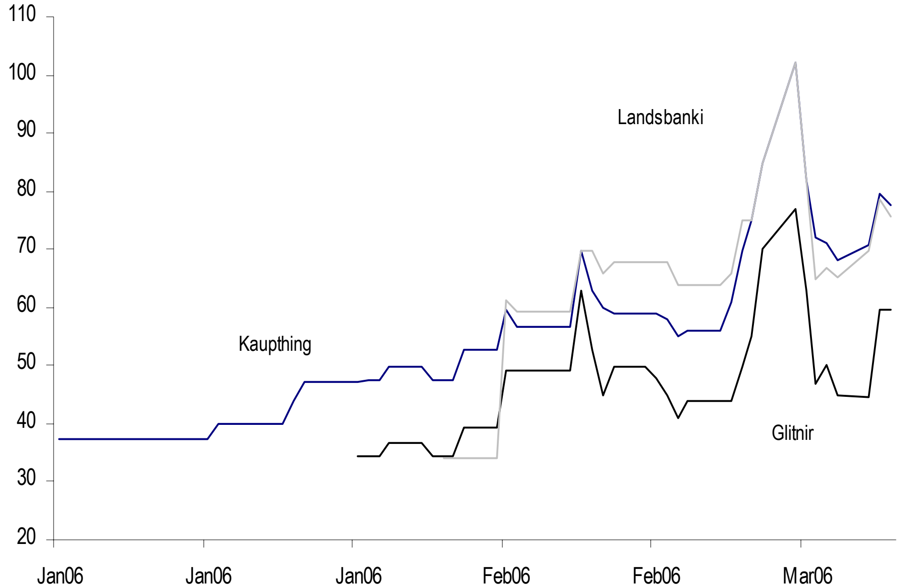
- We see real risk in being short Icelandic sovereign CDS at current levels due to the risk of a short squeeze owing to its attractiveness at current levels, given that it is 0% risk-weighted as an OECD sovereign.

J.P. Morgan Securities Ltd.

"What's going on with Icelandic banks?"

A lot and not very much is the simple, though not particularly, helpful answer. On an operational front nothing has really changed, the banks reported respective YE'05 operating profits of €834mn and RoE of 34% at Kaupthing; Landsbanki €394mn and RoE of 45.2%, and Islandsbanki (subsequently renamed Glitnir) €299mn & 30.3%, all markedly up from the previous year. What has happened is that the "market" has begun to focus on some of the structural issues and risks around the names and this has caused considerable volatility in their respective spreads.

Figure 1: Icelandic bank spreads have been volatile since the beginning 2006



Source: JPMorgan

"Why has this not been noticed before?"

It has, but the honest answer is that most investors were indifferent, as these issuers were too small and their bonds were off-benchmark for the majority of funds. More recently the firms have grown to a size where their funding needs dictated a much bigger presence on the international debt markets and have consequently attracted more attention. More importantly, an active CDS market has developed and this has allowed people with strong negative opinions to exercise their views.

"Has ever so much attention been focused on a sector so small?"

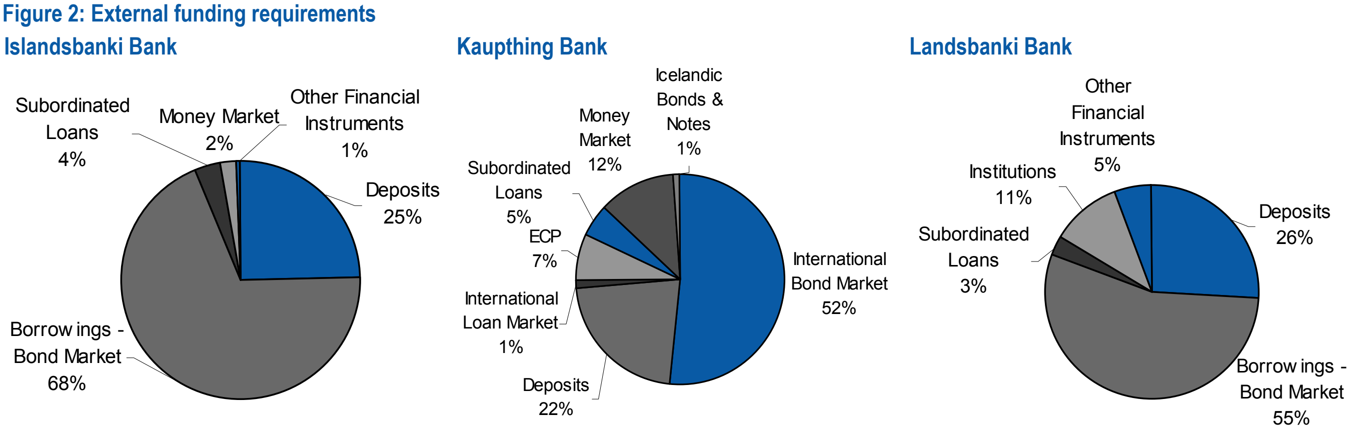
We are pushed to think of an occasion when such a small sector of the credit market has attracted so much attention. It is probably a good sign of the lack of volatility elsewhere in the market. Though at this juncture it is worth highlighting the relatively small size of the domestic Icelandic market, there are less than 300,000 inhabitants and this contributes to the rather unique structure of the domestic economy. The small domestic market size also plays a part in investors' discomfort as despite having one of the highest GDPs per head in Western Europe (due to its natural resources in both fishing and energy), Iceland is effectively comparable in terms of size and economic mass to a couple of London boroughs.

