

30. December 2019



# Medium-Term Debt Management Strategy 2020-2024

**Publisher:**

Ministry of Finance and Economic Affairs

30. December 2019

[postur@fjr.is](mailto:postur@fjr.is)

[www.fjr.is](http://www.fjr.is)

**Design:**

Ministry of Finance and Economic Affairs

©2019 Ministry of Finance and Economic Affairs

# Table of contents

<b>Summary</b> .....	<b>5</b>
<b>1. Debt management objectives and guidelines</b> .....	<b>7</b>
1.1 Debt management guidelines.....	7
1.2 Quantifiable targets.....	8
<b>2. Domestic bond issuance</b> .....	<b>9</b>
2.1 Financing need.....	9
2.2 Deposits.....	9
2.3 Structure of Treasury issuance.....	10
2.3.1 Structure of benchmark series.....	10
2.3.2 Treasury bond issuance from 2020 onwards.....	11
2.3.3 Redemption profile.....	12
<b>3. Foreign bond issuance</b> .....	<b>14</b>
3.1 Deposits.....	14
3.2 Repayment profile.....	14
<b>4. Treasury debt position</b> .....	<b>16</b>
4.1 Treasury debt.....	16
4.1.1 Domestic borrowing.....	17
4.1.2 Foreign debt.....	18
4.1.3 Treasury debt structure.....	18
4.1.4 Redemption profile.....	19
4.1.5 Average time to maturity.....	19
4.2 Investors in domestic Treasury securities.....	20
4.3 Estates' stability contributions.....	21
4.4 Allocations during the horizon of the fiscal plan .....	21

<b>5. Risk management.....</b>	<b>23</b>
5.1 Market risk .....	23
5.1.1 Interest rate risk.....	23
5.1.2 Exchange rate risk.....	24
5.1.3 Inflation risk.....	24
5.2 Refinancing risk.....	25
5.3 Contingent liabilities.....	25
5.3.1 State guarantees .....	25
5.3.2 Municipalities.....	27
5.3.3 Public-private partnerships .....	27
<b>6. Institutional structure.....</b>	<b>28</b>
6.1 Ministry of Finance and Economic Affairs .....	28
6.2 Central Bank of Iceland .....	28
6.3 Consultative Committee on Debt Management.....	29
<b>7. Disclosure of information to market participants.....</b>	<b>30</b>
7.1 Medium-Term Debt Management Strategy.....	30
7.2 Annual Government Debt Management Prospect.....	30
7.3 Quarterly Government Debt Management Prospect.....	31
7.4 Auction announcements.....	31
7.5 Planned auction dates.....	31
7.6 Market Information.....	31
7.7 Government Debt Management website.....	31
7.8 Primary dealers in Treasury securities.....	32
7.9 Investors.....	32

# Summary

This Medium-Term Debt Management Strategy for the period 2020-2024 is presented on the basis of the fiscal plan,<sup>1</sup> in accordance with Article 38 of the Act on Public Finances, no. 123/2015. The strategy is to be presented annually. The Medium-Term Debt Management Strategy is presented over a horizon of five years and is based on the previous strategy, issued in December 2018.

The Medium-Term Debt Management Strategy 2020-2024 (MTDS) lays down the Government's plans for financing its activities during this period. The aim is to map out a clear debt management policy with quantitative targets. The MTDS provides a policy framework for debt management activities, and its key objective is to ensure that the Government's financing needs, and payment obligations are met at the lowest possible cost consistent with a prudent degree of risk. It is also intended to encourage further development of efficient primary and secondary markets for domestic Government securities.

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 separate 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.

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. To reduce refinancing risk, the Treasury aims to keep the redemption profile of Government securities as smooth as possible over time. The average time to maturity should be at least five years and no longer than seven years.

The Treasury has borrowed in foreign currencies in order to expand the Central Bank's international reserves. The Treasury foreign borrowing strategy is aimed at securing regular access to international capital markets and attracting a diversified investor base. Attempts shall be made to maintain benchmark issues

---

<sup>1</sup>Based on the revised 2020-2024 fiscal plan, adjusted for the 2020 National Budget.

at any given time to facilitate domestic firms' access to foreign credit if market conditions and the Treasury debt position permit.

At year-end 2019, gross Treasury debt was equivalent to just over 30% of GDP. The aim is to reduce total debt over the period to approximately 20% of GDP by end-2024. The Treasury's net position — i.e., liabilities net of interest-bearing assets, excluding stability contributions — is expected to be negative by just under 18% of GDP at the end of 2019. The objective for the period is to reduce the deficit further, to about -12% of GDP by the end of 2024. Fiscal policy formulation assumes that total public sector debt — that is, debt excluding pension obligations and accounts payable, and net of cash and bank deposits — will fall from just over 30% of GDP at the end of 2019 to less than 22% of GDP by the end of 2024.

# 1. Debt management objectives and guidelines

The Treasury's debt portfolio is managed with an eye to the following objectives:

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 establish a sustainable debt service profile that is consistent with the Government's medium-term debt service capacity and minimises refinancing risk;
3. To maintain and encourage further development of efficient primary and secondary markets for domestic Government securities;
4. To broaden the Government's investor base and diversify funding sources.

In order to meet the demand for new Government securities issues and to increase the liquidity of marketable series, endeavours will be made to exchange non-marketable Treasury debt with marketable securities insofar as market conditions permit. Such exchanges must be consistent with the objective of keeping the Treasury's long-term interest expense as low as is consistent with a prudent degree of risk.

## 1.1 Debt management guidelines

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 domestic bond market. Issuance of indexed Treasury bonds is irregular and is determined by financing needs and the circumstances prevailing at any given time. New Treasury loans taken in foreign currencies have been used primarily to expand the Central Bank's foreign exchange reserves or to refinance outstanding market issues.

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

Non-indexed debt	50-70%
Indexed debt	20-30%
Foreign debt	10-20%

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 targeted size of each

series is about ISK 40-70bn, with the exception of two-year issues, which shall ultimately be at least ISK 15bn in size.

The average time to maturity of the debt portfolio shall be at least five years and no longer than seven years.

The Government's domestic deposits with the Central Bank of Iceland shall average about ISK 40bn.

