Credit Analysis

Moody's International

Sovereign

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Iceland

Table of Contents:

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This Credit Analysis provides an in-depth discussion of credit rating(s) for Iceland and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website. Click here to link.

Iceland is a highly-developed economy with an extremely wealthy population. Per capita GDP measures about $60,000 based on the $20 billion economy and small population of just 313,000. Iceland is the smallest economy in the world with an independently floating currency.

Iceland compares very favorably to other Aaa-rated sovereigns on some important measures, such as its low government debt, high per capita income, economic flexibility, relatively young demographic profile, and its pension system dynamics. Government authorities also have sufficient access to liquidity and a strong enough balance sheet to weather a crisis in any sector of the economy, a characteristic shared with other Aaa- and Aa-rated countries. Like those other advanced countries, adjustments to external or domestic shocks are made through GDP growth rates, flexible labor and product markets, and floating exchange rates, not by defaulting on debt obligations.

When looking at certain other characteristics, however, Iceland compares less well. The economy is prone to considerable volatility given its size and openness. This has been particularly noticeable in the past decade, when Iceland has attracted a number of large foreign investment projects that overwhelmed the economy, contributing to sometimes huge macroeconomic imbalances despite generally prudent fiscal and monetary policies. This volatility sets it apart from other top-rated peers, as does the private sector's large foreign indebtedness and its highly-leveraged households.

Moody's has become increasingly concerned about the burden of potential contingent liabilities stemming from the Icelandic banks. Iceland's banking system has rapidly internationalized: the system has grown to nine times GDP, and domestic deposits now comprise just one quarter of total system deposits. While Iceland is not the only Aaa-rated country with an outsized banking system, its banks have been thrust into the limelight with the global credit crunch. Banks that rely on wholesale funding have been under enormous market pressure, and few more than Iceland's banks. The downgrade of all three major commercial banks to C- in February 2008 means that Iceland is the only Aaa-rated country to have a banking system with an average financial strength rating below C.

(Continued on next page)

Moody's Investors Service

(Continued from page 1)

The risk of contagion among these three banks has raised concerns about a system-wide crisis. Moody's considers such a crisis to be a very low probability but high severity risk scenario that distinguishes Iceland from other Aaa sovereigns, and accordingly has changed the outlook on the government's ratings to negative.[1] The government's direct debt is very manageable, but the negative outlook is meant to signal the pressures emerging from banking system liabilities, and the incremental increase in the risk that some part of those could come onto the government's own balance sheet.

Macroeconomic Performance

Severe Overheating Begins to Cool

After a long episode of overheating, Iceland is currently in a cool-down phase. The difficult international credit market conditions are reinforcing this trend. Official Ministry of Finance forecasts from January indicate that growth will drop to 1.4% this year and 0.4% in 2009. At the same time, Moody's notes that growth forecasts fluctuate widely for this very small, open economy and therefore the margin for error is quite large.

There are many factors that will determine whether Iceland's economy avoids a hard landing (i.e., a deep and prolonged economic contraction) coming out of this business cycle the way it did in 2004 and on other occasions. The most important factor is the Icelandic banks' funding situation in the context of the global credit crunch, amidst considerable skepticism towards their market access and even the government's own borrowing capacity. This skepticism, along with other concerns, has led to unprecedented risk premia on Icelandic debt. While conditions have objectively worsened and heightened the risk that the authorities may have to find ways, like in other Aaa-rated countries, to support the financial system, it is our view that current CDS spreads unreasonably exaggerate credit risk as evidenced by Kaupthing Bank's recent €1.3 billion private placement. However, if the banks cannot raise enough funds to expand their loan books, the outlook for domestic economic growth dims a lot.

The second factor relates to asset quality. Given the rapid loan growth and the increase of foreign currency borrowing by households in recent years – albeit from a very low level – there are concerns that banks' asset quality will suffer as financial and fixed asset prices and the currency fall. These developments will also cause credit availability to shrink and consumer confidence to falter.

