Credit Objective

Key market performance

		Curr	1d chg	1w chg
iTraxx Sr8	Master - 5Y	81.0	-0.5	14
	HiVol	125.0	2.5	23
	Sen Fins	76.0	0.0	19
	Sub Fins	121.0	0.0	34
	Crossover	487.5	-1.8	81
	Master 5/10Y	6.0	0.0	-6
CDX * Sr9	IG - 5Y	110.0	0.0	13
	HiVol	264.0	0.0	30
	Crossover	350.0	0.0	40
iBoxx * Eur	Non-Financials	105	1	7
	Non-Financials - BBB	148	3	11
	Telecoms	126	2	10
	Non-Financial Hybrids	254	11	20
	Financials	146	5	13
	Bank T1	287	17	31
	Insurance sub	197	6	14

*Source: BNP Paribas, iBoxx * One day lag*

Upcoming credit events

Date	Company	Detail
23-Jan	Carrefour	Sales 2007 FY
23-Jan	Sallie Mae	Results

Source: BNP Paribas, Bloomberg

Upcoming economic events

	Event	Prev	BNPP	Cons
Eurozone	PMI Manufacturing (Jan)	52.6	52.1	52.2
Eurozone	Industrial Orders y/y (Nov)	2.5%	0.5%	1.5%
UK	BoE MPC Minutes	n/a	n/a	n/a

Source: BNP Paribas, Bloomberg

INSIDE

- **Icelandics – No Melting Down**

Market commentary

Following the large declines within the equity markets, speculation was rife on Tuesday morning that there would be concerted rate cuts by the major central banks. The Fed alone acted with an unprecedented 75bp inter-meeting rate cut, before the US opening.

The emergency rate cut took the Fed Funds down to 3.50%. Although this did provide some support to equity markets, with European equities turning positive and US equity futures gaining around 4% from their lows, market sentiment quickly shifted into forecasting the timing and the size of the next rate cut. Our economists believe the wording of the Fed statement seems to exclude further action on 30 January, by implying that additional moves will be data-driven and that the FOMC will continue to assess the situation in thefinancial markets. The rate cut did not provide any new information regarding the US and global macroeconomic outlook, which remains bleak. US equities had relatively low losses compared with yesterday's performance of European equities, though volatility spiked, as the VIX exceeded 37.5% intraday.

We note that the Fed cut was delivered despite Bernanke's well-known reluctance to take inter-meeting actions. This is an additional defeat for the Chairman, who already had to abandon ambitions on inflation targeting, as concern over growth increased. Although a rate reduction can ease the lack of liquidity or the conditions of heavily indebted corporates, it can do little to mitigate counterparty risk or to quickly solve the stress accumulated in the structured credit market over the past months. Fed Funds futures point to a serious possibility of another 25bp cut next week at the scheduled FOMC meeting and market movements seem to favour such additional step.

The inter-meeting move by the Fed arguably relieves some of the pressure on the ECB to intervene. The ECB will most likely wait and see what the reaction is. If the Fed's move does prove temporary in terms of raising confidence and stalling the large declines across the equity markets, then the ECB will be forced to cut too.

Credit indices opened significantly wider in the morning, with the Crossover up to 530bp, but retraced to close the day at around 490bp for the Crossover and 80bp for the Master even after the Fed's announcement. The iTraxx financial senior reached a high of 80bp and tightened later to 76bp. The US CDX IG opened with a very wide print of 125bp, which reduced to 118bp at the time of writing.

US financials' earnings release

Results from the major banks (BAC, WB etc.) confirmed that the economic slowdown continues to have a direct impact on earnings. Both BAC and WB reported disappointing earnings that were below consensus (BAC EPS: 5¢ vs. consensus of 21¢; WB EPS: 8¢ vs. consensus of 0.33¢). The other banks – National City, Fifth Third and KeyCorp – all reported a loss or disappointing earnings. Bank earnings were affected by significant CDO writedowns (BAC: $5.3bn, WB: $1bn) coupled with a general increase in loss provisions due to a general deterioration in asset quality. Not unexpectedly, Ambac posted a $3.3bn loss – its biggest ever – after writing down the value of its guarantees on subprime debt. The company's new interim CEO said that the company is "exploring the attractiveness of various alternatives" leading to a rally in its CDS and stock prices.

More earnings are due tomorrow, from banks and homebuilders (including SunTrust Bank, SLM Corporation, Colonial Bank, Sovereign Bankcorp, Capital One and Ryland). The street has downgraded its guidance on many US banking institutions since early January, Suntrust, Sovereign and Cap One in particular.

Credit news

■ Quebecor North America's second-largest publicly traded printer, sought protection from creditors in the U.S. and Canada after it failed to secure refinancing as talks over a rescue deal failed. S&P cut its ratings to D. The downgrade follows Quebecor World's non-payment of interest expense on its $400 million 9.75% senior unsecured notes, which was due 15 January 2008 and its subsequent bankruptcy filing. The company was rated BBB- as late as May 2005 (S&P).

