Medium-Term Debt Management Strategy

2015 – 2018

FJÁRMÁLA- OG EFNAHAGSRÁÐUNEYTIÐ

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1 Executive summary

The *Medium-Term Debt Management Strategy 2015-2018 (MTDS)* lays down the Government's plans for financing its activities during this period. The principal objective of the strategy is to ensure that the Treasury's financing need and payment obligations are met at the lowest possible cost that is consistent with a prudent risk policy. It is also intended to encourage further development of efficient primary and secondary markets for domestic Government securities.

Benchmark issues of Treasury bonds are structured so that each series is large enough to ensure effective price formation in the secondary market. Each year it will be ensured that there is effective price formation with two-, five-, and ten-year benchmark Treasury bonds. In order to reduce refinancing risk, the aim is to keep the repayment profile of Treasury securities as even as possible. The average time to maturity should be at least five years.

The Treasury borrows in foreign currencies in order to expand the Central Bank's foreign exchange reserves. The Treasury foreign borrowing strategy is aimed at securing regular access to international capital markets and attracting a diversified investor base.

At year-end 2014, gross Treasury debt was equivalent to 75% of GDP. The aim is to reduce total debt over the period until it falls below 60% of GDP by end-2018. Net debt was 40% of GDP at the end of 2014 and is to be reduced to approximately 25% of GDP by year-end 2018.

The strategy describes debt management objectives and guidelines, the current composition of the debt portfolio, inherent risk factors, and contingent liabilities. It also describes the institutional structure of debt management and explains how information disclosure to market agents and investors is carried out. The Ministry of Finance and Economic Affairs is responsible for the central government's debt management, formulates its debt management strategy, and makes decisions regarding securities issuance. Government Debt Management, a special department within the Central Bank of Iceland, is responsible for executing the Treasury's debt management strategy in accordance with an agreement between the two parties.

The *Medium-Term Debt Management Strategy* is revised and updated annually.

2 Debt management objectives

The principal objectives of Treasury debt management are:

1. To ensure that the Treasury's financing need and payment obligations are met at the lowest possible long-term cost that is consistent with a prudent risk policy;
2. To ensure that the debt repayment profile accords with the Treasury's long-term debt service capacity and minimises refinancing risk;
3. To maintain and encourage further development of efficient primary and secondary markets for domestic Treasury securities;
4. To broaden the investor base and diversify funding sources.

2.1 The debt management strategy

The *Medium-Term Debt Management Strategy 2015-2018 (MTDS)* lays down the government's plans for financing its activities during this period. It is revised and updated annually.

The aim is to map out a clear debt management policy with quantitative targets. The MTDS provides a policy framework for debt management activities aimed at minimising the Treasury's interest expense, with a prudent degree of risk.

3 Debt management guidelines

This section describes the guidelines for effective management of the Treasury's debt portfolio over the medium term.

In order to meet the demand for new Treasury issues and to increase the liquidity of benchmark series, efforts will be made to exchange non-marketable Treasury debt for benchmark series insofar as market conditions permit. Such exchanges must be consistent with the objective of minimising the Treasury's interest expense in the long run, while ensuring a prudent degree of risk.

3.1 Debt portfolio structure

The following discussion of the debt portfolio structure excludes loans taken to expand the foreign exchange reserves. Loans taken to expand the reserves are covered by a separate policy, which is discussed in Section 5 on foreign issuance.

The debt portfolio is structured so as to minimise overall risk and encourage the development of a well-functioning market that can attract a diverse group of investors and set pricing benchmarks for other financial products.

The Treasury emphasises the issuance of nominal debt, as nominal Treasury bonds form the basis of an effective bond market. Issuance of indexed Treasury bonds is irregular and is determined by the financing need and the circumstances prevailing at any given time. New Treasury loans taken in foreign currencies will be used to expand the Central Bank's foreign exchange reserves. There is no policy providing for foreign borrowing to finance central government operations.

The guidelines for the composition of the Treasury's debt portfolio are as follows:

Non-indexed debt	70-90%
Indexed debt	15-30%
Foreign debt	0-10%

Figure 1 shows the composition of the debt portfolio as of year-end 2014, excluding loans taken to expand the foreign exchange reserves. Non-indexed debt constituted 75% of the total, indexed debt 24%, and foreign debt 1%.

Debt portfolio composition, excluding reserve loans

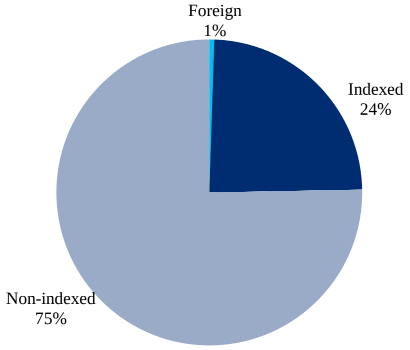

Figure 1

3.2 Borrowing guidelines

The Ministry of Finance and Economic Affairs has set guidelines for debt management, based on the provisions of the Act on Government Debt Management. The principal guidelines for the debt portfolio are as follows:

1. *Repayment profile:*
   The aim is to have the long-term repayment profile of Treasury securities as smooth as possible and the individual issuances of similar final size.
2. *Benchmark series:*
   Benchmark issues will be structured so that each series is large enough to ensure effective price formation in the secondary market. The number and size of the series shall take account of Treasury debt. The goal is for each series to have a final size of ISK 40-100 billion, except for two-year bonds, whose minimum final size will be ISK 15 billion.
3. *Refinancing percentage:*
   The ratio of Treasury redemptions in any calendar year shall not exceed 15% of GDP.
4. *Maturity:*
   The average time to maturity of the debt portfolio shall be at least five years.
5. *Deposits:*
   The Treasury's domestic deposit balance with the Central Bank of Iceland shall average ISK 60-70 billion.

3.3 Quantitative targets

Clear, quantitative targets for debt management provide an assessment of Treasury debt sustainability. The targets are based on the Government´s policy and macroeconomic conditions. In accordance with the medium-term baseline forecast for 2015-2018, the targets are as follows:

1. The ratio of gross Treasury debt to GDP shall be below 60% by 2018. The long-term goal is to reduce the ratio to a maximum of 45% of GDP.
2. Redemption of domestic Treasury bonds shall be below 10% of GDP each year.

These targets are subject to revision of macroeconomic and fiscal assumptions. The assumptions will be updated as necessary.

4 Domestic bond issuance

The Treasury's financing need will be met through issuance of Treasury securities in the domestic market and a reduction in the Treasury's deposits with the Central Bank of Iceland. This section focuses on medium-term financing needs and Treasury deposits. It also discusses Treasury securities issuance, including repayment profile policy, average duration, and build-up of benchmark issues.