The volatility has been exacerbated by broker comments from some of the Icelanders' direct competitors questioning, unsurprisingly, their economic viability.

"What are these structural risks?"

Like many firms there are numerous risks and concerns, but in the case of the Icelanders they broadly they break down into two sorts, macro and micro. Perhaps the most unusual feature is the macro issues. It goes without saying that Iceland is a small country, therefore there is an insufficient domestic deposit base to support the banks and as they have grown they have been forced to go abroad and tap the international markets for funds. Added to this the entire Icelandic economy is going through a boom, which has seen large increases in the stock market but also in other asset prices. Finally, on a macro level due to the small size of the domestic economy there has been a material amount of cross-investment and – for us even more importantly – cross lending in the system.

Figure 2: External funding requirements



Source: Company data

Unusually on a macro basis a number of outside agencies such as the OECD, S&P and Fitch have raised concerns about the growing level of leverage in the domestic economy as well as the sharp rise in asset prices in both shares and property. There are also concerns about the economic imbalances that are currently being caused by some large FDI projects, and about Icelanders' level of external indebtedness. Finally, due to the high rates imposed by the Icelandic government to try and control the economy the currency has become a favoured subject of a 'carry trade' by certain international investors.

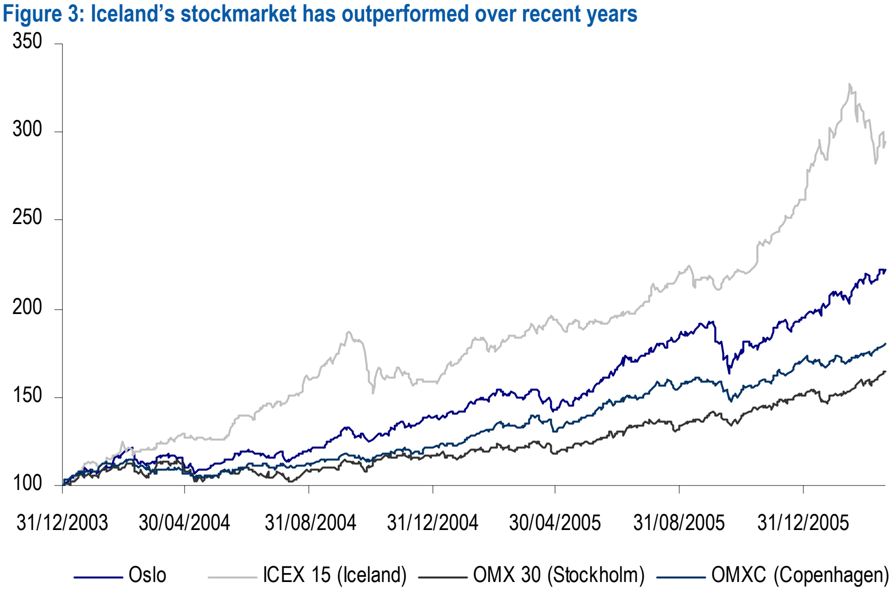
On a micro basis there are concerns about the sustainability of some of the banks' income given reliance in recent times on private equity and trading gains. Additionally, some of the banks' key clients have aroused interest due to the level of acquisitions they have undertaken. Finally, institutions like Kaupthing have also been rather active in terms of corporate activity both in terms of size but also frequency. Obviously, all corporate activity carries its own risks. Though this could be viewed as another angle – that buoyed by a strong domestic stock market banks have taken the opportunity to expand outside of their home market to convert the premium their equity trades at into real assets, rather like AOL and TimeWarner. Finally, we have not been reassured by the reaction of the various management teams to the recent spread widening; despite their best efforts they appear to have been ineffective in reducing volatility.