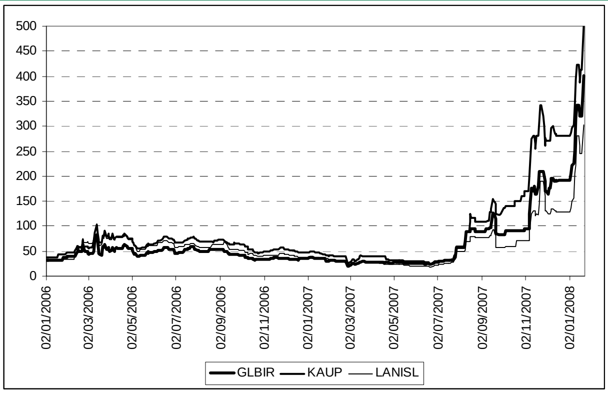
Credit Portfolio Strategy

Fundamental News

Icelandics – No Melting Down

We have been negative on Icelandic banks since early October, but Q4 reporting next week for these banks and current repricing has forced us to review our stance. Our preference in terms of credit quality from best to worst among these banks is LANSIL, GLBIR, and KAUP, so we agree with how the market is pricing it.

5Y senior mid CDS



Source: BNP Paribas

Concerns initially over Gnúpur Investment Co sparked a significant widening of Icelandic banks' bond and CDS spreads a couple of weeks ago, and spreads have never recovered.

In our view, the market initially overreacted about concerns over investment companies, and since then Icelandic banks have been punished by market risk aversion and a general bear market. To put things into perspective, KAUP 5-year senior CDS are trading around 555/570bp as we write, implying a breakeven default probability of 38% over five years and 13% over one year. This probability includes both default and market risk; however, we struggle to imagine KAUP defaulting. While we remain cautious on Icelandic banks' fundamentals, we feel that current spreads offer some opportunities, especially in Landsbanki. Although we believe the market also overreacted on Kaupthing, we are less comfortable with this name and feel that it is the one on which Icelandic fears tend to crystallise. We look into some of the issues here.

Gnúpur was founded in October 2006 and bought some large stakes in Icelandic blue chips, presumably at the top of the market. But a volatile stock exchange led to values falling, margin calls and forced sales by Gnúpur. Gnúpur agreed a financial restructuring with creditors. The questions we consider are: Who are the creditor banks? How bad is this exposure for the banks, especially if including exposure to similar investment companies? What are the wider market implications?

Who are the creditor banks?

KAUP said it was not the corporate bank of Gnúpur, and that therefore any losses endured by KAUP due to recent developments will be insignificant; which leaves GLBIR and LANISL, and both have said that their exposure is not significant. KAUP said Gnúpur was a shareholder in Kaupthing and FL Group. These shareholdings have now almost been sold entirely to other investors. Since the restructuring Kaupthing's exposure to Gnúpur is zero.

GLBIR said it is not an equity investor in Gnúpur and that the company is not one of its large exposures, adding that recent events relating to Gnúpur will not have a significant impact on the bank's asset quality.

LANISL said that Gnúpur is a small company (we understand €200mn of net equity when the company started, but it was since leveraged). The bank said it was involved in the restructuring of Gnúpur, but that it lost no amount in the process. The bank says its exposure is limited and potential loss negligible, if any.

How bad can exposure to investment companies get for the banks?

More importantly, will Gnúpur's woes trigger a domino effect with other investment companies and therefore compound the problem for the Icelandic banks? This is the risk, although Gnúpur was the most recent investment company, and therefore the one with highest acquisition prices so likely to suffer the heaviest losses.

Concerns extended to Exista and FL Group, the two biggest listed investment companies in Iceland. Exista, founded in 2001, had total assets of €8.5bn at the end of Q3 2007 and has a current market cap of ISK149bn (€1.55bn). It is also a significant shareholder of Kaupthing (23%) and Sampo Group (20%). On 10 January, it gave an update on its funding and liquidity position. It said that as of 31 December it had committed liquidity that covered refinancing needs for 50 weeks (42 weeks if Exista's full commitment of 35mn shares in Kaupthing Bank's right issue is included). The refinancing need for the year 2008 amounts to a total of €1.2bn, weighted towards the latter part of the year. Exista will publish its annual accounts for 2007 on 31 January, which will include a further update of the Group's funding and liquidity position.

FL Group was originally established in 1973, albeit under a different name, and has ISK101bn (€1.05bn) in market cap currently. It is a significant shareholder in Glitnir, with a 29% stake. In December, FL Group announced two separate equity increases of ISK10bn and ISK54bn, leading to ISK180bn (€1.9bn) in total equity. The larger of the two increases was due to finance the acquisition of holdings in property companies. It announced on 21 January that it had divested part of its holding in Commerzbank (currently 1.15% from 2.9% at end 2007 and 4.3% at end Q3 2007). Total realized and unrealized losses were ISK2.6bn (€27mn).