Offsetting these negative variables could be the stimulus provided by the exchange rate, which has depreciated by over 30% against the euro since the onset of the credit crunch in August 2007. The current ISK level should prove an important stimulus to export-led growth, as has been witnessed in the past. Even the banks' asset performance has normally improved after the currency weakened because of the preponderance of domestic lending to exporters. Other sectors will be hit hard, however, especially those that have borrowed in foreign currency without being naturally hedged, and this will contribute to the economic malaise.

One main downside to the depreciation of the ISK is well-above-target inflation. Inflation was running at about 8.7% in the year to March, against a target of 2.5% ± 1.5%. This situation (and the fast depreciation of the ISK) prompted the Central Bank of Iceland to hike interest rates again in late March, this time by 125 bps to 15%, a further disincentive to demand. In line with ECB practices, the authorities have been harmonizing their rules governing overseas branch reserves and collateral requirements for transactions with the Central Bank of Iceland to ease banks' liquidity situation, even if on the margin. This 'carrot and stick' approach indicates the immense challenges facing the monetary authorities from the current global circumstances.

On balance, Moody's baseline expectation for the economy is for a short-lived but steep and abrupt downturn, with growth likely to be at or below zero in several upcoming quarters. This is not in itself a credit event for the sovereign, however. Iceland's oft-proven flexibility to deal with adverse circumstances, whether it be sharp and sudden exchange rate adjustments or quota cuts in its vital fisheries sector (9% volume cut expected for 2008), is a testimony to its credit strength.

[1] The background to the sovereign rating action was discussed in Moody's Special Comment, *Iceland's Aaa Ratings at a Crossroads*, published January 2008.

Banking Sector's Internationalization Slows

The current credit crunch is slowing down the internationalization of the banking system. The recent cancellation of Kaupthing Bank's purchase of the Netherlands bank NIBC is one such example. Difficult funding conditions ironically will ease the pressure arising from growing contingent liabilities on the sovereign for a time, unless the scarcity of funding leads to a crisis. Shrinking contingent liabilities would bear favorably on the government's ratings. However, Moody's would still need to evaluate the situation in terms of the highly stringent requirements commanded by a Aaa sovereign rating.[2]

Structural Factors Complicate Iceland's Policy-Making

The lack of reform of the government-owned Housing Finance Fund continues to create distortions in the economy. The dominance of this institution over the mortgage market may have been one the factors for the banks to pursue faster internationalization and greater dependence on wholesale funding than would have otherwise been the case, thereby increasing the exposure of the country to the current credit crunch.

Another important structural weakness – traditional monetary policy tools' lack of effectiveness – is unavoidable in an economy as small and open as that of Iceland in the absence of capital controls. The availability of external financing during the recent period of ample external liquidity meant that the high local interest rates in Iceland did not slow credit growth, and were not helping to contain overheating pressures.

Political/Social Developments

Iceland's small size, wealth, and homogenous population have helped create a consensus-based society and a political climate characterized by only small ideological differences between political parties. These unique characteristics have allowed policymakers to make financially painful decisions when necessary to preserve the country's universal well-being with little if any political fallout.

Icelanders share roughly similar values on such issues as environmental conservation and the maintenance of the social welfare network, although the former is being tested by the energy-intensive aluminum projects that have been undertaken in recent years. Incomes are significantly higher and more evenly distributed than the OECD average, and unemployment is very low – factors that tend to reduce political conflict. In many ways, Icelanders' shared perspective on economic and social policy has provided the basis for the country's success in achieving very high standards of living.

There have been some recent important political shifts. The 12-year string of coalitions formed between the Independent Party and the Progressive Party was broken after the parliamentary election in May 2007 resulted in a weak turnout for the PP. Instead, the IP asked the Social Democratic Party to form a government. The new coalition commands a strong majority.

The new government is also pursuing some key changes regarding foreign and economic policy. The SDP is more hesitant than IP about pursuing new large-scale foreign investment projects, although its opposition could possibly soften if the economic downturn is prolonged. The SDP is also much more supportive of joining the Eurozone than its coalition partner. Iceland is already an EFTA member, but has hesitated from moving towards full EU membership largely because of its concern about control over its vital fisheries sector. A second but also important reason for wanting to stay out of the EU has been policymakers' desire to have an independent monetary policy as a small and open economy. The weakening of the ISK and the problems posed by the vast internationalization of the banks has bolstered support for the abandonment of the ISK in favor of adopting the euro, although the authorities are so far reluctant and have stated unequivocally that this would only be done in the context of EU membership.