"I understand the economy is due for a recession"

There has been considerable speculation this week regarding the state of the Icelandic economy following the publication of a negative report by one of the Icelanders Nordic rivals. The Icelandic banks themselves it should be noted, again not an independent source, have stated that they are expecting a contraction in domestic growth rates as well. The big question seems to be, to what extent?

If we use reputable, independent sources such as the OECD or the rating agencies they all note the "credit boom" "asset price inflation" and "macro-economic imbalances" and generally hold the view that the economy is overheating but point towards a cooling off towards the end of the year and into 2007 on the back of reduced FDI. The government's attempts to deal with the inflation and credit expansion by raising interest rates have pushed the FX rate up, as it attracts investors looking for 'high carry' currencies. There is also an expectation that a fall in FX rates should boost Icelandic exports – an important component for an economy of Iceland's size. Additionally, the large FDI has been in projects that will ultimately be used to further diversify the country's exports.

Figure 3: Iceland's stockmarket has outperformed over recent years



Source: JPMorgan

So to us, as financial analysts, while the economy does look overdue for a correction, outside sources are not predicting a deep recession. Additionally, the ratings agencies note that the last two recessions (2002 and 1991-92) were relatively mild, which is one of the reasons why the economy is rated Aaa/AA-. Finally, Banks do not fail every time there is a recession.

"What would you highlight as key risks?"

While we note above most independent observers are not predicting a economic collapse, the structure of the economy is somewhat unique and not one we are entirely comfortable with. Hence in terms of big risks to the banks themselves, we think they are (assuming the funding holds) the cross-holdings and related party and equity based lending. Given the small domestic market, it is perhaps not surprising that there is some level of cross-holdings among the major investment companies, corporates and banks, but we are surprised at the level.

While the 3 main banks do not hold direct stakes in each other (though they do hold competitors' equity in nominee accounts) , these nominee accounts have been used as collateral for loans, plus the banks themselves account for a major portion (approximately 62% as of 20th March 2006) of the domestic stockmarket. Therefore, we see any movements as likely to have wider systemic effects. Moreover, with limited free float, limited foreign ownership, a mandatory pension system in which 10% of wages and salaries must be invested as well as tax breaks for additional voluntary contributions plus importantly for us apparently no ability to short sell in even the largest stocks, we view the Icelandic market as potentially less efficient than other markets.

In terms of cross-holdings, our concern is that we have seen similar cross-holding structures before, for example in the Norwegian market in the early 1990s and more recently in the UK with the split capital trusts. In both cases there was a hard landing. More importantly, given that we are talking about banks we have less visibility on the levels of debt in the 'system/construct'. While we note that the banks have stated that they have stressed tested their positions for various conditions and also that not all these Icelandic entities are dependent on Iceland for revenue, we still have strong suspicions that there is likely to be very high correlation across asset classes. Additionally, we believe that their corporate clients and retail customers are more heavily leveraged than the European average. Unfortunately, for us this cannot be tested until the system is genuinely under duress.

"I thought funding was the big short-term issue?"

Yes it is, funding and liquidity is important as it is as it is for any bank. We believe the reliance on the wholesale market and the short-term nature of their funding is a serious flaw in their business models. But despite the current market sell-off we still see a lot of liquidity in the wider financial system and we believe the obligations of the Icelanders are likely to be able to be met at the present time, albeit at higher spreads. This view was partially confirmed recently when Kaupthing managed to close a syndicated lending agreement at spreads markedly lower than what the CDS market was suggesting.

However, while funding appears supported in the short term we still think that a material risk is that funding problems can become a self-fulfilling prophesy. The recent rally in spreads has awoken a lot of investors to the underlying risks in the businesses and we do think that the Icelanders will be hard pressed to continue their original expansion plans and previous reliance on the wholesale markets; this may be a problem in its own right for reasons we discus later. Additionally, we suspect that certain investors may soon seek to reduce exposure.

"What about this bank's liabilities being 3x GDP?"

