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Update

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Government of Iceland – A3 Stable

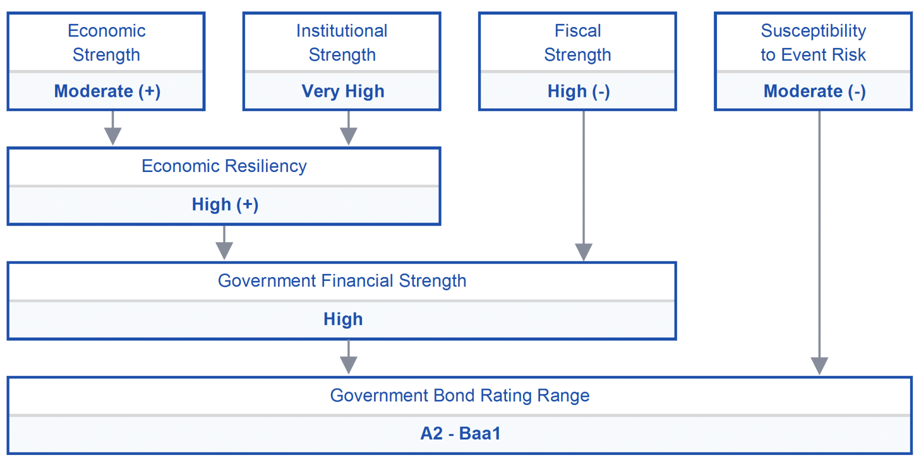
Update Following Recent Upgrade, Concluding Rating Review

Summary Rating Rationale

» Iceland's **credit strengths** include (1) economic flexibility and wealth, which provide significant shock-absorption capacity; (2) a deep natural resource base that affords robust growth potential; (3) strong institutions focused on avoiding vulnerabilities that led to 2008 banking sector collapse; and (4) a well-funded pension system, long working lives and favorable demographics.

» Iceland's **credit challenges** include (1) a very small economy subject to high volatility; (2) substantial, albeit reduced, exposure to external risks, which requires careful management of capital account liberalization to protect economic and financial stability; and (3) large contingent liabilities derived from state-owned companies.

Exhibit 1
Iceland's A3 stable rating is determined by four factors



Source: Moody's Investors Service

This Credit Opinion provides a discussion of the credit rating(s) for the Government of Iceland and should be read in conjunction with Moody's most recent Credit Analysis and rating information available on Moody's website.

Key Indicators

Iceland	2010	2011	2012	2013	2014	2015	2016F	2017F
Real GDP (% change)	-3.6	2.0	1.2	4.4	2.0	4.0	5.0	3.9
Inflation (CPI, % change, Dec/Dec)	2.5	5.3	4.2	4.1	0.8	1.9	2.3	4.2
Gen. Gov. Financial Balance/GDP (%)	-9.8	-5.6	-3.7	-1.8	-0.1	-0.5	17.1	0.9
Gen. Gov. Primary Balance/GDP (%)	-5.0	-1.4	1.0	2.7	4.7	3.9	20.7	3.6
Gen. Gov. Debt/GDP (%)	100.2	115.2	100.2	91.3	84.7	68.5	55.2	49.6
Gen. Gov. Debt/Revenues (%)	252.9	287.1	240.5	216.8	187.1	162.2	93.6	118.1
Gen. Gov. Interest Payment/Revenues (%)	12.0	10.3	11.3	10.9	10.4	10.5	6.0	6.5
Current Account Balance/GDP (%)[1]	-0.9	-0.5	0.5	7.2	5.0	4.8	4.0	2.3
External Debt/CA Receipts (%)[2][3]	504.9	409.6	366.1	410.3	358.5	307.1	231.9	224.0
External Vulnerability Indicator [4]	109.1	145.5	46.3	78.8	123.5	66.9	56.8	48.2

[1] Excludes DMBs undergoing winding up in 2008-2015.
[2] Current Account Receipts
[3] The services component of current account receipts is not adjusted to account for FISIM services related to the DMBs undergoing winding up. The primary income receipts are adjusted to account for FISIM services related to the DMBs undergoing winding up.