## 1.2 Quantifiable targets

Clear, quantitative targets for debt management demonstrate the sustainability of Treasury debt. The targets are based on the fiscal plan for 2020-2024, the outlook for Treasury performance, the economic outlook, and the state of the domestic economy. In accordance with the fiscal plan for 2020-2024, the targets are as follows:

- The ratio of Treasury debt to GDP shall be about 20% by 2024.
- Total general government debt according to the debt rule shall be 22% by year-end 2024.

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



## 2. Domestic bond issuance

The Treasury's financing need will be met through issuance of Government securities in the domestic market and reduction of Treasury deposits with the Central Bank of Iceland. This section focuses on medium-term financing needs and Treasury deposits. It also covers the arrangement for Treasury securities issuance, including policies on redemption profile and average maturity, as well as the structure of benchmark series.

### 2.1 Financing need

The Treasury's estimated borrowing need is based on the assumptions in the 2020 National Budget for that year, as well as on the assumptions presented by the Ministry of Finance and Economic Affairs in the fiscal plan for 2020-2024.

The net borrowing requirement (financing balance) is either positive or negative. A positive financing balance shows a surplus on Treasury operations and financial activities, which can be used to pay down 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.

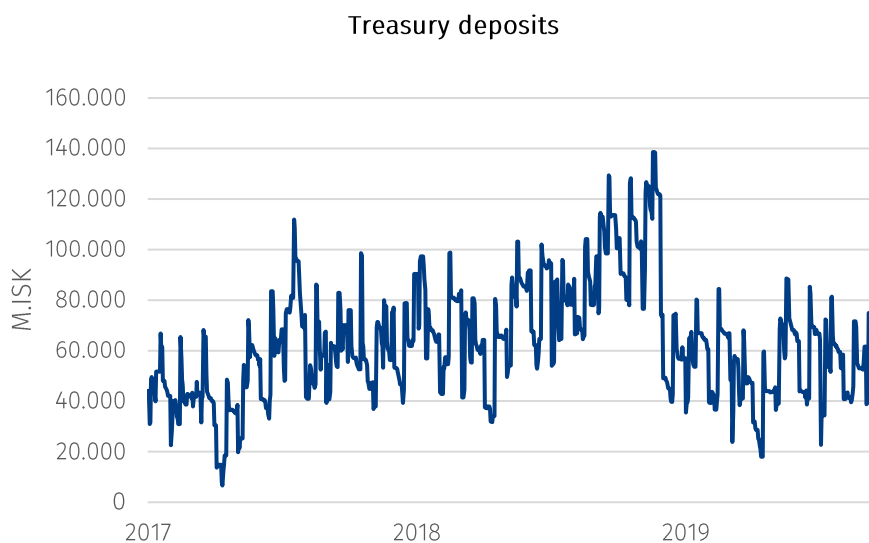
Table 1 shows the net financing balance according to Treasury estimates for 2020-2024. According to the estimates, the net financing balance will be positive in the next few years.

Net financing balance (ISK m)				
2020	2021	2022	2023	2024
9,600	75,900	3,000	5,700	5,700

*Table 1*

### 2.2 Deposits

Treasury deposits were, on average, lower in 2019 than they have been in recent years. The inflow of stability contributions has slowed down, so general deposits have increasingly had to meet maturities of Treasury notes. At the same time, the Treasury's financial position and net financing balance have declined. At the end of November 2019, the total balance of Treasury accounts amounted to ISK 63 bn. and is expected to be close to that amount by the end of the year. The aim is to maintain a deposit balance of as close to ISK 40bn as possible at any given time.



*Figure 1*

## 2.3 Structure of Treasury issuance

This section focuses on the structure and set-up for issuance of Government securities in the domestic market.

### 2.3.1 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 on two-, five-, and ten-year benchmark series will be ensured.

A ten-year series is defined as one whose maturity at issuance is approximately 11 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 each year for bonds classified as two-, five-, and ten-year benchmark issues, although each year's issuance in each series will be determined by the borrowing need at the time in question and by the size of the series concerned. Nominal and inflation-linked bonds with maturities other than two, five, and ten years will be issued irregularly, depending on the Treasury's financing needs at the time.

The targeted size of each series is about ISK 40-70bn, with the exception of two-year issues, which shall ultimately be at least ISK 15bn in size. 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. The target applies primarily to new issues, but attempts will be made to adapt outstanding series to it in coming years, if the opportunity arises.

Monthly issuance of Treasury bills will vary, depending on investor demand and the Treasury's financing need at any given time. Treasury bills are used in part for Treasury liquidity management, with maturities ranging from one month to 12 months.

#### Benchmark issuance

Series	Maturity	Amount issued	Frequency of issuance
Treasury bills	up to 12 months	Variable, * depending on current market conditions	Variable
Treasury bonds, nominal	2 yr	ISK 40-70bn if previously issued for a longer period; otherwise, ISK 15-70bn if issued for only 2 yr	Annually
Treasury bonds, nominal	5 yr	ISK 40-70bn	Annually
Treasury bonds, nominal	10 yr	ISK 40-70bn	Annually
Treasury bonds, nominal	Other maturities	ISK 40-70bn	Irregular
Treasury bonds, index-linked	Other maturities	ISK 40-70bn	Irregular

Table 2

### 2.3.2 Treasury bond issuance from 2020 onwards

In the National Budget, year-2019 issuance was estimated at ISK 52bn, including Treasury bonds in the amount of ISK 40bn and expansion of outstanding Treasury bills in the amount of ISK 12bn. An example of Treasury securities 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 20 0205 means that the bond is a nominal bond maturing on 5 February 2020. 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.

