Rating Action: Moody's upgrades Iceland's sovereign ratings to Baa2; outlook stable

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New York, June 29, 2015 -- Moody's has today upgraded the government of Iceland's government debt ratings to Baa2 from Baa3. The rating outlook is stable.

The upgrade reflects the following key drivers:

1) The initiation of a careful process of capital account liberalization that is expected to reduce the country's external vulnerabilities, while protecting economic and financial stability;

2) Expectation of further improvement in the government's gross and net debt position over the next three to four years, thanks to robust growth, further fiscal consolidation and debt pre-payments;

3) Improvements to macro-prudential and micro-prudential regulation designed to preserve the stability of Iceland's financial system in the future.

In a related decision, Moody's raised Iceland's country ceilings for long- and short-term foreign currency debt and deposits to Baa2/P-2 from Baa3/P-3, and its country ceilings for local currency debt and deposits to Baa1 from Baa2.

KEY DRIVERS FOR THE UPGRADE OF ICELAND'S GOVERNMENT DEBT TO Baa2

First driver: Expectation of reduced external vulnerabilities due to orderly capital account liberalization

The first driver for the upgrade of Iceland's government debt ratings to Baa2 is the expectation of reduced external vulnerabilities following what we expect to be an orderly process of capital account liberalization. On June 8, the government announced that it is moving forward with a comprehensive strategy for capital account liberalization in the coming months. The plan, devised by a Ministerial Steering Committee of local and international experts, involves three steps meant to overcome the substantial risks to balance of payments stability associated with the liberalization process. With an estimated ISK 1.2 trillion in domestic claims held by non-residents, or nearly two-thirds of the country's nominal GDP, a sudden withdrawal would severely disrupt Icelandic financial and foreign exchange markets.

The first step in the process is the requirement that the creditors of the estates of the three large Icelandic banks that failed in 2008, which at ISK 900 billion are the largest component of these claims, agree to "stability conditions". These conditions are essentially threefold; a release of domestic assets (the so-called "stability contribution"), the extension of maturities on foreign currency-denominated domestic deposits and the refinancing of government foreign currency funding from the time when the "new banks" were launched. In return for their agreement to these conditions, and with an exemption from the Foreign Exchange Act from the Central Bank, creditors will be enabled to achieve the dissolution of the failed banks without bankruptcy (composition) and distribute their other assets to creditors without disrupting the foreign exchange market. The bank estates have all submitted proposals on the basis of these conditions rather than incur a 32%-39% "stability tax" on the total assets of the failed banks.

The authorities will earn significant revenue -- estimated at ISK 400-500 billion -- from the transactions. The Stability Tax bill earmarks these funds for the reduction of government debt as the assets mature, a process that is expected to be front-loaded over the next three years. Moreover, the estates' creditors will write off the substantial external liabilities owed to them by the estates. Although these obligations had not been serviced since the banks collapsed, they represented notional external liabilities in excess of 400% of GDP. After the write-off, Iceland's net external debt position will be reduced to around 20%-25%.

The second phase of the capital control liberalization involves dealing with the large stock of so-called "offshore" krónur, mostly owned by non-residents, that are trapped by the capital controls. Holders of these assets will be offered a choice between three options: long-term treasury bonds denominated in either krónur or euro, a currency auction, or locked non-interest-bearing accounts. The aim will be to extend the maturity profile of these liabilities, and investors who choose the foreign currency auction to exit will pay a premium to do so.

The third stage of the capital account liberalization process will take longer to complete, and will involve the gradual liberalization of Icelandic residents' overseas foreign currency denominated investments. The capital controls constrain portfolio diversification, and key asset managers such as the pension funds, as well as households and corporates, have a smaller proportion of their portfolios invested abroad than they did pre-crisis. The timetable for this stage of the process is not yet defined, and will likely be dictated by the success of the earlier stages of liberalization in avoiding disruptive capital flows.

Second driver: Expectation of continued favorable debt dynamics supported by robust growth and balanced budget

The second driver for Moody's upgrade of Iceland's rating to Baa2 relates to the expected further decline in nominal government debt in the next three to four years, thanks to robust nominal growth and significant fiscal consolidation supported by debt restrictions to be imposed by a planned new budget law. Nominal GDP is likely to increase by 7%-8% annually in 2016-19, benefiting from both stronger domestic and external demand.