4.1 Financing need

The Treasury's estimated financing need is based on the assumptions in the National Budget for 2015 and on the assumptions presented by the Ministry of Finance and Economic Affairs in *Fiscal Policy 2016-2019* [Icelandic: *Ríkisfjármálaáætlun 2016-2019*.]

The net financing balance shows whether operations for the year generate a surplus to reduce debt or a deficit to increase it. The net financing balance is either positive or negative. A positive balance indicates a surplus on Treasury operations and financial activities, which can be utilised to reduce debt. A negative balance reflects a deficit on Treasury operations and financial activities, which must be financed through borrowing or a decrease in cash and cash equivalents.

Table 1 shows the net financing balance according to Treasury estimates for 2015-2018. According to the estimates, the net financing balance will be positive in the next few years.

Net financing balance (ISK millions)

2015	2016	2017	2018
26,818	27,718	25,594	12,700

Table 1

4.2 Deposits

Treasury deposits with the Central Bank of Iceland amounted to approximately ISK 143 billion at year-end 2014. As a guideline, the Treasury's domestic deposit balance with the Central Bank of Iceland shall average ISK 60-70 billion. The end-2014 balance was somewhat above the guideline amount. This is due to the Government's indexed mortgage debt relief package. Before the end of the year, payments were made in the amount of ISK 1.5 billion, and in the first quarter of 2015, a total of ISK 51 billion has been paid towards indexed mortgage debt relief.

In addition, foreign-denominated balances totalled ISK 350 billion at the end of the year. The Treasury's foreign balances are part of the Central Bank of Iceland's foreign exchange reserves. It has been considered necessary to maintain large reserves in view of the risk that could accompany liberalisation of the capital controls. If successful steps are taken to lift the controls in the near term, opportunities to reduce the Central Bank's reserves could develop.

4.3 Structure of Treasury securities

This section focuses on the structure and arrangements for issuance of Treasury securities.

4.3.1 Structure of benchmark series

Benchmark series will be structured so that each series is large enough to ensure effective price formation in the secondary market. The number and size of the series shall take account of Treasury debt. Each year, effective price formation for two-, five-, and ten-year benchmark bonds will be ensured.

By definition, when a ten-year series is first auctioned, it will mature after approximately eleven years. Bonds will be sold in the series until nine years remain to maturity, whereupon issuance is suspended. The bond is reopened at about six years to maturity and is offered for sale until about four years remain to maturity (five-year series). Finally, the bond is reopened at two years to maturity (two-year series). Effective price formation will be ensured in series falling under the two-, five-, and ten-year benchmark series categories each year, and each year's issuance in each series will be determined by current financing needs and the size of the series concerned. Nominal and inflation-indexed Treasury bonds with other maturities will be issued irregularly, depending on the Treasury's financing need and the conditions prevailing at the time.

The goal is for each series to have a final size of ISK 40-100 billion, except for two-year bonds, whose minimum final size will be ISK 15 billion. Attempts will be made to expedite the build-up of the series until they reach a size sufficient to ensure effective price formation in the secondary market. The size of bond series will also be determined by the Treasury's financing need at any given time.

Six-month Treasury bills will be issued in series that are reopened for expansion at three months to maturity. This allows for the monthly sale of three- and six-month Treasury bills. Monthly issuance of Treasury bills will vary, depending on investor demand and the Treasury's financing need at any given time.

Table 2 shows planned benchmark issuance.

Series	Maturity	Issuing amount
Treasury bills	3 and 6 months	ISK 5-30 billion
Nominal Treasury bonds	2 years	ISK 40-100 billion if initially issued with a longer maturity; ISK 15-100 billion if issued for only 2 years
Nominal Treasury bonds	5 years	ISK 40-100 billion
Nominal Treasury bonds	10 years	ISK 40-100 billion
Nominal Treasury bonds	Other	ISK 40-100 billion
Inflation-linked Treasury bonds	Other	ISK 40-100 billion

Table 2

4.3.2 Treasury bond issuance from 2015 onwards

Planned issuance for 2015 is ISK 55 billion, as is stated in the Government Debt Management *Prospect* published at the end of 2014. An example of Treasury bond issuance in coming years is shown in Table 3. It should be noted that the table is only for illustrative purposes, and actual issuance plans may be subject to change. The table includes Treasury securities already issued, with the identifier codes of the series concerned. The identifier RB 15 0408 means that the bond is a nominal bond maturing on 8 April 2015. For Treasury bonds that have not yet been issued, the first number indicates the maturity year and the second number indicates the length of the bond; i.e., two-, five-, or ten-year benchmark series. The shaded cells show when the series are open. Issuance in series with other maturities will be irregular, depending on the Treasury's financing need and investor demand.

In 2015, effective price formation will be ensured with RIKB 17 (two-year), RIKB 20 (five-year), and RIKB 25 0612 (ten-year). Issuance in these series will be determined by their total size and the Treasury's financing need. Issuance of other series will then be determined by issuance in these three series and the Treasury's financing need.

Sample issuance calendar

Year	2015	2016	2017	2018	2019	2020	2021	2022	2023
	RB	RB	RB	RB	RB	RB	RB	RB	RB
0	**15 0408**	**16 1013**	17-2 Yr	18-2 Yr	**19 0226**	**20 0205**	21-2 Yr	**22 1026**	23-2 Yr
1	**16 1013**	17-2 Yr	18-2 Yr	**19 0226**	**20 0205**	21-2 Yr	**22 1026**	23-2 Yr	24-2 Yr
2	17-2 Yr	18-2 Yr	**19 0226**	**20 0205**	21-2 Yr	**22 1026**	23-2 ár	24-2 Yr	**25 0612**
3		**19 0226**	**20 0205**		**22 1026**			**25 0612**	
4	**19 0226**	**20 0205**		**22 1026**			**25 0612**		
5	**20 0205**		**22 1026**	0		**25 0612**			28-5 Yr
6		**22 1026**		0	**25 0612**			28-5 Yr	
7	**22 1026**			**25 0612**			28-10 Yr		
8			**25 0612**	0		28-10 Yr			**31 0124**
9		**25 0612**		0	28-10 Yr			**31 0124**	
10	**25 0612**			28-10 Yr			**31 0124**		
11			28-10 Yr			**31 0124**			34-10 Yr

Table 3

4.3.3 Repayment profile

One of the objectives of Treasury debt management is to ensure that the repayment profile of Treasury securities is as even as possible. In order to reduce refinancing risk, the aim is to keep the size of each series at or below ISK 100 billion upon maturity. Figure 2 shows the repayment profile of domestic liabilities at year-end 2014, excluding Treasury bills.