[4] (Short-Term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/ Official Foreign Exchange Reserves

Summary Rating Rationale (continued)

On 1 September 2016, we upgraded Iceland's government bond and issuer ratings to A3 from Baa2, concluding the review that we initiated in June 2016. The two-notch upgrade of Iceland's government rating reflects the speed and extent of the country's recent progress in recovering from its 2008 banking crisis. Sustained growth and fiscal restraint allowed a very sizeable reduction in government debt over the past year, which we expect to continue and to be sustained with the deployment of the proceeds of the failed banks' estates over the coming years.

Iceland's rating trajectory has lagged the improvement in some of its core fundamentals since the financial crisis, because of the residual risks posed to economic and financial stability by the complex process of removing the capital controls first imposed in 2008. However, cautious but steady progress in addressing the problems in the banking sector and in relaxing capital controls has considerably reduced the risks to economic and financial stability from the final stages of capital account liberalization.

Among the key credit strengths supporting Iceland's A3 credit rating are its high levels of wealth and strengthening economic dynamism thanks to favorable demographics and improving household, corporate and government balance sheets. Accumulated wealth provided an important buffer during the severe economic adjustment after the banking crisis. The economic recovery is on a more sustainable footing than was growth in the pre-crisis era given the rebalancing of the economy and large external surpluses, which are bringing down the country's once-sizeable public and external debt.

The country's public finances have improved significantly, and the government's gross debt burden – while still high – has declined rapidly from 2012 onwards. If the government's large cash buffers are taken into account, the public debt is at a moderate level in the European context. In addition and in contrast to many other highly-indebted European countries, Iceland has a nearly fully funded private pension system, which bodes well for long-term fiscal sustainability.

According to our sovereign bond methodology, Iceland exhibits `moderate (+)' Economic Strength. Iceland's GDP-per-capita is among the highest in the universe of Moody's-rated sovereigns, despite the significant loss in wealth owing to the banking and currency crisis of 2008, at $46,097 on a PPP basis as of 2015. This positions Iceland in the same territory as Aa-rated sovereigns (median per-capita GDP in 2015 of $46,783) and as a clear outlier in the A-rating range ($29,156).

In addition to high income levels, Icelandic households possess substantial pension assets amounting to more than 150% of GDP. This is not only positive for the long-term underlying fiscal position of the country, but also allowed a relatively smooth adjustment process following the banking system's collapse as households could temporarily withdraw money from their pension savings for debt repayment and consumption purposes. Offsetting the high level of wealth is the small size of the economy, which increases its vulnerability to shocks.

We assess Iceland's Institutional Strength as `very high', reflecting the country's strong scores on the Worldwide Governance Indicators (WGI). Iceland ranks at the 86th percentile of the WGI's measure of "Government Effectiveness" and the 87th percentile of "Rule of Law", well above the A-rating category median. Iceland benefits from clear competitive strengths in areas such as its high-quality education system, an innovative business sector, an efficient labor market and well-developed infrastructure.

In addition, the authorities have made significant progress in bringing the economy, the financial system and the public finances back onto a sustainable path. The government has implemented important changes to its institutions and to the banking sector's regulatory framework – with the latter focusing exclusively on domestic operations – so as to avoid a repeat of the factors that led the crisis. Finally, Iceland has a long tradition of broad cooperation and consensus on economic matters between government, employer and employee associations, which is a credit strength.

We consider Iceland's Fiscal Strength to be `high (-)', a function of Iceland's rapidly declining, gross general government debt-to-GDP ratio. The foreign currency portion of the government's debt is also shrinking quickly, having fallen to 20.3% in 2015, exposing the sovereign balance sheet to less exchange rate risk. However, the government's contingent liabilities are very large, mainly guarantees for Housing Financing Fund (HFF) liabilities. A mitigating factor is the significant financial assets that the government has acquired as part of the resolution of the failed bank estates, which will be deployed to pay down government debt in coming years.

We assess Iceland's Susceptibility to Event Risk as `moderate (-)', mainly reflecting the risks to economic and financial stability emanating from the process of capital control liberalization. Risks to financial stability from the banking sector have moderated significantly since the 2008 banking sector crisis. In our view, the banking system should be able to withstand the relaxation of capital controls, as the central bank and the banking regulator require the banks to maintain very high levels of liquidity and capital.