Moody's notes that the central government budget is again recording budget surpluses, although the general government runs small deficits. The government's Spring Fiscal Plan outlines its medium-term strategy to use the central government surpluses to cut the government's debt from about 77% of GDP in 2014 to under 50% of GDP by the end of 2019. The consensus on this strategy seems broad-based among politicians and the population. Moody's also expects that growth will remain balanced, with moderate but declining current account surpluses over the next three to five years, and that economic diversity will increase as a consequence of growth in tourism and sizeable new foreign investment projects to produce silica and silica-aluminum compounds.

Third driver: Enhanced regulatory environment intended to avoid the recurrence of financial crises

Following the financial collapse, the government, central bank and financial regulatory authorities have devised policies intended to avoid any such recurrence in the future and to bring the Icelandic prudential framework into compliance with Basle requirements. The Financial Supervisory Authority's capacity has been deepened. Measures have been put in place to improve Icelandic banks' liquidity, increase the maturity of their funding and strengthen their capitalization with a view to achieving or exceeding the new Basle norms (a new Act of Financial Undertakings calls for the Basle rules on capital buffers to be incorporated). New legislation also is being put in place for lending, which is intended to mitigate risks such as in the in the housing market. In Moody's view, the steps that the Icelandic authorities have taken in this context are meaningful.

RATIONALE FOR THE STABLE RATING OUTLOOK

The stable outlook reflects the balance between a number of upside and downside risks. The gradual removal of the capital controls and the reduction of the external and economic vulnerabilities posed by the failed banks' estates constitute a significant milestone in Iceland's recovery and represent important upside risks for future growth, public debt reduction and normalization of the financial system.

Set against that, the dismantling of capital controls carries uncertainties and risks, particularly in an uncertain global growth environment. The lack of a fully functioning banking system, high if declining levels of household and corporate indebtedness and significant contingent liabilities also weigh on the country's risk profile.

Monetary and macroeconomic policy challenges could also arise from wage-driven inflation in the next two years. Although the latest wage agreement was reached at lower levels than initially demanded, the increase over 4 years has been significantly higher than can be justified by inflation and productivity gains. The central bank has indicated its determination to act to restrain inflationary pressures. However, some industries operate on tight profit margins and will have to raise prices, fuelling inflation.

Relatedly, the pending wage settlement for public sector unions will have both direct and indirect impact on government finances. If the recent wage agreement reached in the private sector is matched or exceeded by the public sector unions, the authorities may need spending cuts elsewhere in order to achieve fiscal targets. Further indirect costs to the government budget will also derive from government support for the housing costs tied to agreements negotiated in the private sector.

WHAT COULD CHANGE THE RATING UP/DOWN

Iceland's rating could be upgraded if the economic recovery were sustained and significant fiscal consolidation were achieved. A smooth resolution of the failed bank estates and successful relaxation of capital controls affecting residents, with the exchange rate remaining broadly stable during the lifting of capital controls, would also imply upward pressure on the rating.

Conversely, the rating could be downgraded if the government's commitment to fiscal consolidation were to show signs of waning, thereby halting the declining trend in the public debt ratio. The rating could also be downgraded if the capital control liberalization were to prove disorderly for any reason, leading to large and/or sudden capital outflows and a severe weakening of the exchange rate, with negative consequences for the domestic economy and financial stability.

GDP per capita (PPP basis, US$): 43,637 (2014 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 1.9% (2014 Actual) (also known as GDP Growth)

Inflation Rate (CPI, % change Dec/Dec): 0.8% (2014 Actual)

Gen. Gov. Financial Balance/GDP: 0.5% (2014 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: 4.4% (2014 Actual) (also known as External Balance)

External debt/GDP: 202.1

Level of economic development: Moderate level of economic resilience

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 25 June 2015, a rating committee was called to discuss the rating of the Iceland, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have improved. The issuer's institutional strength/framework, has materially increased. The issuer's fiscal or financial strength, including its debt profile, has materially increased.

The principal methodology used in these ratings was Sovereign Bond Ratings published in September 2013. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this rating action, if applicable.

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