[2] Moody's will soon be publishing a series of analytical papers addressing the meanings of sovereign ratings throughout the rating scale.

Government Finances and Debt

Iceland's general government financial position is strong, reflecting modest direct debt, high labor force participation rates, low unemployment, a young population, and a well-funded pension system. The consensus-driven society and a proven ability and willingness to adopt painful measures when faced with adversity provide the government with considerable flexibility to deal with shocks.

Gross general government debt is equivalent to about 30% of GDP and 60% of annual revenues. Fiscal surpluses, privatization proceeds, and strong GDP growth have more than halved these ratios from 60% of GDP and 145% of revenues a decade ago. The government's €1 billion eurobond issue in 2006 was a reversal of course from the strategy of retiring external obligations once the annual budget position had moved into surplus. The bond was issued, however, to strengthen the reserve position of the Central Bank of Iceland, in direct response to the liquidity pressures that Icelandic banks faced for a short time in 2006, leaving the net debt unchanged.

While there has been a sizeable fiscal tightening (a correction of 10% of GDP in the fiscal surplus between 2003 and 2006), fiscal policy could arguably have been even firmer to contain the buoyancy of domestic demand and avoid or at least reduce overheating. The problem is mainly on the spending side: Iceland's general government spending is considered high compared to other advanced countries when taking into account the relatively less generous social welfare system than the other Nordics and nonexistent defense bill. At 25% of GDP, public consumption is among the highest in the OECD. Rapid spending increases, even if lower than those of nominal GDP, along with large tax breaks have been key stimuli to demand in recent years.

The government is now running a countercyclical fiscal policy to buffer the effects of the economic downturn. The government still expects to register a surplus this year (1.9% of GDP), even with loss-related tax deferrals and credits and the continuation of tax cuts, but the size of the expected surplus is far smaller than last year's 5.2% of GDP. Public investment projects previously delayed because of the overheating conditions are now moving forward. This will be one factor contributing to the budget moving into a deficit programmed at -0.8% of GDP for 2009, the first fiscal deficit since 2003.

Public Finances Protected Against Age-related Spending Pressures

Public finances in Iceland are relatively more insulated against age-related spending pressures than other advanced industrial countries. Public pension fund assets have grown rapidly and are equivalent to over 130% of GDP. In fact, the country's triple-pillared pension system is heavily funded against future liabilities. Aside from these explicit reserves, Iceland's labor market and demographic characteristics also position it favorably in this context. It has the second-highest labor force participation rate in the OECD after Switzerland and Icelanders have unusually long working lives and workweeks. The population is also relatively young and fast-growing. These relatively unique demographic characteristics for an advanced economy strengthen the revenue base and assure fiscal sustainability over the long term.

Contingent Liabilities are Large

While the government has a low direct debt, contingent liabilities are enormous. The banking sector in Iceland represents the most burdensome contingent liability. Moody's considers the three large commercial banks in Iceland as "too big to fail," a concept that is not affected by the banks having been fully privatized, meaning that we would expect a very high degree of systemic support by the Icelandic authorities for the banks in the event of a stress situation. Given the scale of the banks' international operations, however, any systemic threat would prove extremely costly to the government if that eventuality were to materialize.

Implicit guarantees consist primarily of the debts of the state-owned Housing Finance Fund. Given the nature of the collateral, these liabilities, totaling about 60% of GDP, are generally considered to be relatively low risk to the government. The debt of Landsvirkjun, the government-owned national power company, is also a contingent liability. Landsvirkjun is rated Aaa/negative only because of government support; on a stand-alone basis its financial situation is not particularly strong, especially after having accumulated large debts to finance power expansion for projects in recent years (including $1.2 billion in relation to a single project).