Interesting thing statistics. Obviously as the Icelanders have expanded abroad they have bought more overseas assets, in the form of other financial institutions. By definition, financial institutions have leveraged balance sheets. Obviously as purchases by Icelandic-domiciled firms these get aggregated to become 'Icelandic' overseas obligations - <u>even though some of these businesses have previously had nothing to do with Iceland.</u>

We would imagine that if Scotland ever goes independent then RBS and HBOS would have a rather similar effect on Scotland's GDP. Or perhaps closer to home just the City of Westminster or more specifically Curzon Street and Berkeley Square on a standalone basis relative to the rest of London. What we do see as an issue is that when these firms do buy anything overseas quite often it will get reclassified to Icelandic risk by certain financial institutions' risk departments. Obviously, banks tend to have a finite level of single country or name exposure they are willing to take. We think that there is a possibility that while the firm may be diversified, certain counterparties may be increasingly unwilling to take Icelandic risk.

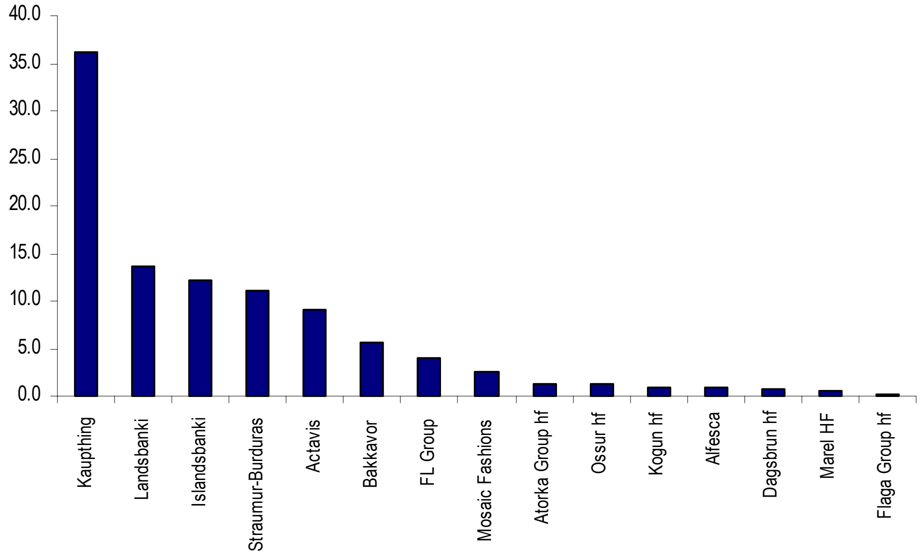
"Do you think any of these firms are better than the others?"

Not really. If you were going to operate on a micro level and ignore the wider structure of the economy you could arguably make a case on an individual basis that Islandsbanki/Glintir could be considered more attractive than its peers due to its choice of diversification of income and apparent conservatism in terms of risk profile. However, we believe if it is Iceland that the investor is genuinely worried about then Kaupthing could present a more logical choice, as while it is more of a pure-play capital markets company, based on 2005 financials it has the least amount of operating income coming from the Icelandic market and substantial overseas investments that could be sold,.

That said, as we highlighted in our trade note we saw Icelandic sovereign CDS as a good risk proxy, hence in our opinion to try and take a 'we like this one but not this one' approach at this stage would be rather futile. While the banks have been rather quick to distance themselves from each other we believe that given the size of the home market, the interlinking through both debt and equity exposures between the major players and the absolute size of the stock market that these firms represent that in a real crisis that all the firms would suffer to some extent on operational basis. More importantly, at that stage we do not think that the international markets are likely to differentiate to any point that is likely to make a material difference to their ability to do business.

