STANDARD & POOR'S

Global Credit Portal
RatingsDirect®

January 29, 2010

Research Update:

Republic of Iceland Ratings Kept On CreditWatch Negative On Continuing Uncertainty About International Financing

Primary Credit Analyst:
Moritz Kraemer, Frankfurt (49) 69-33-99-9249;moritz_kraemer@standardandpoors.com

Secondary Credit Analyst:
Kai Stukenbrock, Frankfurt (49) 69-33-999-247;kai_stukenbrock@standardandpoors.com

Table Of Contents

Research Update:

Republic of Iceland Ratings Kept On CreditWatch Negative On Continuing Uncertainty About International Financing

Overview

- The availability of sufficient external financing to support Iceland's economic adjustment and capital-account liberalization program remains uncertain as the nation heads toward a referendum on the Icesave legislation on March 6, 2010.
- We are keeping our 'BBB-/A3' foreign currency ratings and our 'BBB+/A-2' local currency ratings on Iceland on CreditWatch with negative implications for a further three months until the end of April 2010.
- We expect to resolve the CreditWatch status when we obtain greater clarity on the availability of external financing, which may only occur after the referendum.

Rating Action

On Jan. 29, 2010, Standard & Poor's Ratings Services said its 'BBB-/A-3' long- and short-term foreign currency ratings and its 'BBB+/A-2' long- and short-term local currency ratings on the Republic of Iceland remain on CreditWatch where they were placed with negative implications on Jan. 5, 2010.

Rationale

The CreditWatch status indicates the likelihood of a downgrade if we see that political uncertainty is increasing and external liquidity pressures are likely to persist in the wake of President Olafur Ragnar Grimsson's veto of the "Icesave Act," which parliament passed late last year.

At the time of the CreditWatch placement, we expected to have greater clarity by the end of January on the implications of the President's veto on the political will to enact other measures to restore investor confidence as well as information about the availability of official external financing. However, a decision on continued financing from the International Monetary Fund (IMF) and the Nordic governments to underpin Iceland's economic adjustment policy has taken longer than we anticipated.

The provision of external credit has been thrown into doubt by the refusal of Iceland's President to sign a law that would have extended a state guarantee on bilateral loans from the governments of The Netherlands and the U.K. to the Icelandic Deposit Guarantee Fund. The purpose of these loans was to pay back The Netherlands and the U.K. for compensating depositors of the Dutch and

British branches of Icesave, part of the failed Icelandic bank Landsbanki. Resolution of the Icesave issue is a condition for ancillary bilateral funding from the Nordic nations, which is part of Iceland's IMF agreement. As a result of the veto, we expect disbursements on the remaining $2.3 billion under the IMF program to be delayed. Moreover, the parameters of the program might have to be reworked, possibly including higher primary surplus targets. The IMF financing is, in our view, key to bolstering the central bank's foreign exchange reserves (currently about €2.5 billion) and facilitating an eventual easing of capital controls put in place in November 2008.

Whether or not the Icesave legislation will become law is now going to be decided by the Icelandic electorate in a referendum on March 6, 2010. Opinion polls suggest that a significant majority of the public remains opposed to the legislation and a rejection at the referendum appears likely. In 2009, Iceland's parliament passed similar Icesave loan guarantee legislation, which was signed by the President. This legislation stipulated that the guarantee would not be open ended, and we believe it is partly for this reason that the Dutch and British governments rejected it.

If the referendum were to be rejected, further political negotiations could still lead to a compromise acceptable to all three nations, possibly facilitated by a neutral mediator. We consider that the upcoming general elections in the U.K. could increase the risks to a potential compromise. We also think it is conceivable that the Nordic governments might continue to disburse the bilateral loan tranches without a formal new agreement between Iceland and the Dutch and British governments, which would unlock complementary IMF financing. Indeed, the first Nordic tranche was disbursed in mid-December 2009, following cabinet's agreement on the Icesave bill. This was despite disbursement being subject to parliamentary approval, which only followed at the end of the month and was subsequently vetoed by the President.

We believe that any developments that lead to secure external financing could bring the Icelandic government's adjustment and financing program back on track and stabilize the rating, as would an unexpected "yes" vote at the referendum. Failure to generate a compromise that would secure continued external financial support, possibly exacerbated by a collapse of the ruling coalition, would hamper the already difficult environment for policy formulation and implementation and increase the risk of continued economic disruption and another currency depreciation.

Debt leverage in Iceland's private sector is still very high, in our view, and public-sector borrowing needs are significant. In our opinion, if external liquidity were to dry up, it would further dampen confidence in Iceland's economic prospects, elevate risks to its still fragile financial sector, and might trigger additional needs for government support for the country's banking system.

CreditWatch

We expect to resolve the CreditWatch status before the end of April 2010, once there is greater clarity about the prospects for resuming multilateral and bilateral external financing flows and the political will to enact other measures to restore investor confidence. If we see that a political impasse persists or if we consider Iceland's access to official external financing to be more than just temporarily impaired, we could lower our ratings on Iceland by one or two notches. A political compromise securing continued access to external funding or a surprise referendum outcome approving the Icesave legislation could lead to an affirmation of the ratings at the current level.

Related Research

- Republic of Iceland Foreign And Local Currency Ratings Placed On CreditWatch Negative Following Icesave Veto, Jan. 5, 2010
- Sovereign Credit Ratings: A Primer, May 29, 2008

Ratings List

CreditWatch/Outlook Action

Iceland (Republic of)	
Sovereign Credit Rating	
Foreign Currency	BBB-/Watch Neg/A-3
Local Currency	BBB+/Watch Neg/A-2
Iceland (Republic of)	
Senior Unsecured	BBB+/Watch Neg/--
Senior Unsecured	BBB-/Watch Neg/--
Short-Term Debt	A-2/Watch Neg
Commercial Paper	A-3/Watch Neg

Ratings Affirmed

Iceland (Republic of)	
Transfer & Convertibility Assessment	
Local Currency	BBB-

Additional Contact:
Sovereign Ratings;SovereignLondon@standardandpoors.com

Complete ratings information is available to RatingsDirect on the Global Credit Portal subscribers at www.globalcreditportal.com and RatingsDirect subscribers at www.ratingsdirect.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow (7) 495-783-4011.

772002 | 300031015