Example of issuance

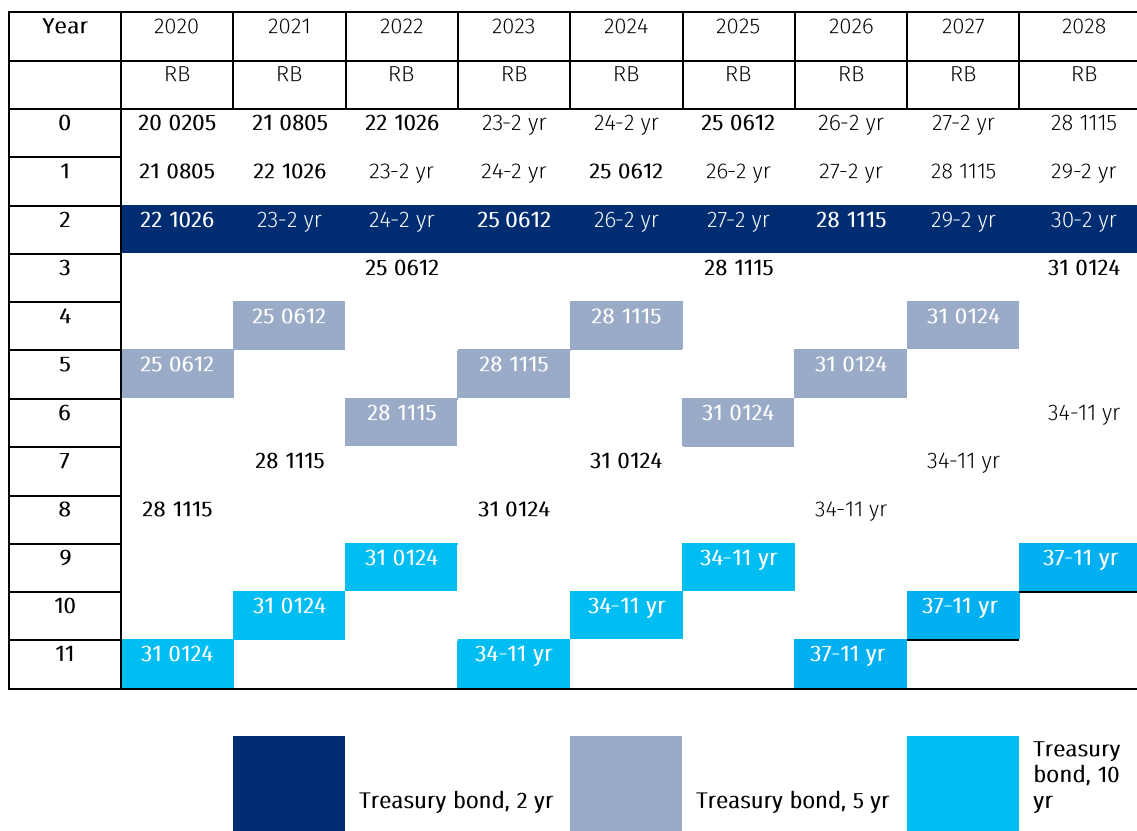


Table 3

### 2.3.3 Redemption profile

One of the objectives of Treasury debt management is to ensure that the redemption 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 70bn upon maturity. Until 2016, the maximum size of each series was set at ISK 100bn. Given that the Treasury's domestic issuance need has diminished markedly, owing to an improved fiscal outcome and to irregular revenues that will be used to pay down debt, attempts will be made to reduce the maximum size of each series to around ISK 70bn. Instead, continued emphasis will be placed on effective price formation for two-, five-, and ten-year benchmark issues. The new targeted maximum applies mainly to new benchmark series, but in coming years the size of outstanding series will be reduced with buybacks or switch auctions, as market conditions allow. Figure 2 shows the redemption profile of domestic liabilities at year-end 2019, excluding Treasury bills.

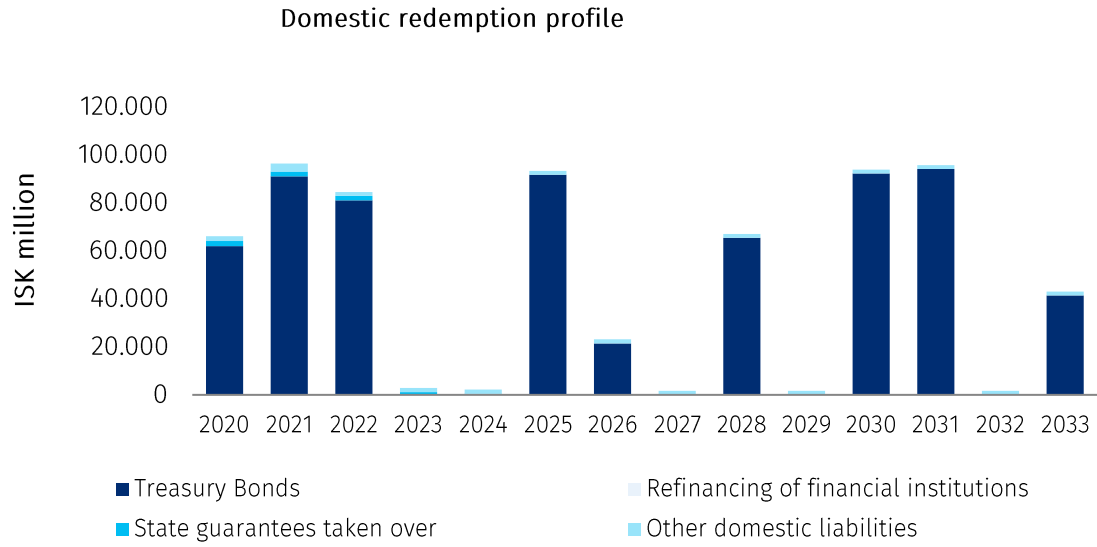


Figure 2

## 3. Foreign bond issuance

New Treasury loans taken in foreign currencies have been used primarily to expand the Central Bank's foreign reserves or to refinance outstanding market issues. The structure of Treasury debt provides the flexibility to borrow funds in foreign currencies and requires that foreign debt constitute 10-20% of the loan portfolio. The foreign borrowing need is assessed when foreign issuance is under consideration, and it is important that decisions be taken with a view to foreign exchange risk and, no less important, with a view to the Treasury's role of ensuring that Iceland has access to foreign credit markets.

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 aim is to issue marketable Treasury bonds in foreign markets on a regular basis. The principal aim of such issuance is to refinance outstanding marketable bonds. However, the flexibility for foreign borrowing provides an opportunity to finance specific projects in the future or to use the funds for a specific purpose. Government issuance in foreign markets facilitates domestic firms' access to foreign credit and provides an important benchmark for borrowing terms. The aim is to maintain at least one such benchmark foreign bond issue if market conditions and the Treasury debt position permit. 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.

