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Iceland's international credit ratings²

Borrowing by the Republic of Iceland is based on credit ratings issued by international agencies. These ratings have improved in recent years and the Republic of Iceland's creditworthiness is now on a par with some of the most reliable borrowers in the world. Credit ratings form the framework for the interest terms granted to borrowers, depending on market conditions at any time. In recent years, the Republic of Iceland's borrowing costs have steadily fallen in pace with its improved credit rating. As a general rule, the sovereign rating sets a credit ceiling. Terms for sovereign borrowing therefore provide a reference for other borrowers. Icelandic banks and corporate borrowers have benefited from the improving terms granted to the Republic of Iceland, saving the economy considerable sums in interest payments to foreign creditors.

Iceland's credit rating is based on its macroeconomic strength, infrastructure, economic dynamics, business flexibility and growth outlook. Its reputation for reliability in debt service certainly benefits the country.

In international financial markets, the function of credit rating agencies is to analyse the risks involved in financial transactions and thereby sort out the chaff from the grain in the business community. The following article discusses the activities of credit rating agencies and their ratings and opinions about the Republic of Icelandic and Icelandic banks as borrowers in international markets.

Credit ratings for Iceland

Iceland enjoys strong confidence as a borrower in international markets. This is evident from the ratings shown in Table 1. Of the three leading international agencies, two award a rating in the AA cate-

Table 1 Republic of Iceland credit ratings 2001

	<i>Foreign currency</i>		<i>Local currency</i>	
	Long-term	Short-term	Long-term	Short-term
Moody's	Aa3	P-1	Aaa	P-1
Standard & Poor's	A+	A-1+	AA+	A-1+
Fitch	AA-	F1+	AAA	-

gory for sovereign foreign currency debt and AAA for local currency borrowing. Other Icelandic borrowers benefit from the high sovereign rating.

Short-term ratings

International agencies also give Iceland short-term ratings. Originally these ratings were announced in connection with the Republic of Iceland Euro-commercial paper programme.³ Moody's gives a rating

1. The author is Director of the International Department of the Central Bank of Iceland.

2. This is an abridged English version of the author's article published in the Central Bank of Iceland quarterly publication *Peningamál*, 2001/3. The author wishes to thank Björn G. Ólafsson and Jón Th. Sigurgeirsson for assistance in preparing this version.

3. The Republic of Iceland has two commercial paper issues in international markets. The Euro-commercial paper facility was renegotiated in 1995. Besides raising the ceiling to US\$ 500 million, the agreement contained a number of innovations, including authorisation for the Republic to issue notes in other currencies than the US dollar, which was formerly the sole currency. Under a new agreement which enters into effect in 2001 the Republic may also make an issue in the US CP market for up to US\$ 500 million.

in its highest short-term category, P-1. Likewise, Standard & Poor's and Fitch give ratings in the highest categories, A-1+ and F1+ respectively. These credit ratings are in fact a fundamental precondition for note issuance on either side of the Atlantic. There is no question that the short-term ratings given by Moody's and Standard & Poor's, and later by Fitch, have contributed to securing favourable terms for the short-term Republic of Iceland issuance which has been made in Euro-market ever since 1986.

Changes in the Republic's credit ratings

In connection with preparations for the Republic's bond issue in the US market early in 1994, Moody's and Standard & Poor's were asked to provide a credit rating for Iceland. Near the end of 1993, representatives of these agencies held talks with Icelandic authorities. Both announced their opinions early in 1994 and affirmed their ratings.⁴ Standard & Poor's led the way by publishing a credit rating for Iceland in January 1994 which gave an A for long-term debt and A-1 for short-term debt. Moody's announced an A2 rating for Iceland in January 1994 as well.

The two companies' economic outlook analyses for Iceland turned out to be broadly similar. Both listed positive and negative aspects. They acknowledged the strength of the economy as reflected in high national income per capita, and pointed out Iceland's democratic tradition and political stability. Industry growth potential was also acknowledged, together with the government's successful economic policy implementation as reflected in low inflation and an improved foreign trade balance. Structural reforms, including financial deregulation, opening of the economy and the increasing shift from centralisation to market forces were also praised. However, they expressed concerns about lack of diversification in an economy dependent on marine resources where there is a certain risk of shocks due to changes in natural and external market conditions. The level of foreign debt was also identified as a stumbling-block.

Iceland's first change in its credit ratings was in 1996, with Standard & Poor's announcement in March that year that it had upgraded its rating for long-term foreign currency debt by one notch, from

A to A+. At the same time it upgraded its short-term rating from A-1 to A-1+, the highest that it awards for this category. Sovereign local long-term bonds received a rating of AA+. Announcing its upgraded credit rating, the company said it reflected enhanced economic policy implementation and strong fisheries resource management.⁵

A month later, Moody's announced its decision to review Iceland's credit rating⁶ and in June the same year this was upgraded by one bracket from A2 to A1. Moody's announcement pinpointed the success of the government's structural reforms in establishing macroeconomic balance,⁷ and cited the small central government surplus, low inflation rate, stable exchange rate, trade liberalisation, market deregulation and financial liberalisation.