In 2008, the Treasury issued a five-year inflation-indexed bond to recapitalise the Central Bank of Iceland after the collapse of the banks. The bond matured on 1 January 2015. In the recent term, the Ministry of Finance and Economic Affairs and the Central Bank have conducted a review of the financial interactions between the Treasury and the Central Bank. Based on the authorisation contained in Article 4 of Act no. 122/2014 Amending the Act on the Central Bank of Iceland, no. 36/2001, the Bank's capital was reduced by 26 b.kr. and the reduction used to reduce the principal of the bond to a year-end 2014 total of ISK 145 billion. In addition, the terms of the bond were amended at the end of the year. The bond will now be a 29-year annuity bond bearing nominal interest based on the deposit rate offered by the Central Bank.

Domestic repayment profile

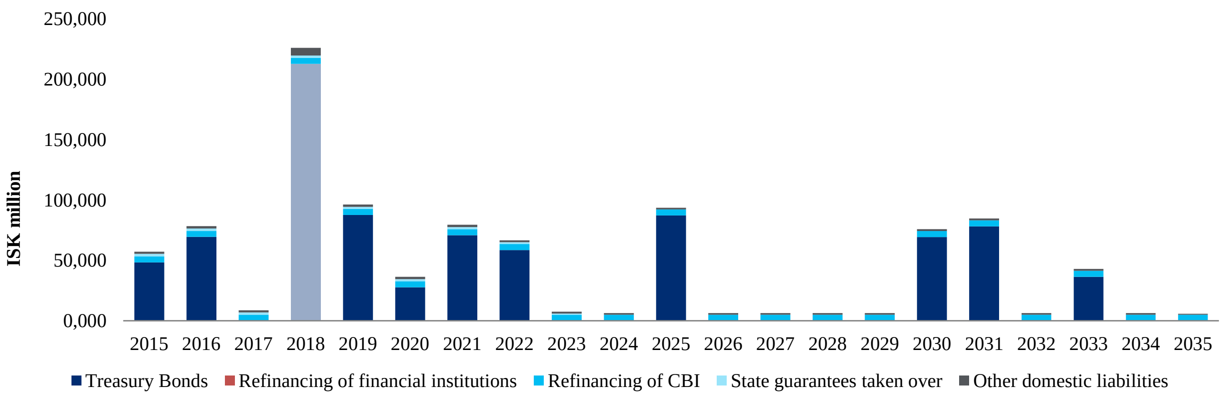

Figure 2

The Treasury’s largest single maturity is in 2018, when RIKH 18 1009 matures in the amount of ISK 213 billion. The series, a special issue undertaken to capitalise the financial institutions, is offset by share capital and subordinated loans. According to *Fiscal Policy 2016-2019*, it is planned to sell a 30% stake in Landsbankinn in 2015 and 2016, or that comparable measures will be taken, and use the proceeds to pay down the bond.

In coming years, measures may be taken to reduce the risk attached to refinancing large maturities, among them buybacks and exchange auctions, including RIKH 18.

4.3.4 Average time to maturity

The aim is to keep the average time to maturity of Treasury securities at a minimum of five years. In recent years, targeted efforts have been made to lengthen the average time to maturity of outstanding debt. The average duration is managed with issuance of securities of varying maturities. If domestic market conditions permit, it is also possible to use interest rate swaps and buybacks, and/or hold exchange auctions to ensure that the average time to maturity remains within the defined guidelines. As of year-end 2014, the average time to maturity was 7.3 years.

5 Foreign issuance

The Treasury borrows in foreign currencies in order to expand the Central Bank's foreign exchange reserves, but not to finance Treasury operations. The Treasury debt structure does provide some scope for foreign-denominated borrowing, but the proportion of foreign debt will be low so as to facilitate debt portfolio management with respect to exchange rate risk.

The strategy for foreign debt financing aims at maintaining regular access to international credit markets and facilitating access to a diverse investor group. To this end, the Treasury aims to issue bonds in foreign markets on a regular basis. The main purpose of this strategy is to refinance outstanding marketable bonds and the debt undertaken in connection with the SBA (stand-by agreement). Regular issuance of marketable bonds in the international capital markets is also intended to enhance name recognition of the Republic of Iceland as an issuer.

The Central Bank attempts to manage the currency composition of the foreign exchange reserves so as to minimise fluctuations in the value of its foreign-denominated assets net of foreign-denominated debt. The currency composition of the reserves therefore reflects the currency composition of the foreign loans provided by the Treasury to the Bank to expand the reserves. Generally speaking, this is an asset and liability strategy under which the Treasury and Central Bank's balance sheets are considered on a consolidated basis.

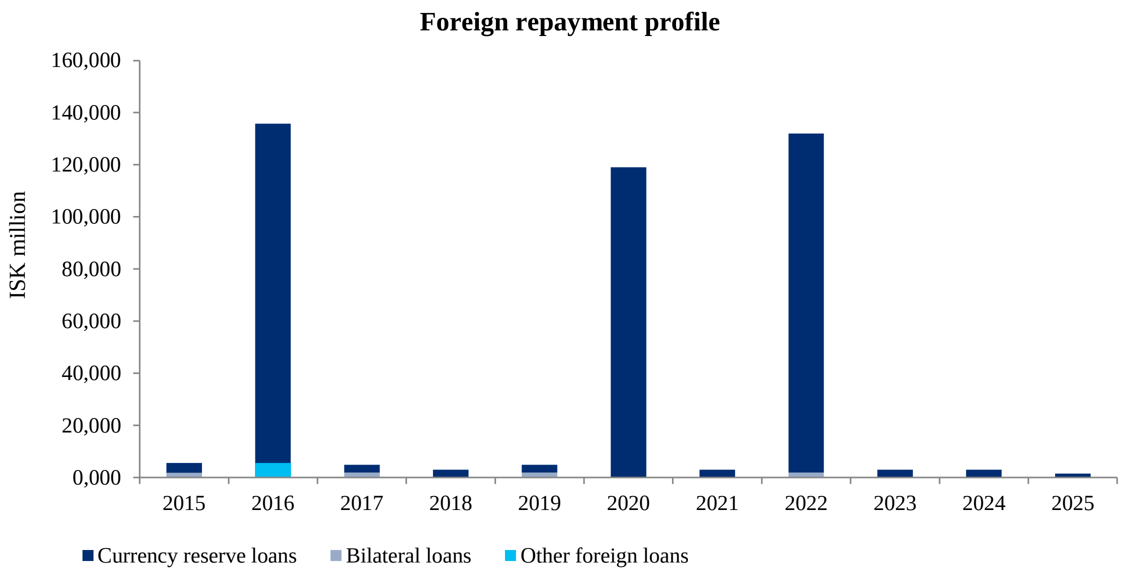

Figure 3

Figure 3 shows the repayment profile of Treasury foreign debt as of end-2014. The largest maturities in coming years are in 2016, 2020, and 2022. The maturities concerned are the Treasury bonds issued in US dollars in 2011 and 2012 and the eurobond issued in 2014. The proceeds of the eurobond issued in July 2014 were used to prepay the rest of the bilateral loans from the Nordic countries in connection with the SBA. The original maturity dates of the bilateral loans were in 2019 and 2021. The loan from Norway to the Central Bank was also refinanced by the Treasury at that time. Of the loans taken in connection with the SBA, only the loan from Poland to the Treasury and a portion of the IMF's loans to the Central Bank are still outstanding. The Central Bank prepaid the majority of the IMF 2015 maturity at year-end 2014.