Rating Outlook

The stable outlook speaks to the balance of risks that we foresee for the rating at the A3 level. We expect growth in the coming years to be moderate but balanced, supported by the further liberalization of capital controls. Enhanced regulation is expected to maintain the capitalization and stability of the banking system, including by preventing its overseas expansion along the lines seen prior to the crisis.

Countervailing risks are being addressed. Iceland has been attracting substantial capital inflows, which are likely to continue given higher interest rates, low inflation and the economy's favorable prospects. In response, the central bank put in place a Capital Flow Mechanism (CFM) in June this year to discourage short-term speculative capital inflows.

The authorities are alive to the potential pressures implied by high employment levels and the high pay awards granted last year. And while the emergence of the Pirate Party creates a level of uncertainty as to the direction of future policy following the upcoming election on October 29, we do not believe that it will change materially given the country's consensus-based politics.

Factors that Could Lead to an Upgrade

We could upgrade Iceland's ratings (i) once the relaxation of controls on capital outflows, including the liberalization of offshore krónur, is completed, (ii) if accompanied by an improvement in government debt and debt service metrics by end-2018 that is beyond current expectations, and (iii) assuming the rating agency continues to expect that the government's management of the economy and banking system will ensure that the boom-bust cycles and macro imbalances of the past will be avoided.

Factors that Could Lead to Confirming the Current Baa2 Rating

Downward pressure on Iceland's ratings could develop if economic or financial volatility were to re-emerge and threaten debt sustainability, particularly should Iceland again have to resort to capital controls.

Recent Developments

The economy is now growing rapidly, led by robust household spending and investment, including expansion of the fast-growing tourist infrastructure. We expect growth to reach 5% this year, led by buoyant domestic demand and tourism, and by 3.9% in 2017. Iceland's economic recovery has benefitted from favorable terms of trade because low oil prices and a strong dollar boosted revenues from the mostly dollar-denominated export base. Moreover, the authorities have resolved a large portion of the external debt overhang that led to the systemic financial crisis.

The current account surplus is likely to narrow in the coming years as aggregate demand strengthens, pulling in imports, and as the benefits of lower oil prices tail off, although the surplus is still large. Positive and sustained balance of payments dynamics have allowed the Central Bank of Iceland (CBI) to purchase substantial foreign exchange in the FX market, bolstering its free FX reserves.

The impact of high public and private sector wage settlements on inflation has been kept in check by the tightening of monetary policy last year, the exchange rate's appreciation and the renewed downturn in oil prices. Inflation moderated to 1.1% y-o-y in July, below the Central Bank's 2.5% inflation target band and somewhat lower than the 1.6% in 2015.

An anticipated further reduction in debt to GDP derives in large part from the deployment of the assets received in last year's resolution of the failed bank estates to pay down debt. It also reflects ongoing fiscal consolidation, enacted under a medium term fiscal strategy devised consistent with the Organic Budget Law passed in December 2015 and its accompanying fiscal rules.

In June 2016, the central bank auctioned part of its FX reserves for offshore krónur (mainly non-resident-owned ISK assets trapped when capital controls were imposed in late 2008 at the time the old banks collapsed), thereby further reducing the overhang of such assets. The auction was successful insofar as it cleared approximately one-third of the offshore krónur overhang, with 98.4% of the offers accepted in the auction and subsequent tender. However, the largest holders of offshore krónur demurred from participating, leaving approximately ISK 237 billion outstanding. While the few remaining holdings of offshore krónur are sizeable at 8% of GDP, we believe that the event risk they pose for Iceland's external position is very limited.

The liberalization of capital controls on residents will begin immediately after parliamentary approval of the relevant legislation, followed by a further easing of such controls on January 1, 2017. The unwinding of restrictions will begin by reducing or removing restrictions on various type of capital outflows such as for external debt payments, FDI and real estate investments, among others.

We expect that the prospect of capital controls on residents being relaxed poses only a limited risk to the Icelandic economy and financial system. National savings are high and the external position is in surplus, both on a flow (current account) and a stock (Net International Investment Position) basis. Icelandic banks are highly liquid and have access to both foreign and domestic capital markets. The central bank's FX reserves are above the IMF's Reserve Adequacy Metric, the level recommended by the IMF for the start of capital controls being liberalized. While some downward pressure on the 'onshore' exchange rate is to be expected in the next few months, the inflationary impact is likely to be rather contained and the devaluation would support competitiveness and narrow the gap between the onshore and offshore exchange rates.