### 3.1 Deposits

The Treasury's foreign-denominated deposits, which constitute a portion of the Central Bank of Iceland's international reserves, amounted to ISK 148bn as of December 2019. The foreign deposit balance increased by EUR 440m this summer, and at that time the Treasury issued a bond at 0.1% fixed interest and a yield of 0.122% – the lowest in the history of the Republic.

### 3.2 Repayment profile

Figure 2 shows the redemption profile of Treasury foreign debt as of end-2019. The largest maturities in coming years are in 2020, 2022, and 2024. The Government's foreign loans consist of market issues, one in US dollars (from 2012) and the others in euros (from 2014, 2017, and 2019).

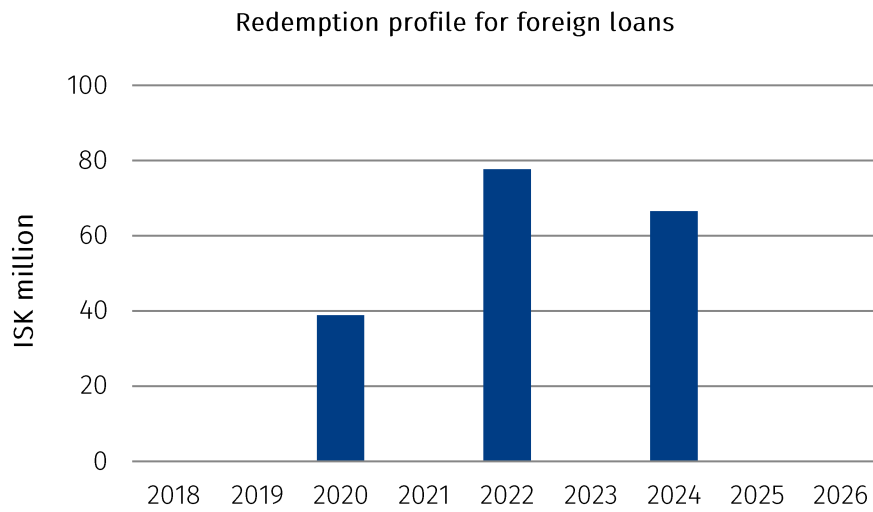


Figure 3

## 4. Treasury debt position

This section describes the Treasury debt position and loan portfolio structure at the end of 2019. 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 2011-2019, and outlines expected developments through 2024. It closes with a discussion of deviations from the fiscal plan presented this past spring.

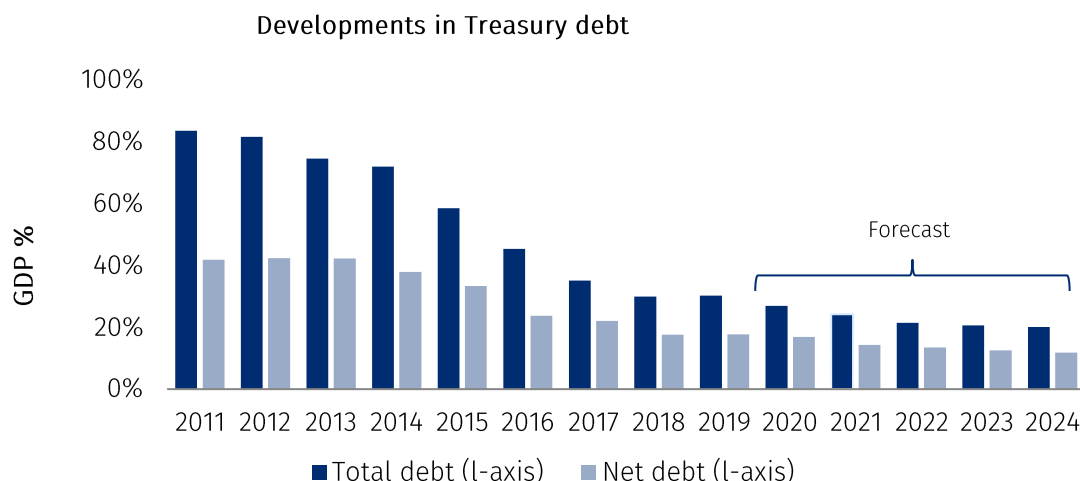


Figure 4

### 4.1 Treasury debt

Treasury debt totalled ISK 885bn at year-end 2019, or just over 30% of GDP. The aim is to reduce debt in stages to about 20% of GDP by end-2024. Table 4 gives a breakdown of Treasury debt at year-end 2019.

The Treasury’s net position — i.e., liabilities net of interest-bearing assets, excluding stability contributions — was negative by about 18% of GDP at the end of 2019. The objective for the period is to reduce the deficit further, to about -12% of GDP by the end of 2024.

Article 7 of the Act on Public Finances, no. 123/2015, stipulates that the objectives in the fiscal plan and fiscal strategy concerning public sector performance and balance sheets shall comply with several requirements. One of these requirements is that total debt, excluding pension obligations and accounts payable, and net of cash balances and deposits, must be less than 30% of GDP. If the debt ratio according to the fiscal rule rises above 30%, the excess portion must decline by an average of at least 5% (1/20) per year over each three-year period.



At the end of 2019, the public debt ratio was 29%. The ratio is expected to decline in coming years as debt is paid down and GDP rises. At the end of the period, public sector debt according to the debt rule in the Act on Public Finances is estimated at 22% of GDP.

Treasury debt <sup>2</sup> at year-end 2019	
Amounts in ISK m	
<b>Domestic</b>	
<i>Marketable bonds</i>	
Treasury bills	21,600
Treasury bonds, index-linked	236,500
Treasury bonds, nominal	406,200
 Non-marketable debt	
Domestic liabilities	34,300
Domestic liabilities, total	<b>698,600</b>
<b>Foreign debt</b>	
<i>Foreign reserve loans</i>	
Foreign reserve loans	183,100
Foreign liabilities, total	<b>183,100</b>
Total liabilities	<b>881,700</b>

*Table 4*

#### 4.1.1 Domestic borrowing

Marketable bonds include Treasury bills and both index-linked and nominal Treasury bonds. As of year-end 2019, outstanding marketable securities totalled ISK 666bn.