The risk of contingent liabilities or guarantees becoming a direct liability of the government all at once is very small. The government's low debt burden, however, is an important rating consideration in that it ensures enhanced flexibility for handling systemic weaknesses in any sector of the economy.

Peer Comparisons: Government Direct Debt Ratios Compare Well

Iceland's gross general government debt ratios of 30% of GDP and 60% of revenues are far lower than its peer group of Aaa-rated advanced industrialized countries. The averages for the peer group are 53% and 135%, respectively. On the other hand, the government has extensive contingent liabilities which pose a higher risk of becoming the responsibility of the fiscal authorities due to the more difficult credit market conditions, the propensity for contagion among the Icelandic banks, and the seasoning of a very fast-growing loan book. Hence, to repeat, the government's low direct debt burden is all the more critical.

International Investment Position

Iceland's External Debt Has Financed Growing Internationalization

Iceland's external debt measures about 500% of GDP and the economy's net international investment position stands at -125% of GDP, largely because of the sizeable foreign currency indebtedness of the private sector, especially of the banks. These ratios are clearly high, but also reflect the small size of the Icelandic economy and international perspective of Icelandic banks and corporates.

Iceland's small size and openness, its relatively narrow economic base, and its large foreign debt render it susceptible to unusually large business cycle fluctuations by industrial country standards. Concerns about Iceland's financial stability emanating from the large increase in foreign debt intermediated by the banks, however, are exaggerated. A good part of domestic credit growth has financed acquisitions abroad, and debtors have extensive natural hedges in foreign currency (see table below). Foreign currency credit growth overseas diversifies the banks from Icelandic risk. Such investments generally enhance the economy's growth potential and resilience to shocks.

Foreign Currency-Denominated Lending at year-end 2006

FX income < 33% of total	21%
FX income 33%-67% of total	15%
FX income > 67% of total	25%
FX lending to non-residents	39%

Source: Financial Stability 2007, Central Bank of Iceland

Current Account Deficit Remains High

Massive foreign investment projects equivalent to a whopping 25% of GDP got underway in 2003 and over the next four years. The projects located in Iceland to exploit its massive energy potential from geothermal and hydropower sources. Still, the scale of the plants, especially during the construction phase, put a lot of pressure on the country's external finances because of their huge equipment import requirements. The overheating of the economy – triggered by the investment cycle, a real effective appreciation of the ISK of 20% between 2004-05, tight labor market conditions, abundant global liquidity (not to mention the "carry trade" attracted to Iceland's high interest rates), and arguably insufficiently tight fiscal policy – explain the very large current account deficit as well.

The investment projects' spillover effect on domestic demand contributed further to widening the current account deficit, which peaked at 25% of GDP in 2006 as the latest construction phase drew to a close. The deficit remained large at 16% of GDP last year because of interest payments on the accumulated external debt as well as still-buoyant consumer demand that kept the trade deficit wide.

The current account deficit is not expected to evaporate totally even with the massive increase in aluminum exports that are coming on stream. In part, the stickiness of the deficit relates to conservation measures in the fisheries sector, resulting in temporary cutbacks in the catch of some important species.

Another reason the current account deficit is expected to remain sizeable — at close to 10% of GDP according to official Ministry of Finance forecasts for 2008 made in January — rests on the expectation of only a 3.2% volume contraction in import demand. However, current credit conditions, the weaker ISK, and the severe cooling of asset prices could translate into a bigger reduction in imports than is presently expected by the authorities. Finally, the large investment income deficit will contribute to keeping the current account in the red indefinitely, unless the trade position moved into a moderate surplus.

Government's Payments Capacity Strong Despite Outsized CAB

Aside from its proven flexibility, the country's wealth and ability to raise additional capital mean that even large external imbalances do not threaten the government's payments capacity. The government's direct debt is very manageable, but the negative outlook is meant to signal the pressures emerging from banking system liabilities, and the incremental increase in the risk that some part of those could come onto the government's own balance sheet.

