Box 1

Non-residents' issues of króna-denominated bonds

At the end of August it was reported that several foreign issuers, including the Republic of Austria, had issued bonds denominated in Icelandic krónur. Although the rates of interest are high by international standards, they are just below Icelandic bond yields. Maturity is 12, 18 or 24 months.

The following is a brief account of the issuance process and the gains for the issuer. The foreign party issues bonds denominated in Icelandic currency at interest rates slightly below those in Iceland. He sells them to buyers who are attracted by the high interest rate and are prepared to take an exchange-rate risk. The issuer is paid in krónur for the bonds and he makes a swap agreement with the lead manager of the offering to hedge against the exchange-rate and interest-rate risk of the króna. The issuer still needs to pay interest in the swap currency, e.g. US dollars or euros. Then the lead manager makes a corresponding swap agreement with an Icelandic bank to eliminate his risk completely. The Icelandic bank prices the swap with respect to the hedging cost, i.e. what it costs to buy Icelandic instruments in the domestic market, for example T-notes maturing in 2007 or the interest-rate cost on a loan in the interbank market for domestic currency. Conceivably, the foreign broker can take the króna risk himself and then hedge the deal by buying Icelandic instruments in the Icelandic market. An Icelandic bank might already own suitable instruments in its portfolio, removing the need to enter the domestic securities market.

The issuer gains from being able to sell high-interest instruments during a period of low interest rates while taking neither exchange-rate risk nor interest-rate risk. On maturity the swap is reversed, the issuer receives krónur plus the spread and uses this to pay the buyer of the bonds.

The buyer of the bonds earns a high rate of interest but takes an exchange-rate risk. He needs to buy krónur for delivery to the issuer of the bonds on the day of purchase, then on maturity he receives krónur that he must sell. Since the trades are made in the Icelandic forex market, they have an exchange-rate effect. There is little point for the buyer to hedge against exchange-rate risk, since this would wipe out the gain on the interest rate. Conceivably, if the exchange rate of the króna develops very unfavourably for the holder of the instruments, he could sell them forward to remove the risk, but would have to accept the loss so far and the spread, as well as forgoing a conceivable gain if the exchange-rate trend unwinds.

The króna appreciates on the initial transactions, i.e. when the buyer acquires Icelandic currency to pay for the bonds. This is reversed on maturity. Hedging measures stimulate demand in the Icelandic securities market, so that yields fall. The small size of the Icelandic securities market limits the available hedging opportunities, which will gradually erode the gains from ongoing transactions of this kind.