Moody's
INVESTORS SERVICE

London, 29 July 2010 -- Moody's Investors Service has today changed to negative from stable the rating outlook for Iceland's Baa3 local and foreign currency government bond ratings.

Today's rating action was triggered by the recent Supreme Court ruling on the illegality of foreign-exchange-linked loans and government's continuing difficulties in achieving a resolution to its "Icesave" dispute with the UK and Dutch governments. Specifically, the Supreme Court ruling has the potential to cause substantial bank losses on foreign currency-denominated loans to domestic borrowers and may therefore require additional government support to the banking system. Moreover, a failure to resolve the "Icesave" dispute could lead the Nordic countries and the IMF to withhold future disbursements to the Icelandic government.

These two sources of macroeconomic uncertainty are indicative of the generally asymmetric risks facing Iceland and explains the rationale for the negative outlook on its ratings.

Moody's has today also changed the outlook on Iceland's country ceiling for foreign-currency bonds of Baa2 from stable to negative. The outlook on the foreign-currency deposit ceiling of Baa3 has also been changed to negative from stable.

RATIONALE FOR NEGATIVE SOVEREIGN OUTLOOK

"The magnitude of the banking system losses that will result from the recent court ruling is not known at this time but it is clear that Iceland still faces significant risks to its economic and financial recovery," says Kathrin Muehlbronner, a Moody's Vice President -- Senior Analyst and lead analyst for Iceland. On 16th June, the Supreme Court declared that foreign-exchange-linked loans are unlawful and non-binding.

A further ruling of the Supreme Court related to the applicable interest rate in case of loan conversion from foreign to domestic currency is expected in the autumn. It is also unclear at this juncture whether the ruling will apply to all foreign-exchange linked loans (around 50% of outstanding loans) or only a subset (e.g. only household loans). "Although banks have some buffer to absorb losses due to their currently high capitalization levels, Moody's does not rule out that Iceland's banks will be faced with further losses following the Supreme Court decision", says Ms Muehlbronner. "Moreover, this could in turn require the government to inject further capital into the banks as the only realistic provider of additional capital."

This is not the only uncertainty clouding the outlook for the Icelandic economy: A solution to the "Icesave" dispute with the UK and Dutch governments is also still outstanding. In Moody's opinion, this could potentially exert renewed pressure on the funding provided by the IMF and the Nordic governments and the timeframe for the lifting of capital controls. While acknowledging that recent economic data have largely been positive, Moody's believes that these significant and persistent uncertainties have the potential to undermine Iceland's recovery.

Moody's currently projects that real growth will turn positive in 2011, but this projection is subject to significant downside risks. Moody's notes that the Icelandic government's debt is already elevated for the country's current rating level. General government debt is projected to reach 150% of GDP this year in gross terms and 86% in net terms. Net debt is forecast to increase to almost 100% of GDP next year.

POTENTIAL TRIGGERS FOR A DOWNGRADE

Moody's says that downward rating pressure on Iceland's sovereign rating could result from (1) indications that the ongoing uncertainties will negatively impact the real economy, (2) renewed stress in the banking system and a resultant need for further capital injections by the government, which would further increase the already elevated levels of government debt, and (3) pressure on Iceland's external liquidity, which could be related to an inability to resolve the "Icesave" dispute.

Conversely, the rating agency says that positive pressure on Iceland's rating could develop if there are signs of a sustained economic recovery and successful solution to the current uncertainties.

PREVIOUS RATING ACTION & METHODOLOGY

Moody's last rating action affecting Iceland was implemented on 23 April 2010, when the rating agency changed the outlook on the Baa3 rating to stable from negative.

The principal methodology used in rating the government of Iceland is "Moody's Sovereign Bond Methodology", published in 2008. This methodology can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating these issuers can also be found in the Rating Methodologies sub-directory on Moody's website.

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