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Moody's Assigns Negative Outlook to Iceland's Rating

London, <Rating Date Pending> -- Moody's has changed its outlook to negative from stable on Iceland's Aaa government bond ratings and Iceland's country ceiling on foreign currency bank deposits. The outlooks on the Aaa/P-1 long- and short-term country ceilings for bonds and notes, both domestic and foreign currency, and the Aaa local currency bank deposit ceiling remain stable.

Among the reasons that Moody's rates Iceland at Aaa are its advanced economic structure, low government debt, high per capita incomes, and nearly fully-funded pension system. "Iceland is a highly creditworthy developed country whose public finances and wealth compare very favorably even against many of its Aaa peers," said Moody's sovereign analyst Joan Feldbaum-Vidra.

“The assignment of a negative outlook to the government’s ratings and the foreign currency bank deposit ceiling mainly reflects last week's downgrades of the country’s three main commercial banks' financial strength ratings to C-,” said Feldbaum-Vidra.

The analyst said that an important feature of a Aaa-rated sovereign is a banking system with high average financial strength ratings, and pointed out that no other Aaa country has a banking system rated below C. Since the banking system is a contingent liability of any government, she said that the lower intrinsic strength of the Icelandic banks differentiate Iceland from other Aaa countries.

Feldbaum-Vidra acknowledged that Iceland is not the only Aaa-rated country with an outsized banking sector, and emphasized that the Icelandic banks are sound, with strong franchises, healthy capital adequacy and good liquidity, and she also pointed out that the risk of a disruptive systemic stress is very low. She noted that the banks' downgrades instead reflect the more difficult operating environment in Iceland and in other countries where the banks operate, as well as the potential deterioration of their asset quality as their fast-expanding loan books begin to season in the coming years, rather than concerns about liquidity.

Indeed, Feldbaum-Vidra said the authorities almost certainly have the liquidity and other tools at their disposal to address any problems that may arise, even in the context of the current global financial environment. Still, the incremental weakening of the banks' financial strength assessments represents a corresponding risk, however minor,

for the Icelandic government, which is reflected in the negative outlook on the government's ratings.

“Even with sufficient liquidity, the current global credit conditions render Iceland somewhat more vulnerable than other Aaa sovereigns since its banks have been subjected to periods of financial contagion,” said the analyst. “It does not reflect a radical reassessment of Iceland’s credit standing but incremental concerns that the authorities should be able to address.”

The analyst stressed that the Icelandic authorities remain fully capable of handling a crisis in the banking sector, even one driven by liquidity or funding issues. However, she said, “The negative outlook indicates our view that further internationalization of the sector could stretch the authorities’ capacity to effectively respond to a crisis.”

“Given these concerns, the recent cancellation of a large acquisition by one Icelandic bank is seen as positive from the perspective of the sovereign credit rating, as it slows down the growth of banking system foreign operations, and hence potential contingent liabilities for the government,” said Feldbaum-Vidra. The analyst was referring to the cancellation of the Kaupthing Bank’s purchase of Dutch bank NIBC. “Difficult credit market conditions will also reinforce this slowdown, although with additional costs to the banks.”

Feldbaum-Vidra also explained that should the scale of the contingent liabilities recede significantly, Moody's would consider such a development positively, although in light of the highly demanding requirements that characterize a Aaa sovereign.

Any rating actions affecting other entities in Iceland will be announced separately.

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