FITCH DOWNGRADES ICELAND TO 'A-'/'AA'; ON RATING WATCH NEGATIVE

Fitch Ratings-London-30 September 2008: Fitch Ratings has today downgraded the Republic of Iceland's Long-term foreign and local currency Issuer Default ratings (IDR) to 'A-' (A minus) and 'AA' from 'A+' and 'AA+', respectively. The Short-term IDR is also downgraded to 'F2' from 'F1' and the Country Ceiling to 'A' from 'AA-' (AA minus). In addition, Fitch has placed Iceland's sovereign ratings on Rating Watch Negative (RWN).

"The Icelandic authorities' decision to take a majority stake in Glitnir Bank yesterday has underlined the deteriorating credit profile of Iceland's major banks. Following this action and the ensuing Fitch downgrades of the banks, Fitch judges that the risks to macroeconomic stability and sovereign creditworthiness arising from distress in the banking system have materially increased," says Paul Rawkins, Senior Director in Fitch's London-based sovereign rating team.

"However, Iceland's sovereign ratings remain supported by its low government debt ratio, high GDP per head and institutional strengths. The government's own external debt service profile is very modest and it still has tools at its disposal to manage pressures emanating from the financial sector" adds Mr Rawkins.

Fitch downgraded Iceland's three largest banks, Glitnir Banki hf., Kaupthing Bank hf. and Landsbanki Islands, earlier today. All three banks have been placed on RWN.

Today's sovereign rating action comes on the back of a Negative Outlook which was assigned in April 2008, pending financial sector developments. Injection of EUR600m of new capital into Glitnir will be reflected in a drawdown of the international reserves. While this drawdown will be mitigated by the proceeds from EUR300m of sovereign borrowing from European banks, the costs of supporting the banking system are now crystallising on the sovereign's balance sheet. Given the banks' high external leverage - net external indebtedness exceeds 370% of current external receipts - and their near-term funding needs, Fitch believes Iceland will remain highly vulnerable to global financial developments.

Fitch's rating action also comes in the wake of renewed deterioration in Iceland's macroeconomic imbalances. Although there has been a significant improvement in the trade balance this year, a sharp deterioration in the balance on net income threatens to widen the current account deficit to 20% of GDP in 2008, at a time when sources of external financing have become increasingly strained. Meanwhile, Fitch estimates that the combined impact of this year's steep fall in the exchange rate, coupled with double-digit inflation, could push the stock of private sector credit beyond 500% of GDP by year-end, exacerbating the risk of a hard landing for the Icelandic economy in 2009.

Fitch notes the higher 'A-/AA' ratings of the sovereign compared to the banks reflect the continued intrinsic financial strengths of the government: general government debt remains modest at 28% of GDP, while the authorities can point to a favourable external debt service profile and liquid foreign currency resources of over USD6bn. In addition, the sovereign still has a range of financial options, including the issuance of foreign debt. However, the sheer size of the Icelandic financial system - some 900% of GDP - and its near-term external funding challenges underscore the need for a timely policy response to stem any further loss of confidence in the financial system.

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