Ben Ashby
(44-20) 7325-5749
Ben.Ashby@jpmorgan.com

Figure 4: Relative stockmarket weightings of the ICEX 15.
As of COB 17/03/06

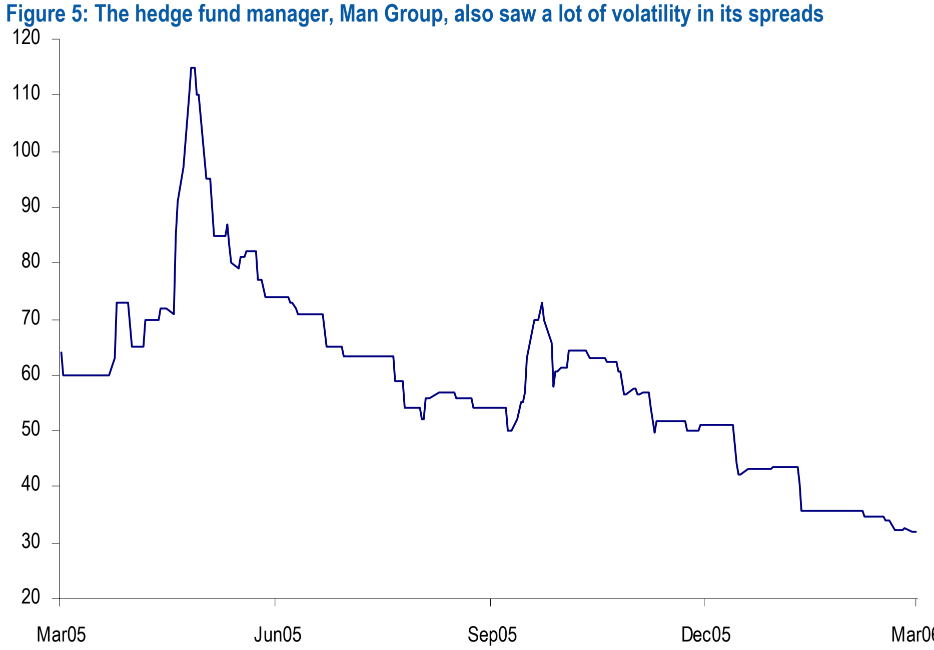


Source: Bloomberg

"Any other firms with similar characteristics?"

Man Group– a genuine hedge fund – trades at around 33bp – this is despite very little visibility around its business model. Man also underwent a rather short term sell-off last year due to the collapse of Refco, a competitor in certain business lines. 3i, a pure private equity play, (Underweight) trades at 24bp, NIB Cap another bank that has recently been bought by private equity has been downgraded several notches to A3 trades 27bp in 5Y senior. In terms of income breakdown and dependence on wholesale market funding the US brokers look very similar to the Icelanders. The issue with the Icelanders is the highly concentrated home market. (All spreads as at COB 23/03/06).

Figure 5: The hedge fund manager, Man Group, also saw a lot of volatility in its spreads



Source: JPMorgan

While we broadly agree with some investors' concerns about a number of issues, our issue is timing. In such a strong liquidity environment with a still-big technical bid, we suspect that the Icelandic names – now that they have liquid CDS instruments – will begin to be included in CDOs. However, given the lead time in building structured products we would only expect the structured bid to kick in around now.

"What do you think of the ratings?"

Not much is the honest answer. Moody's in particular has placed great store on the level of sovereign support, and while we believe the core Icelandic group may be supported we are a little more dubious should it come to problems that originated from one of their overseas acquisitions. Additionally, we have doubts that either Moody's and Fitch have really been able to gauge the level of systemic risk in the system. Finally, given their small home market and dependence on high risk forms of revenue, in our opinion, we believe they are over-rated and would view them at best as low A as current ratings put them in line with much-larger, more diversified Nordic banks operating in much larger domestic markets.

But we think the ratings are important as a number of institutions place great store by them. For us, at current spreads and ratings we believe that there is a very high probability that the Icelandic banks will attract a structured bid. We believe that this will start to pull spreads down to levels more consistent with their rating.

"What are the potential catalysts?"

The other issue we have on the timing front is the lack of short-term catalysts, other than market sentiment, to really justify any widening. However, we do see a number of potential catalysts in the medium run to give cause for deterioration in credit quality.

Trading losses/Domestic stock market sell-off
Given that we have highlighted the cross-holdings and cross-lending (and equity based lending) as one of our top risks obviously we see a sell-off in the domestic market being a key risk. While firms like Kaupthing have stated that they remain 'bullish' on Iceland (a statement not wholly unsurprising to us), we have been interested in the speed of the sell-off in the Gulf markets (also closed systems with limited foreign ownership and solid economic fundamentals) with effectively no catalyst other than confidence and negative feedback. Further, given the amount of margin lending in the economy we have big concerns that this may exacerbate problems.

Genuine funding issues
Obviously like all financials firms, confidence is key. Moreover any business that requires a material amount of wholesale market funding has the potential to be shut out but we believe there will have to be more distress in the wider market or concerns about the banks to justify this. As Kaupthing demonstrated it can still close syndicated deals, though continued negative sentiments has the potential to be a self-fulfilling prophesy.

Market sell-off in wider market –a related point we would highlight, is that in a sell-off in the wider market and a retrenchment by international investors combined with the new high-beta rating on these firms could cause distress if they could not get funding away.