Non-marketable Treasury liabilities include bonds issued in connection with the Treasury's purchase of Reykjavík and Akureyri's holdings in Landsvirkjun. The Treasury's issue in connection with the acquisition of Landsvirkjun is an

<sup>2</sup> Forecasted at year end 2019

indexed annuity bond maturing in 2034. At year-end 2019, other outstanding non-marketable securities totalled ISK 34bn.

#### 4.1.2 Foreign debt

At the time the fiscal plan was issued, foreign loans taken by the Treasury to strengthen the Central Bank's international reserves consisted of three market issues, one in US dollars and two in euros. In 2014, the Treasury issued a foreign-denominated bond in the amount of EUR 750m. The proceeds were used to prepay the outstanding balance of bilateral loans from the Nordic countries, of which 60% of the principal had been paid in 2012. In December 2017, the Treasury made an offer to owners of those bonds for the entire outstanding amount of the series, and owners holding a nominal amount of about 400 million euros accepted the offer. Alongside that buyback, the Treasury issued a new five-year eurobond amounting to 500 million euros, maturing in 2022. Shortly after issuing the current fiscal plan, the Treasury issued another EUR 500m eurobond. Alongside that issuance, the Treasury bought back a portion of its 2014 issue, whose outstanding balance is now EUR 292m.

In 2011, the Treasury re-established its access to foreign credit markets with the issuance of a USD 1bn bond with a five-year maturity. That bond matured in 2016 and has been paid in full. In 2012 the Treasury reconfirmed its market access with another issue, also for USD 1bn, but with a ten-year maturity. In spring 2017, the Treasury bought back a large share of the 2012 issue, or USD 877m nominal value. During the autumn of that same year, the Treasury also bought back USD 31m, leaving the outstanding balance of the bond at USD 92m as of end-2019.

#### 4.1.3 Treasury debt structure

Figure 5 shows marketable and non-marketable Treasury debt as of year-end 2019, including loans taken to expand the foreign exchange reserves. Domestic loans are classified as nominal Treasury bonds (48%), index-linked Treasury bonds (27%), Treasury bills (2%), and other loans (4%). As is discussed in Section 4.1.2, the Treasury issued a new Eurobond in 2019 and the ratio of foreign debt rose to 21% by the end of the year 2019.

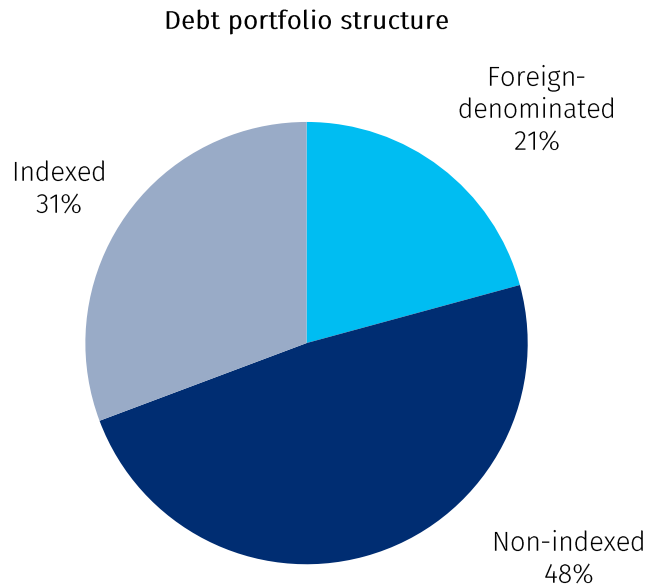


Figure 5

#### 4.1.4 Redemption profile

Figure 6 shows the Treasury redemption profile based on the balance as of end-2019. The goal is to keep the redemption profile of domestic and foreign debt as smooth as possible.

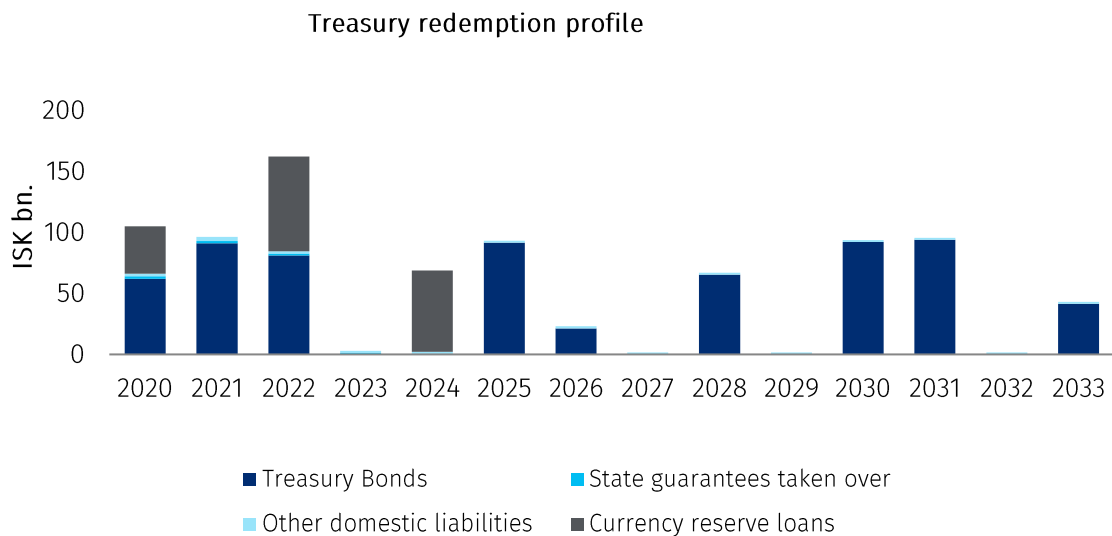


Figure 6

#### 4.1.5 Average time to maturity

The objective is to ensure that the weighted average time to maturity of Treasury bonds is at least five years and no more than seven years. The average time to maturity of the debt portfolio is managed through issuance of Treasury securities with various maturities. If domestic market conditions permit, it is also possible to use buybacks and switch auctions to ensure that the average

time to maturity remains within the defined guidelines. As of year-end 2019, the average time to maturity was 5.7 years.

