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Research Update:

Ratings On The Republic of Iceland Affirmed At 'BBB-/A-3'; Outlook Stable

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Overview

- We view Iceland as having the institutional capacity to address financial sector problems and build an environment more conducive to job creation and sustainable economic growth.
- We expect the economy to continue to expand by 2%-3% annually between 2012 and 2015.
- External and public-sector debt levels are high but we expect fiscal consolidation to continue.
- We are affirming our 'BBB-/A-3' long- and short-term sovereign credit ratings on Iceland.
- The stable outlook balances our view of Iceland's improved economic fundamentals with downside risks associated with capital controls being lifted over the next few years.

Rating Action

On Oct. 17, 2012, Standard & Poor's Ratings Services affirmed its 'BBB-/A-3' long- and short-term sovereign credit ratings on the Republic of Iceland. The outlook is stable.

The transfer and convertibility assessment remains at 'BBB-'.

Rationale

The ratings on Iceland are supported by our opinion of its prosperous and flexible economy, and its institutional capacity to address financial sector problems and build an environment more conducive to job creation and sustainable economic growth. The rapid post-crisis adjustment, on both the fiscal and external accounts, has allowed Iceland to complete its IMF program and regain market access, with its foreign currency debt maturity extended up to 10 years.

The ratings are constrained by high external and public-sector debt, which we believe could become higher still if not for capital controls limiting residents' rights to invest overseas and nonresidents' ability to exchange krona holdings for foreign currencies. The banking sector has undergone significant restructuring, but private sector nonperforming loans (NPLs) remain high.

Since the onset of the 2008 financial and economic crisis, the Icelandic economy has demonstrated its resilience by reigning in its twin deficits, both

fiscal and external. After contracting by more than 10% during 2009-2010, Iceland's GDP began to recover. The 36% depreciation in its real effective exchange rate since mid-2007 has helped its economic rebalancing.

We expect the Icelandic economy to continue to expand by 2-3% annually between 2012 and 2015. We do not believe the anticipated global slowdown will weaken export volumes significantly, since goods' export volumes are constrained by supply rather than demand factors. On the other hand, terms of trade are likely to worsen as global demand weakens. This already appears to be leveling off the current account position (excluding deposit institutions in winding-up proceedings) at a deficit of around 1% of GDP in 2011. Medium-to-long-term growth will depend largely on supply factors such as increasing capacity in energy intensive sectors or further diversifying exports.

In our view, exceptionally lax financial sector oversight contributed to the boom-bust cycle in Iceland. That said, other long-standing economic policies have served the economy well. These include measures to ensure high labor-market participation; at 85%, Iceland's is the highest in Europe and one of the highest in the world. We also expect that efforts to attract net FDI (which totaled 7.3% of GDP in 2011) will bear fruit, enhancing already-high capital intensity and productivity levels in the small and increasingly open Icelandic economy.

The recovery of domestic demand in 2011 improved tax receipts, thereby narrowing the general government deficit to 5.4% of GDP, from 10% in the previous two years. We expect the fiscal account to continue to improve and reach balance by 2014. In May 2012, the Icelandic government successfully issued a $1 billion 10-year bond and used the receipts to prepay an estimated $1.4 billion of official borrowing from the IMF and Nordic countries; this transaction has significantly lengthened the maturity of the Icelandic government's external liabilities.

The high public sector and external debt burden, however, remains a key ratings constraint. In 2008, foreign exchange controls were implemented to limit capital flight and stabilize the foreign exchange rate. The government is following a two-step strategy to gradually lift the capital controls, but significant risks associated with potential capital flight and further weakening of exchange rates would exacerbate the public and external debt burden as a percentage of GDP. Iceland's relatively shallow domestic capital markets also continue to be a ratings weakness.

The financial sector has undergone significant restructuring since the bank defaults of 2008. The new commercial banks have made notable progress in restructuring their balance sheets. Loan loss provisions have declined steadily and we expect the restructuring process to conclude in 2012. However, NPLs remain significant, concentration risk is still high, and further meaningful losses cannot be ruled out. The private sector debt restructuring also significantly weakened the state-owned mortgage lender, Housing Financing Fund's capital position and we expect it to receive additional government support. The financial sector could also be vulnerable to the exchange rate

controls being lifted, as there may be an outflow of deposits. In addition, a significant depreciation of the krona could disrupt the economic recovery, in particular domestic demand, and increase NPLs at banks.

Outlook

The stable outlook balances our view of Iceland's improved economic fundamentals with the downside risks associated with capital controls being lifted over the next few years.

We could consider raising the ratings on Iceland if, by attracting further foreign investment, its economic growth potential is boosted and external vulnerabilities are reduced. Under this scenario, we would anticipate public and external debt declining more rapidly than we currently forecast thereby helping to create favorable conditions for a smooth lifting of Iceland's capital controls. This would likely strengthen Iceland's creditworthiness.

We could consider lowering our ratings on Iceland if net government debt levels increase significantly on further fiscal slippage; costs related to Icesave rulings; higher-than-expected government support of the banking sector, including state-owned mortgage lender (HFF); or substantial currency depreciation as capital controls are lifted.

Related Criteria And Research

- Sovereign Government Rating Methodology And Assumptions, June 30, 2011
- Criteria For Determining Transfer And Convertibility Assessments, May 19, 2009

Ratings List

Ratings Affirmed

Iceland (Republic of)	
Sovereign Credit Rating	BBB-/Stable/A-3
Transfer & Convertibility Assessment	BBB-
Senior Unsecured	BBB-
Short-Term Debt	A-3
Commercial Paper	A-3

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