In 1997, Moody's went one step further in raising Iceland's rating. That April it announced a positive outlook for the rating, pointing to Iceland's success in reducing treasury debt through effective economic policy implementation and the impact of improved economic conditions.⁸

At the end of July 1997 Moody's announced that it had upgraded Iceland's rating.⁹ This increase of one notch to Aa3 finally saw Iceland enter the AA category. A rating of Aaa was also awarded for sovereign local currency debt. An AA rating portrays a reliable borrower only slightly behind the strongest parties in the field, in the AAA category. In its announcement Moody's said the raised rating reflected the outlook for greater business diversification resulting from projects in power-intensive industries and the travel sector. Government structural reforms and policy implementation promoted better economic balance, and good success had been achieved in utilisation of fisheries resources.

It goes without saying that Iceland reached an extremely important milestone when its rating for foreign currency debt was upgraded to the AA category. Iceland thereby earned professional recognition as one of the most reliable borrowers in international markets. However, it is worth noting that at this

4. The opinions of Moody's and Standard & Poor's at this time are discussed in the author's article, Ólafur Ísleifsson (1995).

5. Cf. Central Bank of Iceland news release, March 15, 1996.

6. Cf. Central Bank of Iceland news release, April 11, 1996.

7. Cf. Central Bank of Iceland news release, June 26, 1996.

8. Cf. Central Bank of Iceland news release, March 13, 1997.

9. Cf. Central Bank of Iceland news release, July 31, 1997.

time, the Republic was already borrowing abroad at terms comparable to those of AA-rated borrowers. For its part, the market had effectively raised its own rating ahead of that of the rating agencies.¹⁰

Fitch joins the field

In autumn 1999, the Central Bank of Iceland requested Fitch to announce a credit rating for the Republic. A rating from Fitch, in addition to those from the other two agencies, was seen as a potential way to strengthen the Republic's status as a bond issuer in the European market. Growth in the number of investors who view Iceland as an attractive option could lead to lower borrowing costs and savings for the treasury. Another factor to bear in mind is that the new rules on capital adequacy of credit institutions drafted by the Basel Committee on Banking Supervision assume that liabilities are evaluated according to credit ratings issued by international agencies. Evaluations by Fitch were recognised in the draft BIS rules, together with those by Moody's and Standard & Poor's.

Representatives from Fitch visited Iceland for talks with government officials in December 1999. Fitch's first report on Iceland was published two months later¹¹, awarding the Republic a rating of AA- for long-term foreign currency debt. Local currency debt received the highest rating, AAA. The main assumption behind the Fitch rating was an improvement in Iceland's economic outlook, in part due to reforms to the economic infrastructure.

The Fitch rating is comparable to that issued by Moody's for the Republic of Iceland. It boosts the treasury's position as a borrower, with two ratings in the AA category as opposed to one A rating. As a result, Iceland has a risk weighting of 0%, instead of the 20% risk category applicable under the draft BIS rules, which would have meant corresponding additional costs in raising funds in international markets.

10. This experience seems consistent with a recent study of the relation between credit ratings and credit terms, in Steiner and Heinke (2001). Their comprehensive research suggests that while a lowering of the rating has a discernible effect on credit terms, an increase in it does not result in a change. One explanation is that investors lend more credence to bad news than to good news.

11. Cf. Central Bank of Iceland news release, February 3, 2000.

Current major factors in credit ratings

All three rating agencies published reports on Iceland early in 2001.¹² Moody's and Fitch announced that they had affirmed their ratings for Iceland with a stable outlook. Both companies pointed to a substantial improvement in the public sector debt position. Firm government economic policy implementation, they said, had laid the foundation for robust growth, stability and a large improvement in living standards over the preceding years.

Fitch pointed out that the wide current account deficit was financed mainly by private sector borrowing. This means that the already high external debt ratios have worsened and the banking system has become more vulnerable to a sudden economic downturn. Iceland will remain vulnerable to changes in sentiment since liquid external assets cover just 31% of external short-term liabilities. This ratio may overstate the risk of difficulties, however, since the Central Bank of Iceland has committed credit lines amounting to roughly US\$ 850 million that it could draw on in an emergency. Nonetheless, further periods of pressure on the currency cannot be ruled out.

Despite certain cautionary remarks, Moody's emphasised that the government's capacity to pay the foreign debt is consistent with its Aa3 foreign currency rating at present. Its access to foreign exchange liquidity from commercial banks and other Nordic countries is plentiful and its willingness to pay domestic and external obligations is unquestioned. For these reasons, despite concerns about the external position and the possibility of a balance of payments and/or currency event, Moody's outlook for Iceland's country ceilings was stable.