Rating Methodology and Scorecard Factors

Rating Factors Grid - Iceland

Rating Factors	Sub-Factor Weighting	Indicator	Factor Score
Factor 1: Economic Strength			M+
Growth Dynamics	**50%**		
Average Real GDP Growth (2011-20F)		3.2	
Volatility in Real GDP Growth (Standard Deviation, 2006-15)		4.0	
WEF Global Competitiveness Index (2015)		4.8	
Scale of the Economy	**25%**		
Nominal GDP (US$ billion, 2015)		17	
National Income	**25%**		
GDP per Capita (PPP, US$, 2015)		46,097	
Factor 2: Institutional Strength			VH
Institutional Framework and Effectiveness	**75%**		
Worldwide Government Effectiveness Index (2014)		1.5	
Worldwide Rule of Law Index (2014)		1.7	
Worldwide Control of Corruption Index (2014)		1.8	
Policy Credibility and Effectiveness	**25%**		
Inflation Level (%, 2011-20F)		3.2	
Inflation Volatility (Standard Deviation, 2006-15)		3.7	
Economic Resiliency (F1xF2)			H+
Factor 3: Fiscal Strength			H-
Debt Burden	**50%**		
General Government Debt/GDP (2015)		68.5	
General Government Debt/Revenues (2015)		162.2	
Debt Affordability	**50%**		
General Government Interest Payments/Revenue (2015)		10.5	
General Government Interest Payments/GDP (2015)		4.4	
Government Financial Strength (F1xF2xF3)			H
Factor 4: Susceptibility to Event Risk	**Max. Function**		M-
Political Risk			
Worldwide Voice & Accountability Index (2014)		1.4	
Government Liquidity Risk			
Gross Borrowing Requirements/GDP		-4.1	
Non-Resident Share of General Government Debt (%)		36	
Market-Implied Ratings		A3	
Banking Sector Risk			
Average Baseline Credit Assessment (BCA)		--	
Total Domestic Bank Assets/GDP		189	
Banking System Loan-to-Deposit Ratio		123	
External Vulnerability Risk			
(Current Account Balance + FDI Inflows)/GDP		7.1	
External Vulnerability Indicator (EVI)		48.2	
Net International Investment Position/GDP		-5.9	
Government Bond Rating Range (F1xF2xF3xF4)			**A2 - Baa1**
Assigned Foreign Currency Government Bond Rating		**A3**	

Note: While the information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the rating range. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the indicative rating range.
For more information please see our Sovereign Bond Rating Methodology

Footnotes: (1) Rating Range: Factors 1, Economic Strength, and Factor 2, Institutional Strength, combine with equal weight into a construct we designate as Economic Resiliency or ER. An aggregation function then combines ER and Factor 3, Fiscal Strength (FS), following a non-linear pattern where FS has higher weight for countries with moderate ER and lower weight for countries with high or low ER. As a final step, Factor 4, a country's Susceptibility to Event Risk, is a constraint which can only lower the preliminary Government Financial Strength rating range as given by combining the first three factors. **(2) 15 Ranking Categories:** VH+, VH, VH-, H+, H, H-, M+, M, M-, L+, L, L-, VL+, VL, VL- **(3) Indicator Value:** If not explicitly stated otherwise, the indicator value corresponds to the latest data available.

Moody's Related Research

- **Rating Action**: Moody's upgrades Iceland's government ratings to A3; outlook stable, 1 September 2016
- **Rating Action:** Moody's places Iceland's Baa2 sovereign rating on review for upgrade, 10 June 2016
- **Credit Analysis**: Government of Iceland, 22 July 2015
- **Credit Focus**: Iceland, Government of: FAQ: Capital Controls and the New Liberalization Strategy, 15 July 2015
- **Country Statistics**: Iceland, Government of, 1 June 2016
- **Outlook**: Sovereigns - Global: Stable Outlook Despite Low Growth, Jittery Markets and Uneven Reforms, 4 November 2015
- **Rating Methodology**: Sovereign Bond Ratings, 18 December 2015

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