6 Treasury debt position

This section describes the Treasury debt position and loan portfolio structure, including loans taken by the Central Bank to expand the foreign exchange reserves. It also reviews the debt repayment profile and provides information on the Treasury's investor base. Figure 4 shows developments in the Treasury's debt and debt ratio, net of pension liabilities, from 2008-2014, and outlines expected developments through 2018.

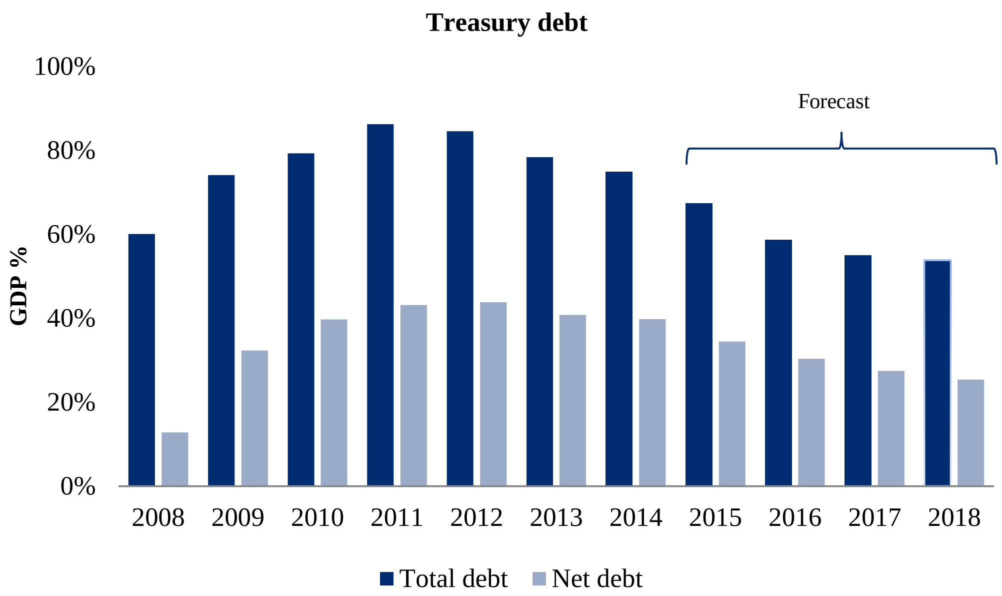

Figure 4

6.1 Treasury debt

Treasury debt totalled ISK 1,495 billion at year-end 2014, or about 75% of GDP. The aim is to reduce it in stages to less than 60% of GDP by year-end 2018. A long-term objective is to maintain a maximum debt-to-GDP ratio of 45%. Table 4 gives a breakdown of Treasury debt at year-end 2014.

Net debt amounted to 40% of GDP at end-2014 and is to be reduced to approximately 25% of GDP by year-end 2018. Net debt consists of total debt excluding interest-bearing assets, receivables, and cash. Cash and receivables amounted to ISK 706 billion at the end of 2014.

Treasury debt at the end of December 2014

			ISK million
Domestic			
	Marketable securities		
		Treasury bills	25,100
		Treasury bonds inflation-linked	205,600
		Treasury bonds nominal	435,200
		Refinancing of financial institutions	212,900
	Non-Marketable debt		
		Refinancing of CBI	145,000
		Other domestic liabilities	57,000
		Total	1,080,800
External borrowing			
	Currency reserve loans		
		Currency reserve loans	408,600
		Other Foreign loans	5,600
		Total	414,200
		Total	1,495,000

Table 4

6.1.1 Domestic borrowing

Marketable securities include Treasury bills, indexed and nominal Treasury bonds, and a special benchmark bond issued to finance capital injections and subordinated loans to financial institutions. The special issue matures in 2018. The outstanding amount at year-end 2014 was approximately ISK 213 billion. This series bears variable interest in order to reduce the interest rate risk on the banks' liabilities. As of year-end 2014, outstanding marketable securities totalled ISK 879 billion.

Non-marketable securities include the bond issued to recapitalise the Central Bank of Iceland after the collapse of the banks in 2008. The outstanding balance of the bond was ISK 145 billion at year-end 2014. In addition to these loans is other non-marketable debt, which is due in large part to the Treasury's acquisition of Reykjavik and Akureyri's stakes in the National Power Company of Iceland (Landsvirkjun). The Treasury's issue in connection with the acquisition of Landsvirkjun is an indexed annuity bond maturing in 2034. At year-end 2014, outstanding non-marketable securities totalled ISK 202 billion.

6.1.2 Foreign borrowing

The loans concluded within the framework of the SBA were used to expand the Central Bank's foreign exchange reserves. The Treasury was granted loan facilities from Denmark, the Faeroe Islands, Finland, Poland, and Sweden, and the Central Bank received loan facilities from the IMF and Norway.

The total amount of the loan facilities granted to the Treasury was EUR 1,480 million.[1] The loan from the IMF to the Central Bank was SDR 1,400 million and the loan from Norway was EUR 480 million.

In 2014, the Treasury issued a foreign-denominated bond in the amount of EUR 750 million. The proceeds of the issue were used to prepay the outstanding balance of the bilateral loans from the Nordic countries. About 60% of the principal had been paid in 2012. At the time of the prepayment in 2014, the Treasury also refinanced the portion loaned by Norway to the Central Bank, increasing Treasury debt by just over ISK 30 billion. At the end of 2014, the Central Bank prepaid a large share of the outstanding balance with the IMF. The remaining balance, ISK 44 billion, matures in late 2015 and 2016. Of the loans taken by the Treasury in connection with the SBA, only the loan from Poland remains, with an outstanding balance of ISK 7.3 billion.

