

September 29, 2008

Research Update:

Republic of Iceland Cut To FC 'A-/A-2', LC 'A+/A-1' On Support For Glitnir Bank; On Watch Neg

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Rationale

On Sept. 29, 2008, Standard & Poor's Ratings Services lowered its long- and short-term foreign currency sovereign credit ratings on the Republic of Iceland to 'A-/A-2' from 'A/A-1', and its local currency sovereign credit ratings to 'A+/A-1' from 'AA-/A-1+'. In addition, the long-term ratings were placed on CreditWatch with negative implications. Furthermore, the transfer and convertibility assessment on Iceland was lowered to 'AA-' from 'AA'.

At the same time, Standard & Poor's also lowered its foreign currency ratings on Ibudalanasjodur (Housing Financing Fund), the government-owned enterprise for housing finance, to 'A-/A-2' from 'A/A-1', and its long-term local currency rating to 'A' from 'A+'. The short-term local currency rating of 'A-1' was affirmed. The long-term ratings on Ibudalanasjodur were also placed on CreditWatch with negative implications.

The rating actions follow the Icelandic government's announcement that it has injected €600 million (5.9% of GDP) of equity into Glitnir Bank, one of Iceland's three large commercial banks. The injection was prompted by mounting liquidity difficulties at the bank, and will give the government 75% ownership of the bank. (For details of the rating action concerning Glitnir, see related research update titled "Glitnir Bank Rating Lowered To 'BBB/A-3' From 'BBB+/A-2'; Outlook Remains Negative," published earlier today on RatingsDirect.)

The required capital injection underlines our often-stated concerns about the high external leverage of the Icelandic financial system, and the contingent liabilities this poses to the sovereign. Due in part to banks' financing of their own rapid expansion abroad as well as that of several local entrepreneurs, net external debt of the financial system has risen to 362% of current account receipts (CARs) in 2007, from 161% in 2003. Domestic credit to GDP, meanwhile, has risen to over 384% from 130% in the same period. These are among the highest ratios for rated sovereigns.

The general government's low net debt burden (forecast at 12.5% of GDP in 2008 prior to the equity injection), including sizeable deposits at the central bank (of more than 27% of GDP by end of August) offer the government sufficient resources to provide Glitnir with the announced equity injection. It should also offer a buffer to address the potential need for further short-term liquidity support to the system. Due to its size and structure, the financial sector will continue to pose a large contingent liability to the sovereign, particularly as both the current international financial environment as well as events in Iceland will further complicate the Icelandic banks' efforts to secure external financing.

CreditWatch

The CreditWatch action, which we aim to resolve in the next three months, reflects prevailing downside risks. Should the financial profile of the financial sector (covering external and domestic liquidity, profitability, and asset quality) deteriorate, leading to further government support and further undermining the nation's external profile, the government's ratings could be lowered. The ratings could stabilize at the current level if the Icelandic banking system's risks to the sovereign are attenuated, either through foreign entry to the system or through an improved external funding profile.

Ratings List

Downgraded

| | To | From |
|--------------------------------------|--------------|--------------|
| Iceland (Republic of) | | |
| Sovereign Credit Rating | | |
| Foreign currency long-term | A-/Watch Neg | A/Negative |
| Foreign currency short-term | A-2 | A-1 |
| Local currency long-term | A+/Watch Neg | AA-/Negative |
| Local currency short-term | A-1 | A-1+ |
| Foreign currency senior unsecured | A-/Watch Neg | A |
| Local currency senior unsecured | A+/Watch Neg | AA- |
| Commercial paper foreign currency | A-2 | A-1 |
| Transfer & Convertibility Assessment | AA- | AA |

Ibudalanasjodur (Housing Financing Fund)

| | | |
|---------------------------------|--------------|-------------|
| Sovereign Credit Rating | | |
| Foreign currency long-term | A-/Watch Neg | A/Negative |
| Foreign currency short-term | A-2 | A-1 |
| Local currency long-term | A/Watch Neg | A+/Negative |
| Local currency short-term | A-1 | A-1 |
| Local currency senior unsecured | A-/Watch Neg | A |

Landsbanki Islands

| | | |
|--------------------------------------|--------------|---|
| Foreign currency subordinated issue* | A-/Watch Neg | A |
|--------------------------------------|--------------|---|

*Guaranteed by the Republic of Iceland

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