Like the other two agencies, Standard & Poor's affirmed its rating for Iceland and announced its findings in a news release issued on March 21, 2001. The rating for foreign currency long-term liabilities remains A+. The rating outlook was stable, but had previously been positive. This is the only example of an agency pulling back in a credit rating for Iceland.

In its news release, the company expressed the same concerns as Moody's and Fitch about the

12. The reports by Fitch, Moody's and Standard & Poor's are published on the Central Bank of Iceland website. The Bank issued a news release following the publication of each respective report, dated February 8, February 26 and March 23, 2001.

widening current account deficit, and also mentions the rapid increase in the level of external indebtedness as main factors behind this change in the rating outlook. The current account deficit reached 10% of GDP in 2000 and external debt 265% of exports. This was compounded by net foreign direct investment outflows of 2% of GDP and negative portfolio flows caused by international diversification by Icelandic private pension funds. The banking system has become more vulnerable to adverse shocks as capital adequacy ratios and provision levels have weakened.

Standard & Poor's makes positive remarks similar to those made by Moody's and Fitch about the general government surplus, which amounted to 2.9% of GDP in 2000 and is estimated at a similar level in 2001.

The agency pointed out that the rating would be strengthened if domestic lending growth and external imbalances are reduced, while structural fiscal surpluses are maintained. Similarly, privatisation of the state-owned banks would also bolster the ratings.

Credit ratings for Icelandic banks

International agencies have increasingly been focusing on Icelandic banks. All three commercial banks can cite ratings from the agencies when procuring credit abroad. The following points are regarded as most important in bank ratings:

- Operating environment
- Ownership and directorship
- Franchise value
- Revenue potential
- Risks and risk management
- Capital structure
- Management

These factors can be compared with the decisive ones for corporate credit ratings, which are generally the following:

- Evaluation of the government, macroeconomic factors
- Business sector outlook
- Regulatory mechanism in the sector, privatisation
- Company management

Table 2. Credit ratings of Icelandic commercial banks

	<i>Moody's rating for Icelandic commercial banks at end-2000¹</i>	<i>Fitch's rating for Icelandic commercial banks in February 2001²</i>
Íslandsbanki-FBA	A2/P-1 C	A/F1 C
Landsbankinn	A3/P-2 D+	A/F1 C
Búnadarbankinn	A3/P-2 D	-

1. The financial strength rating shows the bank's position irrespective of conceivable assistance from the central government or others. Symbols: A extremely strong, B strong, C good, D satisfactory, E weak. 2. Besides the ratings stated in the table, Fitch awarded the banks a support rating of 2. Awarded on a scale of 1-5, the support rating evaluates whether a given bank would receive support, and from whom. A rating of 2 means that government support would seem probable.

- Operating position
- Financial position
- Individual factors affecting the company and its paper (e.g. legal action, links with parent company)
- Liquidity access

In recent years Moody's has published reports on the outlook for the banking system as a whole. Its most recent report¹³ takes a positive view of the banks' position, which it considers generally improved, with good growth opportunities and successful results from cost reduction. In Moody's view, doubtful receivables are within satisfactory limits and provisions are satisfactory. Icelandic banks face a special risk from heavy lending to the fisheries sector, it adds. The Moody's report firmly maintains the strong likelihood that the government would support the banking system if it suffers shocks, and likewise that a bank running into difficulties would receive assistance from the banking authorities.

Relations with international rating agencies

The Central Bank of Iceland is responsible for relations with international rating agencies on behalf of the treasury, and its international department is responsible for the day-to-day relationship. The

13. Moody's Investors Service: Iceland, Banking System Outlook, December 2000.

Central Bank places a strong emphasis on effective communication of information and mutual trust. Various information becomes available on a regular basis, including seasonal material such as the national budget and fiscal budget. Rating agencies are sent material as it appears and other information as needed, for example when unusual events occur and need clarification. Meetings are held with agency representatives, who generally visit Iceland for extensive discussions every year. A vital consideration is that rating agencies have confidence in the information they receive. Efforts are made to submit original source material and documents, and to enable agency representatives to talk to leading experts in the fields being addressed. Particular emphasis is given to direct access by agency representatives to members of the government, to hear first-hand interpretations of government policy and future actions. It seems fair to say that, together with officials from other government authorities in Iceland, the Central Bank has managed to maintain a good professional relationship with the rating agencies, based on mutual trust and frankness.

Conclusion

Moody's, Standard & Poor's and Fitch all rate Iceland among some of the most reliable borrowers in the international arena. They consider Iceland's long-term exchange rate risk marginally greater than in most industrialised countries, partly because of the small scale of the economy and relatively undiversified export production.

Iceland has consolidated its position in international markets in recent years. Ratings from international agencies confirm the good reputation that the Republic of Iceland has acquired as a fully valid participant in the international financial markets. Iceland's ratings entail an acknowledgement of quality for foreign investors and create opportunities for greater prosperity in the future.

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