Other loans taken to strengthen the Central Bank's foreign exchange reserves include two bond issues in 2011 and 2012, each in the amount of USD 1 billion. The bond issued in 2011 matures in 2016, and the bond issued in 2012 matures in 2022. At year-end 2014, the outstanding balance on the two loans combined was ISK 253 billion.

Other Treasury foreign debt amounted to ISK 45 billion as of end-2014.

6.1.3 Treasury debt structure

Figure 5 shows marketable and non-marketable Treasury debt as of year-end 2014, including loans taken to expand the foreign exchange reserves. The debt falls into three categories: non-indexed (55%), indexed (17%), and foreign-denominated (28%).

Debt portfolio structure

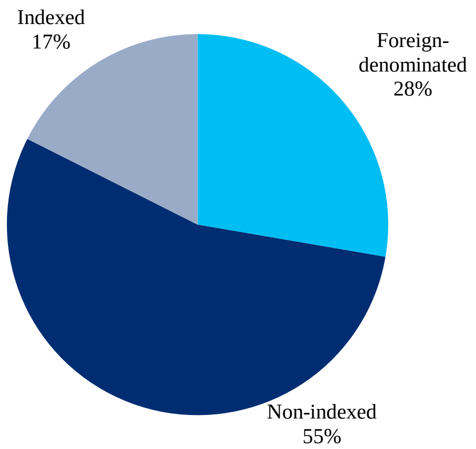

Figure 5

[1] Central Bank mid-exchange rates of 31 December 2014: EUR/ISK 154.3; USD/ISK 126.9; and SDR/ISK 183.8.

6.1.4 Repayment profile

Figure 6 shows the repayment profile for Treasury debt as of year-end 2014. The largest maturities are in 2016, 2018, 2020, and 2022.

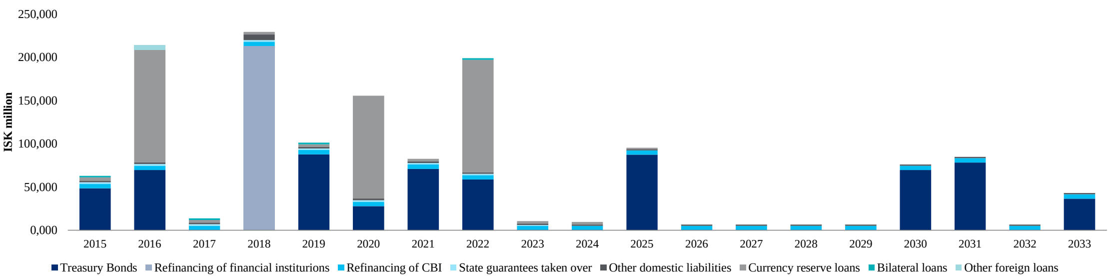

Figure 6

In 2008, the Treasury issued a five-year inflation-indexed bond to recapitalise the Central Bank of Iceland after the collapse of the banks. The bond originally matured on 1 January 2014, but at year-end 2013 it was extended by a year and the interest terms amended to nominal interest determined by Central Bank deposit rates. Following the passage of Act no. 122/2014, Amending the Act no. 36/2001 on the Central Bank of Iceland, in December, the bond was amended again to make it an annuity bond with a 29-year maturity. The chart above takes account of these amendments.

The foreign bonds issued in 2011 and 2012 (each in the amount of USD 1 billion) are scheduled to mature in 2016 and 2022, respectively. If market conditions are favourable, the Treasury may consider reducing the refinancing risk before maturity with bond swaps or buybacks.

The bond issued to finance the capital and subordinated loans of the new banks matures in October 2018. The nominal value of the bond was ISK 213 billion at year-end 2014. The assets offsetting the bond are shares in financial institutions and loans to financial institutions. Efforts will be made to reduce the outstanding balance of the bond with buybacks and bond swaps until its maturity. The fiscal plan presented together with the fiscal budget proposal in autumn 2015 assumes that up to 30% of the stake in Landsbankinn will be sold in 2015 and 2016 or that comparable measures will be taken, and the proceeds used to pay down RIKH 18.

6.2 Investors in domestic Treasury securities

The Treasury issues debt securities with varying maturities, with the aim of attracting a diverse group of investors and minimising financing costs. Figures 7 and 8 give a breakdown of the owners of domestic Treasury bonds and bills as of year-end 2014.[2]

[2] The breakdown of Treasury bond owners includes securities loans.

Owners of Treasury securities

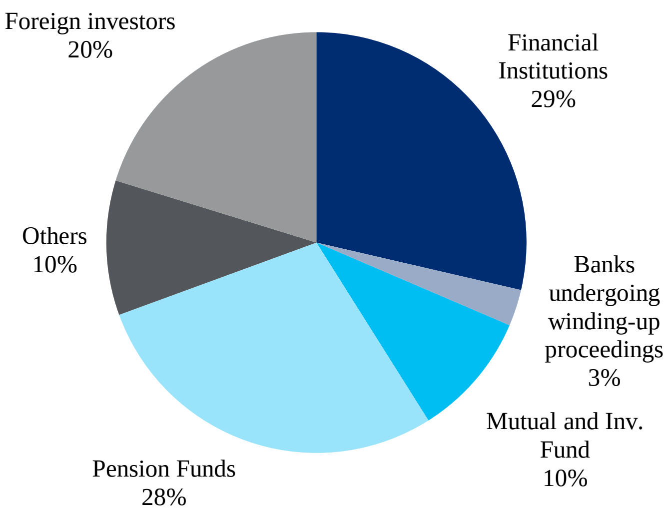

Figure 7

Pension fund and financial institutions are among the largest investors in domestic Treasury securities, with about 29% and 28%, respectively, of outstanding bonds. The financial institutions' largest asset is RIKH 18 1009, the bond issued to recapitalise the new banks. Foreign investors[3] own about 20% of domestic Treasury bonds, while UCITS and investment funds own about 10% and other investors own another 10%.