KAUP is not disclosing its exposure to Exista. However, the bank is not concerned about that exposure and feels that both the company itself – despite recent market turmoil – and the collateral and guarantees KAUP has against this exposure are in good standing. This seems to be corroborated by Q3 accounts showing that lending to significant related companies (including Exista) amounted to ISK68bn, down almost 38% since end 2006 and a relatively small amount of the total loan book (2.2%).

KAUP continues to say that its exposure to general Icelandic Investment Companies with a pledge over shares listed on OMX is only a 'minor' part of the loan book. The Central Bank of Iceland estimated that at the end of 2006, 12% of Icelandic banks' lending was against share collateral. Finally, according to the bank, the loan book has proven to be resilient despite the sharp fall in share prices over the last few weeks and most Investment Companies have met collateral requirements in a timely manner as they have been building up equity in the booming equity markets over the last few years. The bank added that it is satisfied with its exposure and the level of over-collateralisation it holds against such loans.

LANISL's exposure to similar Investment Companies would be limited and the bank does not see this as a major issue. It has collateral, over-collateralisation and margin calls in place.

Seeking to reassure, the Icelandic FSA issued a statement, arguing that the market reaction did not give an accurate picture and that the risks associated with Icelandic banks had been exaggerated. Nevertheless, it is worth revisiting some of the perennial issues surrounding the Icelandic banks.

Equity exposure

Equity exposures have also been reduced since early 2006; however, they remain significant, especially at KAUP and LANISL, with net equity exposure representing 50% and 38% of equity capital respectively, versus a figure of 12% for GLBIR. This is particularly important in the context of a bearish equity market. KAUP is saying that of its equity exposure, only 28% is to the Icelandic stock exchange: Stockholm represents 43%, with the rest spread over Scandinavia and London. However, Financials (the hardest hit at the moment) is the biggest equity exposure in terms of sector (41%), the next sector, Consumer Luxury, representing only 16%.

There have also been concerns that some equity exposure is indirect through lending against share collateral. Again however, these concerns should be somewhat mitigated by the fact that the Central Bank of Iceland estimates that at the end of 2006, 12% of Icelandic banks' lending was against share collateral.

Reliance on wholesale markets

Deposits-to-loans ratios have improved since the early 2006 Icelandic crisis (KAUP 44%, GLBIR 39% and LANISL 76%). However, Icelandic banks remain reliant on wholesale markets, and therefore the current widening in financials brings financing issues up again. KAUP said at a recent equity roadshow that it has sufficient secured liquidity for the next 360 days. However, if cash and CDS levels remain where they are, funding will again become increasingly an issue.

Glitnir said it is in a good position with more than €6bn of funds immediately available, with maturing long-term debt of €2.5bn in 2008 for the parent company and €1bn for its Norwegian subsidiary. The decision two weeks ago by the Central Bank of Iceland to alter the rules on collateral in regular transactions with the Central Bank will improve the Icelandic banks' liquidity position even further. We would expect updates on the banks' liquidity position next week at the Q4 reporting. However, we feel more comfortable with Landsbanki largely because of its higher proportion of funding with deposits.

Over-reliance on Iceland

Again, this has been reduced over the last few years, but Iceland still represents 53% of income at LANISL and 47% at GLBIR. For KAUP, Iceland represented 34% of operating income at the end of September 2007, while the UK represented 31% and Scandinavia 25%. The loan portfolio exposure was 22% Iceland, versus 37% Scandinavia and 20% UK.

Stress-testing by the Icelandic Supervisory Authority (FME) gives some comfort

Icelandic banks all pass regular stress testing by the FME. The test includes the following scenarios: a 20% fall in value of non-performing/impaired loans, a 25% fall in value of foreign shares, a 35% fall in value of domestic shares, 7% fall in value of bonds and 20% weakening of the Icelandic Krona.

Based on these scenarios, the results at the end of June 2007 were: a 1.1% hit on the capital ratio at KAUP (if applied to Tier 1, this would result in a Tier 1 ratio of 9.2%); for GLBIR, the impact was 0.7% (resulting in a Tier 1 ratio of 8.7%); and 2.5% for LANISL (resulting in a Tier 1 ratio of 8.6%), which is a manageable impact.

Olivia Frieser, Axel Swenden

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Recommendation System:

Type	Terminology	Horizon
Credit Trend (1)	Positive/ Stable/ Negative	6 months
Investment Recommendation (2)	Buy/ Add/ Hold/ Reduce/ Sell (*)	Up to 6 months

(1) Credit Trend is based on underlying Credit fundamentals, business environment and industry trends;
(2) Investment Recommendations are as follows:
(*) Buy: Maximise exposure based on improving financial profile and/or significant under-valuation.
Add: Overweight exposure within industry sector/index, based on improving financial profile, and/or defensive characteristics and/or cheap valuation.
Hold: Maintain position based on stable credit fundamentals and/or average expected return characteristics within peer group
Reduce: Underweight exposure within industry sector/index based on weakening financial profile, increased volatility and/or rich valuation.
Sell: Sell exposure/Maximise protection largely based on deteriorating credit fundamentals, negative headline/event risks and/or significant over-valuation.

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