NEWS RELEASE

Nov 19, 2010

R&I Downgrades to BB+, Negative: Republic of Iceland

Rating and Investment Information, Inc. (R&I) has announced the following:

ISSUER: **Republic of Iceland**
Foreign Currency Issuer Rating

R&I RATING: BB+ (Downgraded from (BBB-); Removed from the Rating Monitor)
RATING OUTLOOK: Negative

RATIONALE:

In response to the crippling blow delivered by the global financial crisis in 2008 and the subsequent rapid deterioration in Iceland's real economy, R&I lowered the Foreign Currency Issuer Rating to BBB- and has been carefully observing the economic and other trends. Although two years have elapsed since the crisis erupted, the cleanup of excessive corporate and household debt has not progressed as expected, and Iceland has yet to find the key to economic recovery. Gross public debt has ballooned to a size that exceeds GDP. In light of these circumstances, R&I has downgraded the Foreign Currency Issuer Rating to BB+. The rating has been removed from the Rating Monitor, but the situation remains bleak and the Rating Outlook is Negative.

With just 300,000 inhabitants, Iceland has a strong fishing industry and enjoys per capita GDP of US$38,000 in 2009 even after a sharp depreciation of the Icelandic krona. The country has also taken advantage of its plentiful geothermal- and hydro resources for aluminum smelting and the tourism industry. The social security system has also been well established. Already a member state of the European Economic Area (EEA) since 1994, in July 2009, Iceland applied for membership in the European Union (EU). The three leading commercial banks, however, which rode the financial globalization trend and undertook a full-scale drive to establish a cross-border presence after 2005, floundered in the tempest of the global financial crisis and successively failed. The government ring-fenced itself by not bailing out the banks, and the result has been circumstances in which the external debt in failed banks, which soared to roughly seven times of GDP, are still in the process of restructuring.

The bank crisis battered the real economy, and in 2009 real GDP contracted by as much as 6.8%, which worsened the fiscal situation. Then, a fiscal retrenchment program centered on tax increases and cuts in expenditures were implemented in cooperation with the International Monetary Fund (IMF), and the fiscal deficit has been reduced in 2010 as a result. The ratio of the general government debt to GDP, however, according to the IMF, has almost reached 100%, while that of the net public debt to GDP was 68% at the end of 2009. There is an unresolved issue of compensation to the governments of the United Kingdom and the Netherlands, which shouldered the reimbursement of deposits their own citizens had placed with the failed banks. Concerns still remain over the need for additional capital injections into financial institutions, given the vulnerabilities in the bank balance sheet, and the road to fiscal rehabilitation will not be even.

Many firms and households have foreign currency-denominated loans, which has caused

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marked balance sheet deterioration as a result of both the depreciated domestic currency and asset deflation. Although new banks were created to focus on domestic operations by transferring corresponding assets and liabilities from the failed banks, the ratio of non-performing loans at the new banks is still disturbingly high, with most of them concentrated in the real estate, construction and retail sectors and to households. Under such conditions, R&I believes that investment and consumption are still a long way from achieving a self-sustaining recovery and the economy is expected to further contract in 2010.

Inflation has been brought under control, and the unemployment rate has declined. Moreover, the current account deficit has been sharply reduced, and the exchange rate is steady. However, the slow progress in the restructuring of corporate and household debts, and the presence of restrictions on capital flows, should be viewed as have contributed significantly to this result. An alarmingly high proportion of households are saddled with an underwater mortgage, owing more than the value of their dwelling. If debt restructuring including corporate debt does not move forward, the economy is likely to remain sluggish for a prolonged period of time.

Nevertheless, total assets of all households are still more than three times household debt, and citizens' net pension assets exceed total GDP. There is a large redemption bulge in 2011, but foreign currency reserves are three times the amount of the repayments scheduled in 2011, and at present, conditions do not warrant concerns of a government debt repayment.

In addition to an end to the economic contraction along with a marked progress in the disposal of banks' non-performing loans, no major fluctuations in the exchange rate and no resurgence of inflation once capital controls are removed will be the prerequisites for a revision of the Rating Outlook to Stable.

The primary rating methodology applied to this rating is provided at "R&I's Analytical Approach to Sovereigns". The methodology is available at the web site listed below, together with other rating methodologies that are taken into consideration when assigning the rating.

http://www.r-i.co.jp/eng/cfp/about/methodology/index.html

R&I RATINGS:

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