Owners of Treasury securities

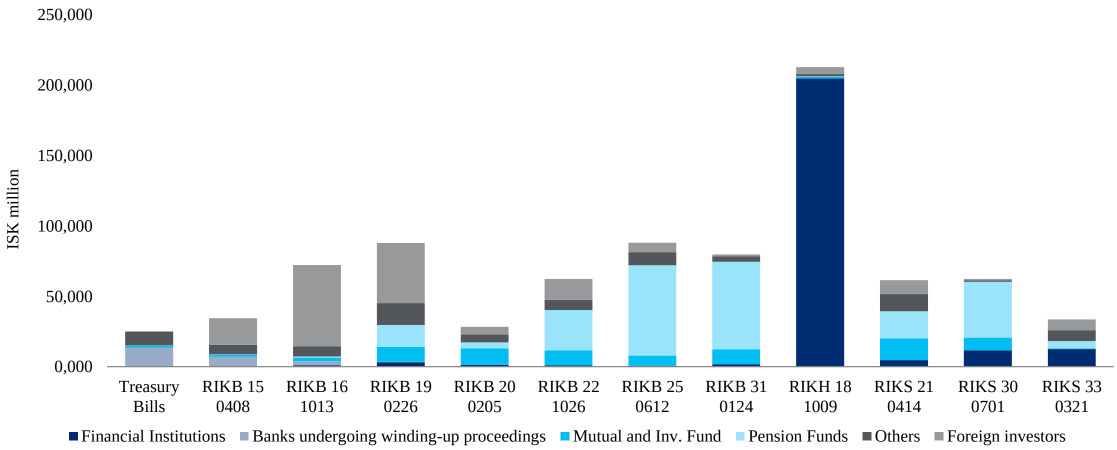

Figure 8

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[3] In the Icelandic Securities Depository system, foreign investors are defined as legal entities with foreign registration numbers; however, it should be noted that some of these foreign registration numbers may belong to foreign investment companies owned by Icelanders. Banks in winding-up proceedings are not included.

7 Risk management

Management of the debt portfolio must take into consideration various risk factors arising from market volatility, such as fluctuations in interest rates, exchange rates, and inflation, as well as refinancing risk related to outstanding loans. The management of these risks is covered in this section.

7.1 Market risk

Financial market volatility, whether due to fluctuations in interest rates, exchange rate movements, or changes in inflation, results in fluctuations in the market value of the debt portfolio. These risks generally referred to collectively as market risk, are discussed in greater detail in the following sections.

Effective risk management aims to reduce risk while simultaneously minimising the interest expense of the portfolio. These goals can be achieved through effective Treasury debt management and targeted use of derivative products.

7.1.1 Interest rate risk

Interest rate risk is the risk that the Treasury’s financing costs will rise due to changes in interest rate terms. Interest rate risk depends on the structure of the debt portfolio. Variable interest rates create the risk that interest rates will rise, thus increasing the Treasury’s interest expense.

Figure 9 shows the interest rate composition of the debt portfolio as of end-2014. The majority of domestic and foreign Treasury bonds (about 71%) bear fixed interest rates, and their payment flows are known throughout their duration. Approximately 29% of the total debt portfolio bears variable rates, and payment flows will change in line with changes in the base interest rate on the loans concerned. Interest rate swaps can be used in order to manage the Treasury’s interest rate risk and, for instance, increase the weight of variable-rate debt.

Interest rate composition

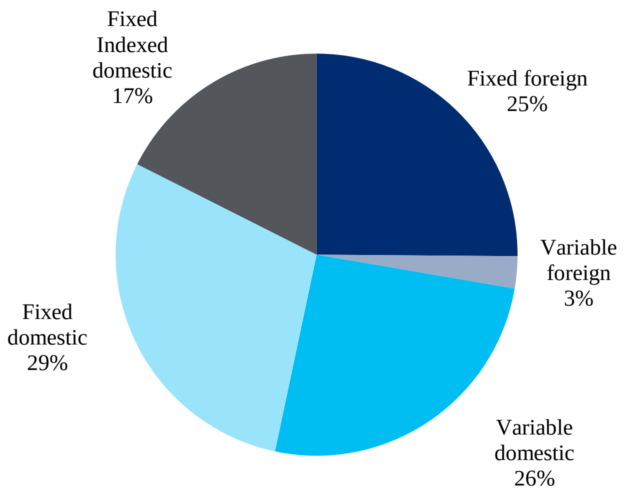

Figure 9

7.1.1.1 Interest rate swaps

The objective of Treasury debt management is to minimise long-term interest expense while pursuing a prudent risk policy. Interest rate swaps can serve as a means of minimising interest expense. Domestic market agents have shown some interest in having the Treasury take the initiative in this area, as it would enable them to diversify their offerings to include longer-term products. The Treasury concluded a swap agreement for fixed versus variable interest in connection with the eurobond issue in summer 2014, but this is its only outstanding interest rate swap agreement. No decisions have been taken on the use of interest rate swaps in the domestic market.

7.1.2 Exchange rate risk

Exchange rate risk is the risk that the Treasury's debt position will deteriorate due to changes in the exchange rate of the Icelandic króna versus other currencies. The Treasury's direct exchange rate risk is limited because the foreign currency and the foreign-denominated bonds it owns offset foreign Treasury debt. The foreign exchange reserves are actively managed according to set currency composition guidelines. The Central Bank attempts to minimise the exchange rate risk attached to the reserves.

7.1.3 Inflation risk

Inflation risk is the risk that indexation on index-linked Treasury bonds will increase the Treasury's financing costs as a result of increased inflation. At year-end 2014, the Treasury's indexed debt amounted to ISK 263 billion, or around 18% of its debt portfolio.

Inflation risk can also be managed with derivatives; however, activity on the Icelandic derivative market is limited at present. The Treasury will be able to manage its inflation risk more effectively once the derivative market has picked up again. The share of inflation-indexed debt in the overall portfolio is deliberately kept low due to the risk that inflation will rise if the króna should depreciate when the capital controls are lifted. It should be borne in mind, however, that the Treasury holds a number of inflation-indexed assets, such as loans to the Icelandic Student Loan Fund. This mitigates inflation risk to some extent.

7.2 Refinancing risk

One of the greatest risks to the debt portfolio centres on refinancing. To reduce refinancing risk, the Ministry of Finance and Economic Affairs aims to keep the repayment profile of Government securities as smooth as possible over the long term.

The largest maturities of Treasury debt in coming years, and those involving the main refinancing risks for the portfolio, are as follows:

a) 2016	ISK 127 billion	To expand foreign exchange reserves (taken 2011)
b) 2018	ISK 213 billion	Capital contribution to financial institutions
c) 2020	ISK 116 billion	To refinance bilateral Nordic loans (taken 2014)
d) 2022	ISK 127 billion	To expand foreign exchange reserves (taken 2012)

a) In June 2011, the Treasury issued a five-year bond in the amount of USD 1 billion. The intention is to refinance half of the debt prior to its 2016 maturity with another foreign market issue. The remainder will be paid from the foreign exchange reserves.

b) In 2008, the Treasury issued a special ten-year bond (RIKH 18) to finance capital contributions and subordinated loans to financial institutions. The end-2014 balance was ISK 213 billion. This loan is offset by shareholdings and subordinated loans in an amount equivalent to ISK 54 billion and maturing in year end of 2019.

c) In summer 2014, the Treasury issued a six-year bond in the amount of EUR 750 million. The proceeds were used to prepay the outstanding balance on the bilateral loans taken from the Nordic countries in connection with the SBA.

d) In May 2012, the Treasury issued a ten-year bond in the amount of USD 1 billion. The bond matures in May 2022.