## 4.2 Investors in domestic Treasury securities

The Treasury issues Government securities with various maturities. The objective is to appeal to a broad base of investors and minimise financing costs. Figures 7 and 8 give a breakdown of the holders of domestic Treasury bonds and bills as of year-end 2019.<sup>3</sup>

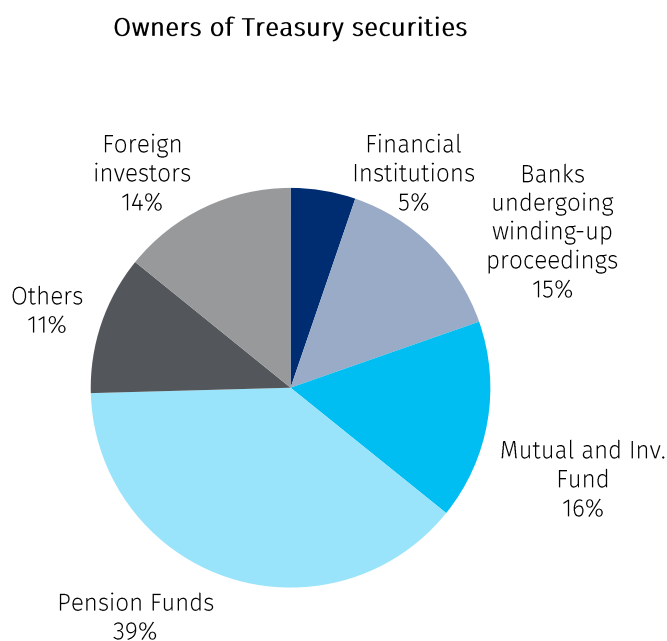


Figure 7

Pension funds, foreign entities, and financial institutions owned just under 60% of domestic Treasury securities at the end of 2019. Pension fund assets accounted for 39% of outstanding Treasury bonds, and they consist mainly of longer-term securities such as RIKB 25, RIKB 31, and RIKS 30. Foreign investors' holdings are mainly in RIKB 22, RIKB 25, RIKB 28, and RIKB 31. Mutual funds and investment funds own about 16% of domestic Government securities, and other investors own about 11%.

---

<sup>3</sup>The breakdown of Treasury bond owners includes securities loans.

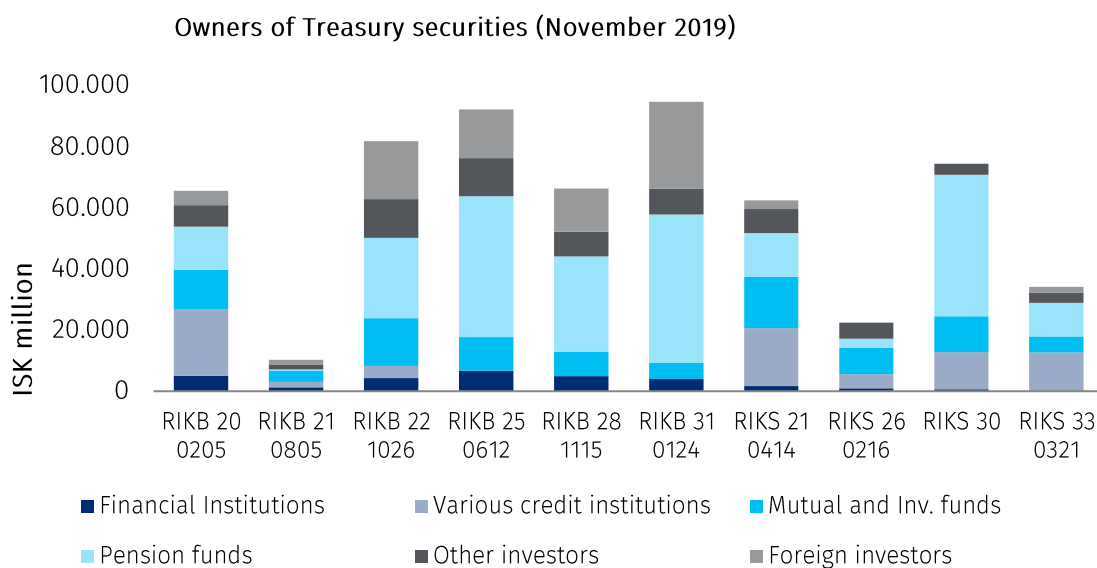


Figure 8

### 4.3 Estates' stability contributions

The estates of the failed financial institutions all had their composition agreements confirmed in late 2015 and early 2016, and in all instances the conditions for stability contributions were satisfied. Agreements were reached with five estates on payment of stability contributions to the Treasury. The stability contributions paid by the estates amounted to ISK 384bn and can be classified broadly as liquid assets, transferred assets, and cash sweep assets, plus the holding in Íslandsbanki and a bond with collateral in Arion Bank. The company Lindarhvoll ehf. was established by the Ministry of Finance and Economic Affairs to oversee the administration, appropriation, and sale of assets other than the holding in Íslandsbanki. Processing of the assets was largely complete by the beginning of 2018; therefore, the Ministry's contractual agreement with the company was terminated at the beginning of February. Revenues from stability contributions have been allocated to reduction of Treasury debt in the amount of ISK 208bn. In addition, the Treasury has made a payment of ISK 40bn to the Pension Fund for State Employees, partly with a transfer of stability assets.

### 4.4 Allocations during the horizon of the fiscal plan

After rapid deleveraging in recent years and large-scale buybacks of Treasury bonds, these measures will slow down markedly, and in coming years debt management will emphasise servicing debt on payment due dates as they occur. RIKB 20 matures in February 2020. Its outstanding balance, after adjusting for disposals in year-2019, is ISK 65bn. Also maturing in 2020 is the outstanding balance of the eurobond issued in 2014, EUR 292m. The index linked RIKS 21, with an outstanding balance of ISK 81bn, matures in April 2021,

and the new two-year RIKB 21, currently ISK 10bn in size, matures in August 2021. In 2022, the nominal bond RIKB 22 matures in the amount of ISK 81bn. Also maturing in 2022 is the outstanding balance of the US dollar bond issued in 2012, which stands at USD 92m, or ISK 11bn. No maturities are scheduled for 2023. Payments for the year include instalments on domestic loans taken in connection with the Landsvirkjun acquisition and the assumption of Government guarantees. In 2024, a eurobond amounting to EUR 500m is scheduled to mature.