Distress of a major institution in the system
By this we do not mean just a bank but indeed any of the major private or public companies that the banks have material exposure to. This is to do with our concerns over concentration risk in the economy. The Icelandic banks have been keen to point out their improvement in provisioning rates over the previous years– however, given that the domestic economy is enjoying a boom it should not come as any surprise. Nor do we know exactly how exposed these banks are to various concerns though they have disclosed a surprisingly large amount of very large concentrations relative to what we would expect from other Western European banks that we do cover.

Severe economic deterioration in domestic market
Our time lines for this – drawing on the external economic agencies - would suggest we are unlikely to see this before the roll-off in the FDI, which runs off towards the end of this year. Therefore outside of a stock market sell-off we believe this is unlikely to occur before end of 2007/beginning 2008.

In fairness the banks themselves do highlight that they are aware of these risks and Kaupthing and Landsbanki recently issued a press release highlighting their stress testing and liquidity positions. While on first reading these seemed compelling we wonder how much all the additional funding requirements such as ability to roll trading lines without posting additional collateral is factored into this.

"What about further acquisitions and strategy?"

We believe that further acquisitions are quite likely. The banks have all indicated that they would like to further diversify their businesses outside of Iceland to reduce risk and diversify income. Dependent of these deals we see some potential for further volatility.

Earnings like to fall sharply

But for us there is definitely a risk that the growth stage seen over the previous years is over. If the international markets are no longer prepared to step up and accept ever greater amounts of Icelandic bank risk then we have difficulty believing these firms will be able to carry on with their original ambitious growth plans. Given that a lot of their share price inertia has been predicated on high growth rates this may cause some difficulty with some of the key investors, not to mention the wider market where as we have pointed out they represent a very large percentage of listed overall market capitalisation.

"Spreads have recovered, so this is the end of it then?"

We don't think so. Just as there was no good catalyst for a sell-off, we think the recovery in their spreads, which coincided with an announcement of a new syndicated facility for Kaupthing, should really be seen as a temporary thing and not an end to all their problems. What's more they have previously stated that they wish to diversify away further from their home market. Hence there will likely be further acquisitions, and also further concerns regarding currencies, activities of major Icelandic clients, economics etc. We believe that these firms are now seen as 'tainted' by the market and are likely to continue to be higher beta. Outside of the structured bid we see no natural owners for this paper.

Over time as we have previously stated, we believe as long as the ratings hold with the agencies the banks will attract the structured bid. But as we have identified above in the catalyst sections there is also the potential for further issues

Where is fair value for 5YR CDS on the Icelandic names?

The recent degree of volatility in spreads begs the question of where fair value should be for these names. However, given that the Icelandic banks are fairly unique in their business profile, it makes the relative value comparison with comparable credits somewhat challenging. In order to overcome this, we have opted for two different approaches with a view to establish a fair value for these names. In a first instance we look at obtaining a valuation which is a risk weighted average of the various parts of each individual business within the wider group structure, and which gives us a 'sum of the parts' for the overall group. In our second approach we compare, the spreads evolution with other distress situations in the European banking markets, to place the relative performance of the Icelandic banks with a comparable context.

For the first ‘sum of the parts’ approach we have decomposed the Icelandic banks into their major business segments, and for each of the businesses looked for comparables that are proxies for these business segments. With this more granular approach, the resulting weighted valuation will more accurately reflect the risk associated with an issuer that has, Icelandic retail banking, UK broker operations and other Scandinavian operations. Hence we have used spreads for where either Investec or Collins Stewart Tullett would price for the UK operations of Kaupthing. For Scandinavia, we have used a blended rate of the less risky, in our opinion, FIH and riskier brokerage operations at a rate to reflect revenue contribution. Finally we have the core Icelandic business, here we have priced at a premium to the average seen in the sovereign CDS over recent weeks. The logic here is that while the Icelandic part of these firms is the most risky it is also the part most likely to be supported by the sovereign. Obviously investors may wish to use their own factor inputs.

Table 1: 'Sum of the parts' valuation – Icelandic Banks

	% Busines Segments	5YR CDS (mids)	Weighted Average Spread
Kaupthing			
UK	34%	44	15
Iceland	30%	30	9
Scandinavia	26%	36	9
Other	10%	28	3
			36
Landsbanki			
UK	12%	44	5
Iceland	84%	30	25
Luxembourg	4%	37	1
			32
Glitnir			
Commercial banking Iceland	25%	30	8
Treasury	17%	30	5
Comercial banking Norway	15%	12	2
Corporate & IB	12%	30	4
Capital Markets	11%	30	3
Other	20%	26	5
			27

