Moody's Investors Service

Global Credit Research
Rating Action
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Rating Action: Iceland

Moody's Downgrades Iceland's Ratings to Aa1

New York, May 20, 2008 -- Moody's Investors Service has downgraded Iceland's government bond ratings to Aa1 from Aaa (negative), and has also lowered the foreign currency country ceiling for bank deposits to Aa1 from Aaa. All other ratings -- including the foreign currency country ceiling for debt, the local currency bank deposit ceiling, and the local currency ceiling for bonds -- are affirmed at Aaa, and all ratings now carry a stable outlook.

Moody's published a special comment in January, "Iceland's Aaa Ratings at a Crossroads," that explained why, despite its considerable credit strengths, Iceland displayed characteristics that seemed increasingly at odds with a Aaa-rated country. That report described the challenges confronting the Icelandic authorities because of the massive internationalization of its banks, whose assets, mostly in foreign currency, now measure about nine-times GDP. In light of the conclusions reached, Moody's changed the outlook on the government's ratings to negative in early March.

"The evaluation of Iceland prompted an intense internal discussion aimed at precisely defining the attributes of a Aaa in the sovereign universe," said Pierre Cailleteau, Managing Director of the Moody's Sovereign Risk Unit. "This led to the publication today of a report titled "What Does it Mean to be a Triple-A Sovereign?" This report highlights "unquestioned access to finance" as one key characteristic of a triple-A sovereign.

"Moody's downgrade reflects the country's potential liquidity constraints given the scale of possible, although highly unlikely, foreign currency needs because of its banking system contingent liabilities," said the analyst for Iceland, Joan Feldbaum-Vidra. Moody's does not believe that any other Aaa sovereign possesses this foreign currency liquidity risk.

She further explained, "This risk should not be overstated. The liquidity package provided by the Nordic community is a prime example that Iceland does have access to finance to handle any problem in its economy, even in its outsized internationalized banks." The analyst made reference to the EUR1.5 billion swap line arranged with Nordic central banks announced last Friday that could backstop the Icelandic government should the need arise. "Iceland's liquidity risks are marginal."

She also said, Iceland's proactive effort to secure finance in advance of a very low probability event that it would need to support its banks in foreign currency is the mark of a very high rating that can withstand shocks. "Even if a systemic banking crisis were to materialize, Iceland would be capable of managing the problem in the spirit of a very highly rated country, as indicated by its solid Aa1 rating."

These unusual circumstances and testing times for Iceland have revealed that the country faces challenges not common to any other Aaa country, and justify notching away from Aaa. Moreover, if faced with a severe stress test scenario emanating from the banking system, the authorities would find themselves much more highly exposed to exchange rate risk than would be acceptable for a Aaa rated country.

Feldbaum-Vidra described the many strong credit features that substantiate Iceland's very high rating, including low direct government debt, highly advanced economic development, economic vibrancy, favorable demographics, and a fully funded pension system, not to mention its remarkable flexibility to handle shocks. These characteristics differentiate it very positively from other Aa and even many Aaa rated governments.

For more information on Moody's credit analysis of Iceland, see "Iceland's Aaa Ratings at a Crossroads," released in January, and "Credit Analysis: Iceland," published in April.

Any rating actions affecting other entities in Iceland will be announced in separate press releases.

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