The 2020-2024 fiscal plan assumes that Treasury issuance will average about ISK 40bn per year. After adjusting for the payments scheduled for each year, net Treasury issuance will be negative by ISK 30-40bn per year. Loan repayments will be financed with surpluses on Treasury operations, plus irregular revenues that could take the form of dividend payments or proceeds from the sale of holdings in financial institutions.

In the past several years, successful economic and fiscal policy and rapid deleveraging have made a positive impact on Iceland's sovereign credit rating. Moody's upgraded the sovereign by one notch in November and changed the outlook from positive to stable.

Deleveraging will also have a favourable impact on the Treasury's interest expense, which is still onerous, although it will decline in coming years, according to the fiscal plan. Reducing interest expense will provide the scope to allocate funds differently in the future.

The objectives in the fiscal plan assume that irregular Treasury revenues will be used to pay down debt. Any additional irregular revenues – e.g., revenues from asset sales – will provide even further scope for reduction of Treasury debt or obligations.

## 5. Risk management

The debt portfolio has certain inherent risks related to market volatility, such as changes in the interest rate, currency exchange rates, and inflation. There is also risk related to refinancing of outstanding debt. The management of these risks is covered in this section.

### 5.1 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 on the portfolio. It is possible to achieve these objectives with effective management of Treasury debt, including systematic use of derivatives.

#### 5.1.1 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 composition of the debt portfolio. Variable interest rates create the risk that interest rates will rise, thus increasing the Treasury’s interest expense. Fixed interest rates on long-term loans create the risk that the Treasury will not benefit from the savings that would accrue in the event of a reduction in market rates.

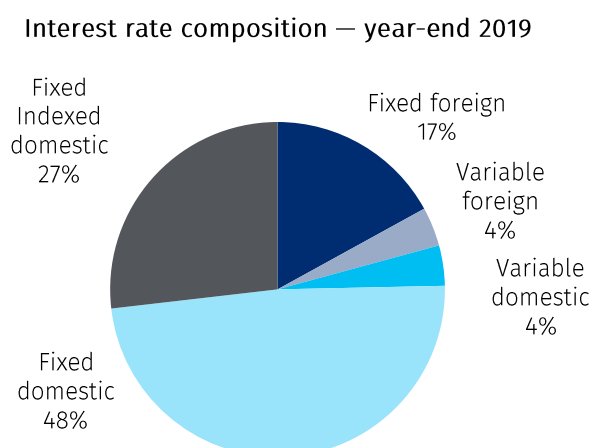


Figure 9

Figure 9 shows the interest rate composition of the debt portfolio as of end-2019. The majority of domestic and foreign Treasury bonds, about 92%, bear fixed interest rates, and their payment flows are known throughout their duration. Approximately 8% of the total debt portfolio bears variable rates; therefore, 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, as is discussed in Section 5.1.1.1.

### **Interest rate swaps**

One objective of Treasury debt management is to keep long-term interest expense as low as is consistent with a prudent degree of risk. Interest rate swaps can serve as a means of managing the Treasury's interest rate risk. The Treasury will be authorised to conclude such agreements for up to ISK 50bn per year. Decisions on issuance will be determined by market conditions at any given time.

In autumn 2018, the first steps were taken in issuing interest rate swaps aimed at mitigating the Treasury's indexation imbalances.

With interest rate swaps, it is also possible to affect the ratio of variable to fixed interest rates and to steer the average duration of the portfolio. The Treasury concluded a swap agreement for fixed versus variable interest in connection with the eurobond issue in summer 2014. If market conditions allow, the aim is to conclude agreements swapping variable and fixed interest rates in the domestic market in coming years, thereby increasing the weight of variable rates in the loan portfolio.

### **5.1.2 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 assets it owns offset its foreign debt. The Treasury's foreign-denominated assets are a part of the Central Bank's international reserves. The currency composition of the Central Bank of Iceland's reserves is actively managed according to set guidelines. One of the Bank's objectives of the Central Bank is to minimise the exchange rate risk of the reserves.

### **5.1.3 Inflation risk**

Inflation risk is the risk that indexation on index-linked Treasury bonds will raise the Treasury's financing costs as a result of increased inflation. At year-end 2019, the Treasury's indexed debt amounted to ISK 238bn, or around 27% of its debt portfolio. With buybacks of nominal bonds in 2018, the ratio of indexed-linked loans has risen further. According to Treasury debt management criteria, attempts shall be made to keep this ratio at or below 30%. As is discussed in



Section 5.1.1.1, the Treasury began issuing interest rate swaps in the autumn with the aim of reducing its indexation imbalances. The Treasury holds a number of inflation-indexed assets, such as loans to the Icelandic Student Loan Fund. This mitigates inflation risk. The Treasury's indexation balance is still negative, however, although attempts will be made to reduce the imbalance in coming years.

## 5.2 Refinancing risk

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

The largest Treasury bond maturities in the years to come – and therefore the greatest refinancing risk in the portfolio – will be in 2020, 2021, 2022 and 2024 as is mentioned above. Continued effort will be made to reduce refinancing risk with buybacks or switch auctions prior to maturity.

## 5.3 Contingent liabilities

Contingent liabilities are the fiscal risks the State has to bear, such as those due to State guarantees or Government decisions to intervene in the management of municipalities or companies that play a key role in the society. The scope of this risk is discussed in Sections 5.3.1 – 5.3.3.