One of the uncertainties related to refinancing centres on whether non-residents will choose to continue investing in Treasury securities once the capital controls have been lifted. It will be the authorities' task to minimise the impact of capital account liberalisation on Treasury financing.

7.3 Contingent liabilities

Contingent liabilities are financial obligations that could fall on the Treasury; for example, due to State guarantees or administrative decisions that entail involvement in the financing of municipalities or corporations that are of key importance in Icelandic society. The scope of this risk can be found in Sections 7.3.1 − 7.3.3.

7.3.1 State guarantees

State guarantees represent the Treasury's greatest indirect liability. State guarantees are governed by Act no. 121/1997. The Treasury may not grant State guarantees without statutory authorisation from Parliament.

State guarantees and related matters are administered by the State Guarantee Fund, which compiles information on the position of the undertakings benefiting from guarantees and assesses the risk attached to the guarantees. The Central Bank oversees State guarantees according to an agreement with the Ministry of Finance and Economic Affairs. The State Guarantee Fund notifies the Ministry of Finance and Economic Affairs if a guarantee is likely to fall on the Treasury. Table 5 shows the status of State guarantees at the end of December 2014.[4]

State guarantees

Position Dec. 31 2014	ISK million	%
Housing Finance Fund (HFF)	881,045	73%
Landsvirkjun	302,586	25%
Others	28,954	2%
Total	1,212,585	

Table 5

[4] *Market Information*, January 2015. (http://www.lanamal.is/en/news/market-information)

7.3.1.1 Housing Financing Fund (HFF)

Pursuant to the Housing Act, no. 44/1998, the role of the Housing Financing Fund is to provide loans for the purchase of housing in Iceland. The Fund is supervised by the Financial Supervisory Authority.

In 2014, the HFF recorded an operating profit of ISK 3.2 billion, as opposed to a loss of ISK 4.4 billion the year before. Its equity amounted to ISK 18.1 billion, and its capital ratio, calculated in accordance with the Regulation on the Housing Financing Fund, no. 544/2004, was 4.5% at year-end 2014, as opposed to 3.4% at end-2013.

The risks facing the Housing Financing Fund are credit risk, liquidity risk, interest rate and inflation risk, prepayment risk, refinancing risk, and operational risk. Of these, prepayment risk and credit risk are by far the most significant, which is reflected in the fact that the Fund's operational losses in recent years stem primarily from loan impairment and increased debt prepayment.

Interest rate risk is also an important risk factor, as net interest income is a large item in the HFF's profit and loss account. Interest rate risk is defined as the risk that fair value or future payment flows on financial instruments will fluctuate as a result of changes in market interest rates. The HFF's low capital ratio makes it difficult for it to protect itself against risks in its operations, making the financial risk to the Treasury greater as a result.

Since 2010, Parliament has approved contributions in the amount of ISK 50 billion to shore up the HFF's capital. The 2015 National Budget provides for a contribution of up to ISK 5.7 billion to offset possible losses during the year. No contribution was made to the HFF for 2014.

The Ministry of Welfare is working on a comprehensive review of housing affairs. It is assumed that proposals will be forthcoming this year.

7.3.1.2 Landsvirkjun

Landsvirkjun's financial position is acceptable, with EBITDA amounting to USD 332 million at year-end 2014, as opposed to ISK 329 million in the previous year. Its equity ratio was 39.9% at the end of 2014, as opposed to 36.3% at year-end 2013. The company's liquidity is sound because of its strong cash position and undrawn revolving credit facilities, which amounted to USD 407 million at year-end 2014, and it is well situated to service its debt in coming years. Its net debt declined by USD 239 million in 2014, to a year-end total of USD 2,190 million. Landsvirkjun's net liabilities have been reduced by a total of USD 484 million since 2010.

Interesting changes have taken place in Icelandic electricity companies' operating environment in recent years. Demand for electricity from Iceland comes from a wide variety of sources. Industries such as silicon processing and data centres, which have long been deemed attractive for Iceland, are now preparing to expand their operations in the country. The demand for electricity now exceeds the supply, which provides both opportunities and challenges.

Landsvirkjun's financial risk consists of market risk, liquidity risk, and counterparty risk. Its market risk is predominantly of three kinds: aluminium price risk, interest rate risk, and exchange rate risk. Landsvirkjun has systematically reduced its market risk in recent years by amending electricity contracts and restructuring its loan portfolio. The company will continue to make efforts to reduce its market risk, including by changing the points of emphasis in its electricity contracts, amending its loan portfolio, and concluding derivatives contracts.

Even though Landsvirkjun has significantly reduced its market risk, its operating performance is somewhat sensitive to developments in aluminium prices, interest rates, and exchange rates. At present, aluminium prices are low and near-term developments are uncertain. The majority of Landsvirkjun's debt bears variable interest rates; therefore, the current low-interest environment counterbalances low aluminium prices.

7.3.2 Municipalities

While there is no legally mandated State guarantee on local authorities' debt, their financial position could generally threaten individual local authorities' ability to fulfil their tasks, and their overall debt level poses a risk to the economy and the Treasury. The high level of indebtedness and weak financial position of some municipalities therefore gives cause for concern.

In 2011, Parliament passed legislation on municipal affairs that provides for increased discipline and sets clearer rules for local authorities' finances, as well as requiring increased supervision and information disclosure on financial affairs. First of all, the new legislation stipulates that municipal consolidations' combined Part A and Part B revenues and expenditures must be in balance over each three-year period. Second, total debt and obligations may not exceed 150% of revenues. It is clear that many municipalities will need several years to adapt their debt position to this maximum. The Act provides for a maximum adaptation period of ten years. It is important that the municipalities use this time well so that their finances become sustainable as soon as possible. According to the Act, decisions on municipal investment, development, or other contractual obligations exceeding 20% of the current year's tax revenues are subject to an impartial appraisal of the impact on the municipality's financial position.

7.3.3 Public-private partnerships

Public-private partnerships can entail financial risk for the Treasury, even in the absence of a State guarantee. Public-private partnerships are governed by the Regulation on Service Agreements, no. 343/2006. The purpose of the Regulation is to define the role and responsibilities of entities that manage long-term projects for individual ministries and public institutions. According to the Government Financial Reporting Act, agreements of this kind must be approved by Parliament. While such partnerships usually represent little direct financial risk for the Treasury, circumstances can develop where the projects need capital in excess of current budget allocations. The main public-private partnerships currently underway are the Vaðlaheiðargöng tunnel and the operation of the Harpa Concert and Conference Centre.