Source: Company Data, JPMorgan estimates

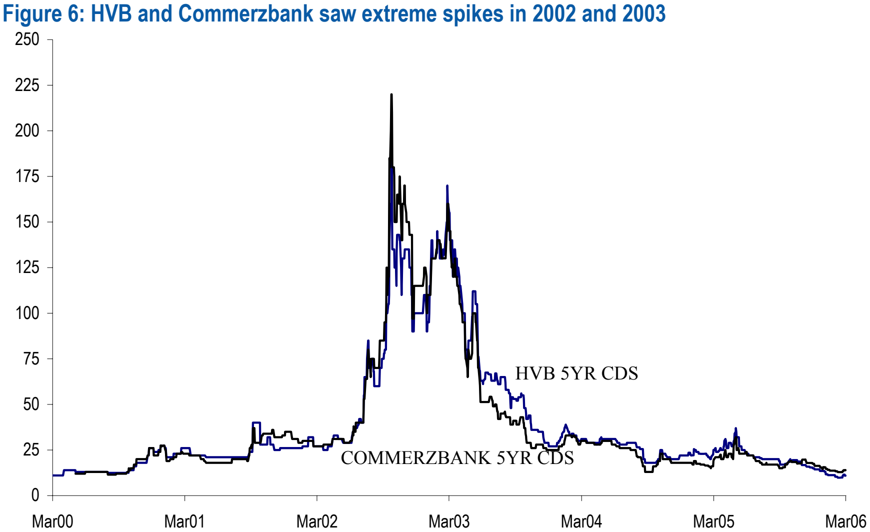
The sum of the parts yields valuations which range from 27bp for Glitnir to 32bp for Landsbanki and 36bp for Kaupthing, which in our opinion reflect a truer reflection of their risk profile. These valuations do suggest that these issuers are trading cheap, in relation to current trading levels. However, the excess spread over our estimated 'sum of the parts' valuation *does not* appear to compensate investors for the level of volatility that these names display at present. We would also seek to a attach a further premium to the spreads and hence would not hold risk at or around the 40bp level.

Ben Ashby
(44-20) 7325-5749
Ben.Ashby@jpmorgan.com

The second approach in terms of getting a closer grasp of what the fair value for the Icelandic banks involves looking at previous ‘blow-up’ or distress situations. This approach is however, in our opinion, far from being perfect given that the term of comparison will be institutions that have actually experienced losses or had some type of event, which in some way has undermined their solvency or credit fundamentals. However, we note for all the attention the Icelandic banks have attracted, these institutions have not actually suffered a negative credit event (a ratings downgrade, situation of loss or asset quality issues) and the market’s reaction has been very much driven by speculation with regard to the financial condition of these names. In addition, we note that the Icelandic banks, despite the disproportionate interest that they have recently attracted, remain relatively less liquid, a fact which will tend to exacerbate spread movements.

Having laid out these caveats and limitations, we compare the spread behaviour of the Icelandic banks with Commerzbank and HVB which experienced a great deal of volatility in 2002/03, amidst investor concerns about the negative impact of credit losses. In terms of 5YR CDS on Commerzbank and HVB, we note that these widened by a factor of 6-7 over the preceding six-month average spread. In this context we think that this represents the outer bound for spread of the Icelandics, with the recent spreads on Kaupthing having increased five-fold over its 2005 average spread levels. However, we would point to the differences between the two German issuers that experienced severe difficulties due to asset quality issues, which undermined their solvency levels. This is in marked contrast with the Icelandic banks, where – at present - there have been no such credit events to substantiate similar spread movements. In addition, we would point out that the comparisons are also undermined by the fact that at present there is much greater degree of liquidity in the market than in 2002. Hence this reinforces our view that the spread reaction has been overdone.

Figure 6: HVB and Commerzbank saw extreme spikes in 2002 and 2003



Source: Company Data, JPMorgan estimates

Another example we could have used was the situation facing LEH following the Russian default. Here the market conditions were even more extreme.

Ben Ashby
(44-20) 7325-5749
Ben.Ashby@jpmorgan.com

"And what if…?"