### 5.3.1 State guarantees

State guarantees represent the Treasury's greatest contingent liabilities. 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 balance of State guarantees at the end of October 2019.<sup>4</sup>

---

<sup>4</sup>Market Information, February 2018. (<http://www.lanamal.is/en/news/market-information>)

## Treasury guarantees as of October 2019

	Amounts in ISK millions	Percentage
Housing Financing Fund	758,318	82%
Landsvirkjun	87,252	9%
Other institutions	80,004	9%
<b>Total</b>	<b>925,574</b>	<b>100%</b>

Table 5

**Housing Financing Fund**

The Housing Financing Fund (HFF) has operated under the auspices of the Act on Housing Affairs, no. 44/1998. In the recent term, its role has changed; instead of being primarily a lender, it is now an institution responsible for administration of housing affairs. In December 2019, Parliament approved the division of the HFF into two parts: the Housing and Construction Agency (HMS) and the ÍL Fund. The HMS will oversee social lending and support the authorities' housing affairs policies. The ÍL Fund will hold all of the HFF's assets apart from social loans, plus all of the Fund's obligations. The objective of splitting up the HFF is to ring-fence the Fund's legacy problems, which primarily entail the imbalances that have developed in its balance sheet as a result of prepayment and early retirement of loans. The ÍL Fund will process assets and liabilities with the aim of reducing the risk and expense incurred by the Treasury. Administration of the ÍL Fund will be transferred to the Ministry of Finance and Economic Affairs, as the Fund's tasks are closely related to Treasury debt and asset management. The Minister shall appoint a three-member task force, which will submit processing proposals to the Minister. No specific capital ratio will be required, and at the turn of the year, market making with HFF bonds will be discontinued and the HFF's credit rating will no longer be assessed.

**Landsvirkjun**

Landsvirkjun's operations have been successful in the recent term. The company's equity ratio has strengthened in the past few years and is now close to a historical high, at 51% as of end-Q3/2019. Its net liabilities have declined significantly since 2012, and this, together with improved borrowing terms, have had a positive impact on its performance. At the end of Q3/2019, its net liabilities totalled USD 1,713m. In recent years, Landsvirkjun's financing has been without a Treasury guarantee, and its older debt, which does still bear a guarantee, is rapidly declining as debt is paid off. The company's profit before depreciation and financial items totalled USD 281m at the end of Q3/2019, and the net profit for the period amounted to USD 128m. Landsvirkjun's financial risk consists of market risk, liquidity risk, and counterparty risk. Its market risk is primarily of three types, relating to developments in aluminium prices, interest

rates, and currency exchange rates. The company has worked systematically to reduce its market risk through derivatives contracts, modifications to the loan portfolio, and amendments to electrical energy contracts. Its counterparty risk is primarily due to electrical energy contracts with manufacturers and derivatives contracts entered into for hedging purposes. Risk is limited through requirements concerning counterparty quality.

### **5.3.2 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. As such, some local governments' high debt levels and weak financial position give cause for concern.

In 2011, Parliament passed the Local Government Act, which 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, it is stipulated that local governments' 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 a few years to adjust their debt position to the new maximum. The adaptation period provided for in the Act is 10 years. It is important to use this time well so that local governments' finances can be placed on a sustainable footing as soon as possible. According to the Act, municipalities' decisions on 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.

The aim of the Act on Public Finances, no. 123/2015, is to promote sound economic policy and strong, responsible management of public sector finances. The Act entails significant changes, and the public sector must comply with a fiscal rule that applies to both the overall balance and public sector debt.

### **5.3.3 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 budgetary allocations. The main public-private partnerships currently underway are the operation of the Harpa Concert and Conference Centre and the construction of the Vaðlaheiðargöng tunnel.

## 6. Institutional structure

Parliament authorises the Ministry of Finance and Economic Affairs to borrow funds and issue Government guarantees each year, in accordance with the National Budget. According to the Act on Government Debt Management, the Ministry of Finance and Economic Affairs is responsible for and oversees debt management and Government guarantees. The Ministry 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.

### 6.1 Ministry of Finance and Economic Affairs

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

### 6.2 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.<sup>5</sup> The purpose of the agreement is to promote more economical, efficient, and effective debt management based on the Ministry's debt management strategy.

A separate department within the Central Bank, Government Debt Management, handles debt management on behalf of the Ministry and ensures that Treasury debt is consistent with the guidelines set 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.

---

<sup>5</sup>The Government Debt Management Agreement of 29. January 2019 based on the agreement of 4 September 2007.

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 such guarantees if authorised by Parliament.

On behalf of the Ministry of Finance and Economic Affairs, Government Debt Management provides market agents with regular information on domestic and foreign Treasury bonds. It also publishes a calendar of scheduled auction dates and annual issuance plans based on the Treasury's projected borrowing need. Furthermore, the department issues press releases on debt management on behalf of the Ministry of Finance and Economic Affairs.

### **6.3 Consultative Committee on Debt Management**

The Ministry of Finance and Economic Affairs appoints a Consultative Committee on Debt Management whose members represent the Ministry and the Central Bank.

The Consultative Committee serves as a forum for the exchange of views on the situation and outlook for capital markets, and on the Treasury's domestic and foreign borrowing and borrowing plans. The Committee is also intended to promote any improvements to the domestic credit market that it deems warranted.

The Consultative Committee makes proposals to the Ministry of Finance and Economic Affairs on the structure, maturity, and size of specific bond series, as well as on 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 meets on a regular basis, or as often as is deemed necessary.

## 7. Disclosure of information to market participants

The Ministry of Finance and Economic Affairs and Government Debt Management attempt to maintain effective communication with market participants through regular publications and meetings with both primary dealers and investors. Press releases are published by the Nasdaq Iceland exchange and on the Bloomberg information system, as well as being distributed to the media and to market agents. The Government uses GlobeNewsWire to broadcast 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*

### 7.1 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
- Treasury debt structure
- Risk management
- Contingent liabilities

### 7.2 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 contains the following information:

- Total issuance volume for the coming year
- Issuance policy for the year
- Buybacks
- Switch auctions

## 7.3 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

## 7.4 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.

## 7.5 Planned auction dates

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

## 7.6 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
- Balance of benchmark Treasury bonds
- Treasury debt structure
- Treasury redemption profile
- Owners of Treasury securities
- Balance of securities loans
- Balance of State guarantees

## 7.7 Government Debt Management website

Government Debt Management publishes information on Treasury debt on the website [www.lanamal.is](http://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 on the site:

- *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](http://www.fjr.is).

## **7.8 Primary dealers in Treasury securities**

Government Debt Management conducts daily monitoring to ensure that primary dealers fulfil their obligations in connection with market making in the secondary market for Treasury securities. Meetings are held with them at least quarterly, and more often if necessary.

## **7.9 Investors**

Representatives from Government Debt Management and the Ministry of Finance and Economic Affairs meet regularly with investors to present Treasury debt management priorities to them.