8 Institutional structure

In each year's National Budget, Parliament authorises the Ministry of Finance and Economic Affairs to borrow funds and issue State guarantees. The Act on Government Debt Management stipulates that the Ministry is responsible for and implements debt management and State guarantees. The Furthermore, the Ministry of Finance and Economic Affairs has also concluded an agreement with the Central Bank of Iceland, providing for specified advisory services and execution in connection with Treasury debt management. The agreement contains explicit provisions on division of tasks and responsibilities so as to ensure that debt management decisions are taken independent of the Central Bank's monetary policy.

8.1 Ministry of Finance and Economic Affairs

The Ministry of Finance and Economic Affairs administers Treasury debt management affairs. It also takes decisions on issuance volume, planned bond auctions, and liquidity management. It also determines yields and amounts of accepted bids in Treasury auctions. Moreover, the Ministry of Finance and Economic Affairs determines the structure, maturity, and characteristics of new issues, as well as deciding on buybacks and/or swap agreements.

8.2 Central Bank of Iceland

The Ministry of Finance and Economic Affairs and the Central Bank of Iceland have concluded an agreement providing for specified advisory services and execution in connection with Treasury debt management.[5] The purpose of the agreement is to promote more economical, efficient, and effective debt management based on the Ministry's debt management strategy.

A special department within the Central Bank of Iceland, Government Debt Management, is mandated by the Ministry of Finance and Economic affairs to handle Treasury debt management in accordance with guidelines adopted by the Ministry. Government Debt Management is responsible for ensuring that borrowing and debt management are in compliance with the strategy set out by the Ministry.

Government Debt Management also administers State guarantees and assesses the Treasury's risk due to such guarantees. It provides the Ministry with opinions on State guarantees and grants them if authorised by Parliament.

On behalf of the Ministry of Finance and Economic Affairs, Government Debt Management handles the regular disclosure of information on the Treasury's domestic and foreign liabilities to market agents, and publishes information on auction dates and planned issuance volume for the year based on the Treasury's estimated financing need. It also issues press releases on debt management on behalf of the Ministry of Finance and Economic Affairs.

8.3 Consultative Committee on Debt Management

The Ministry of Finance and Economic Affairs appoints a Consultative Committee on Debt Management, comprising representatives from the Ministry and the Central Bank.

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[5] The Government Debt Management Agreement of 18 October 2010, based on the agreement of 4 September 2007.

The Consultative Committee serves as a forum for the exchange of views on the situation and outlook in capital markets, and on the Treasury’s domestic and foreign borrowing and borrowing plans. It is intended to encourage improvements in the domestic credit market as it deems appropriate.

The Committee makes proposals to the Ministry of Finance and Economic Affairs on the structure of individual bond series and their maturity and volume, as well as arrangements for market making and auctions. It also proposes risk management guidelines for the Treasury’s domestic and foreign debt portfolios. The Committee discusses and adopts proposals for the Treasury’s issuance schedule in domestic and foreign markets. The schedule specifies the issuance volume, issuance dates, and planned borrowing actions for the year. It must be approved by the Ministry of Finance and Economic Affairs and is then announced to market agents. The Committee is to meet on average on a monthly basis.

9 Information disclosure to the market

The Ministry of Finance and Economic Affairs and Government Debt Management attempt to maintain effective communication with market participants through regular information disclosure and meetings with primary dealers and investors. All news releases are published on the NASDAQ Iceland Exchange and Bloomberg and are distributed to the media and market agents. The exchange uses the data vendor GlobeNewsWire to distribute press releases to foreign media and market participants.

Publications on debt management issued by the Ministry of Finance and Economic Affairs and Government Debt Management include the following:

- Medium-Term Debt Management Strategy
- Annual Government Debt Management Prospect
- Quarterly Government Debt Management Prospect
- Auction announcements
- Planned auction dates
- Market Information

9.1 Medium-Term Debt Management Strategy

The Ministry of Finance and Economic Affairs prepares the *Medium-Term Debt Management Strategy (MTDS)*, which is revised and published annually. It includes the following topics:

- Debt management objectives
- Debt management guidelines
- Issuance policy
- Structure of Treasury debt
- Risk management
- Contingent liabilities

9.2 Annual Government Debt Management *Prospect*

The Annual Government Debt Management *Prospect* is designed to provide market participants with general information on Treasury issuance for the upcoming year. It is published following parliamentary approval of the National Budget and includes the following information:

- Total issuance volume for the year
- Issuance policy for the year
- Buybacks
- Bond swap auctions

9.3 Quarterly Government Debt Management *Prospect*

At the end of each quarter, Government Debt Management issues the *Prospect* for the upcoming quarter. The Quarterly *Prospect* includes the following information:

- Planned Treasury bond issuance for the quarter
- Planned Treasury bill issuance
- Summary of issuance in the previous quarter
- Actions to be taken in the upcoming quarter

9.4 Auction announcements

Press releases on individual auctions are published on the NASDAQ Iceland Exchange at least one business day prior to each auction, indicating which series are to be offered in each instance. The results are published after each auction, on that same day.

9.5 Planned auction dates

The planned dates for Treasury bill and Treasury bond auctions are published on the Government Debt Management website each December. This information is also distributed directly to market participants.

9.6 *Market Information*

Government Debt Management publishes a monthly newsletter entitled *Market Information*. The newsletter contains important information on Treasury debt and State guarantees. *Market Information* is distributed to the media and to market participants and is published on the Government Debt Management website. It includes the following information:

- Highlights from the previous month
- Results of Treasury auctions
- Treasury debt statistics
- Position of Treasury benchmark securities
- Structure of Treasury debt
- Repayment profile for Government debt
- Owners of Treasury securities
- Securities loans
- State guarantees

9.7 Government Debt Management website

Government Debt Management publishes a website, www.lanamal.is, which includes information on Treasury debt management, market prices, yields, and historical statistics on Treasury securities, as well as issue prospectuses. The following information can also be found there:

- *Medium-Term Debt Management Strategy*
- Annual Government Debt Management *Prospect*
- Quarterly Government Debt Management *Prospect*
- Auction announcements
- *Market Information*
- Press releases
- The Republic of Iceland’s sovereign credit ratings

Information on Government debt can also be found on the Ministry of Finance and Economic Affairs website: www.fjr.is.

9.8 Primary dealers in Treasury securities

Government Debt Management monitors primary dealers on a daily basis to ensure that they fulfil their market-making obligations in the secondary market. Meetings are held with them at least quarterly, and more often if necessary.

9.9 Investors

Representatives from Government Debt Management and the Ministry of Finance and Economic Affairs meet regularly with investors to acquaint them with points of emphasis in Treasury debt management.