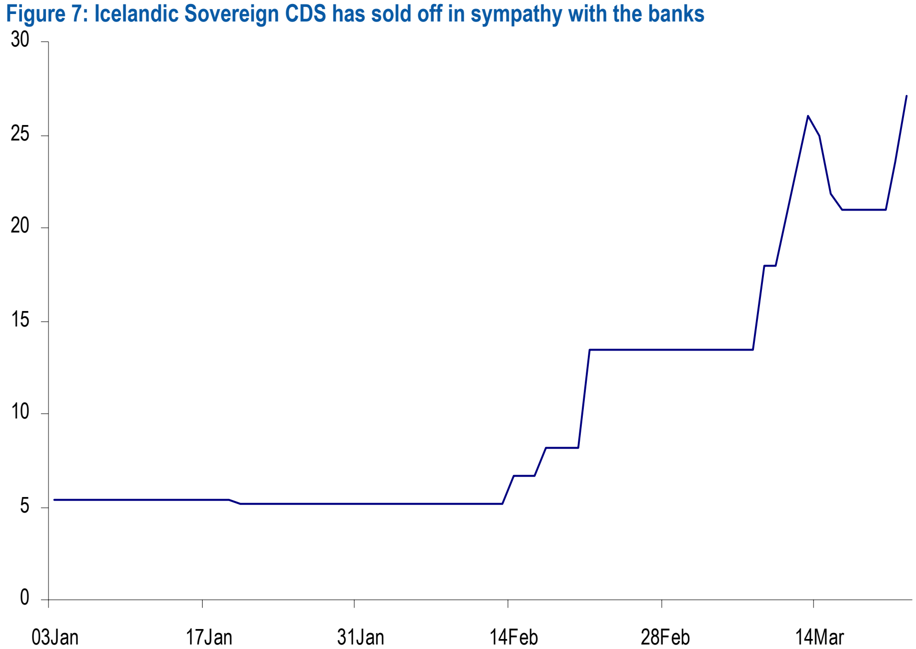
What would happen if the worse case happened? Such as the economy goes into a sharp recession or the stock market crashes or these firms have insufficient funding – would the government bail them out? We believe the government would bail out the core Icelandic businesses, but we remain unsure about all the overseas divisions. The upside to this is that they could be sold as independent entities. Hence, on a relative basis one of Kaupthing's attractions is that it has more overseas assets that could potentially be carved off and sold, relative to its peers.

Additionally, even if the government decided not to intervene given their domestic market share we would expect to see interest from either other (Non-Icelandic) banks or private equity groups. For example, the head of Blackstone Germany said last week that he saw the possibility of a €20bn buy-out of a banking institution. Obviously within this context we see the potential for support, though investors might be somewhat less impressed with private equity ownership.

Trade ideas

We still hold to our original relative-value trade ideas, with the exception that we are growing more cautious on Iceland sovereign CDS as a short. As a member of the OECD (and hence 0% RWA for banks) and with its high domestic credit ratings we believe that there is a potential that bank investors will pull these spreads in, as it is now trading in line with far lower-rated countries like Poland.

Figure 7: Icelandic Sovereign CDS has sold off in sympathy with the banks



Source: JPMorgan

The only additional relative trading view is that among the Icelanders themselves, based on revenue source Kaupthing could be viewed as more attractive than Landsbanki: despite it being a more of pure investment banking business it earns a far greater proportion of its revenues outside Iceland compared to Landsbanki which is smaller, far less diversified and according to the bank far more concentrated in terms of large exposures (10% of equity to any one counterparty). Based on the companies' reported figures in 2005 only 30% of Kaupthing's operating income came from Iceland compared to 65% in Landsbanki's case.

"And the cash bonds?"

We have no formal recommendation on the companies. Neither do they feature in our model trade portfolio. We see dubious merit in the "going subordinated is best" argument. We highlight above in our fair value section where we would be buyers or sellers of risk on a relative value basis.

"So your view is basically…"

We see the risk in these firms as higher than for equivalent firms in the European market that we cover as they are more dependent on volatile (in our opinion) revenues, have greater concentrations of risk and much more uneven funding profile than we would expect to see in equivalently rated European A-rated banks, especially in the Nordic region. However at current levels we see spreads as too high but point out it's a fluid situation and issues like funding problems, trading losses and the complex inter-linkage of the banks and various others players in the domestic economy can take on a life of their own.

That said we have a trading view on these firms entirely predicated on price. At current prices we would generally be buyers of risk at above 50bp and sellers of risk at below 40bp. These levels are of course relative to the rest of the market. Obviously if UBS senior CDS were to start trading at 40bp we would see greater relative value in that. Further, given that we see some potential areas for concern in the fundamentals of the firms relative to companies in our coverage universe, we would not hold these in preference. However, needless to say we may indeed change our views if material facts change.

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Other Disclosures:

Ben Ashby
(44-20) 7325-5749
Ben.Ashby@jpmorgan.com

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