Rating History

Republic of Iceland

	Foreign Currency Bonds & Notes		Foreign Currency Bank Deposits		Gov't Bonds	
	Long-term	Short-term	Long-term	Short-term	Local Currency	Date
Rating Assigned	A2	--	--	--	--	24-May-89
Rating Assigned	--	P-1	--	--	--	30-Oct-90
Rating Assigned	--	--	A2	P-1	--	2-Oct-95
Rating Placed on Review for Possible Upgrade	A2*	--	A2*	--	--	10-Apr-96
Rating Upgraded	A1	--	A1	--	--	24-Jun-96
Rating Placed on Review for Possible Upgrade	A1*	--	A1*	--	--	16-Jun-97
Rating Upgraded	Aa3	--	Aa3	--	--	30-Jul-97
Rating Assigned	--	--	--	--	Aaa	30-Jul-97
Rating Upgraded	Aaa	--	Aaa	--		21-Oct-02
Outlook Assigned	negative	--	negative	--	negative	5-Mar-08

** denotes specific rating placed on review*

Iceland

Annual Statistics

Iceland

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Economic Structure and Performance															
GDP Nominal (US$ Mil.)	6,869.9	7,311.0	7,414.8	8,273	8,732	8,697	7,923	8,908	10,970	13,230	16,323	16,635	19,956	17,803	20,257
Population (Mil.)	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
GDP per capita (US$)	25,634	27,078	27,260	30,195	31,468	30,949	27,800	30,932	37,886	45,294	55,004	55,641	66,090	58,374	65,765
GDP per capita (PPP basis, US$)	21,745	23,385	24,749	26,271	27,443	28,840	30,227	30,118	31,490	34,665	37,096	38,885	--	--	--
Nominal GDP (% change, local currency)	1.4	9.5	8.0	11.8	7.5	8.1	12.9	5.8	3.1	10.4	10.5	13.8	9.5	4.4	3.2
Real GDP (% change)	0.1	4.8	4.9	6.3	4.1	4.3	3.9	0.1	2.4	7.7	7.5	4.4	3.8	1.4	0.4
Inflation Rate (Consumer Price Index, % change, Dec/Dec)	2.0	2.3	1.8	1.7	3.4	5.0	6.7	4.8	2.1	3.2	4.0	6.8	5.9	8.0	2.7
Unemployment Rate (%)	5.0	4.3	3.9	2.8	1.9	1.3	1.4	2.5	3.4	3.1	2.5	1.3	1.0	2.5	3.6
Gross Investment/GDP	16.7	19.0	19.7	24.1	21.8	23.2	21.3	18.2	19.8	23.4	28.3	34.8	27.7	23.5	21.8
Gross Domestic Savings/GDP	20.4	21.6	20.2	19.7	17.1	16.0	20.2	19.7	16.7	17.8	15.9	16.9	17.0	16.4	17.9
Nominal Exports of G & S (% change)	10.6	14.9	-6.1	6.9	2.1	-0.4	5.3	8.5	12.8	20.0	14.3	3.3	32.2	-9.4	22.0
Nominal Imports of G & S (% change)	16.0	16.8	1.5	22.4	3.1	6.3	-11.1	1.3	28.2	28.3	36.6	15.8	10.2	-16.5	12.0
Real Exports of G & S (% change)	-2.3	9.9	5.6	2.5	3.9	4.2	7.4	3.8	1.6	8.4	7.2	-3.9	12.2	9.2	5.0
Real Imports of G & S (% change)	3.6	16.5	8.0	23.4	4.3	8.6	-9.1	-2.5	10.8	14.4	29.4	9.6	-2.2	-3.2	-3.8
Net Exports of G & S/GDP	3.7	3.4	0.5	-4.4	-4.7	-7.3	-1.1	1.5	-3.1	-5.6	-12.4	-18.0	-10.6	-7.1	-3.9
Openness of the Economy[1]	68.8	74.8	71.9	73.9	71.9	74.4	78.6	73.3	71.7	73.9	75.6	82.1	83.3	80.9	82.8
Government Effectiveness	--	1.50	--	2.07	--	2.09	--	2.01	2.23	2.23	2.22	2.13	--	--	--

Iceland

Iceland

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
Government Finance															
Gen. Gov. Revenue/GDP	40.4	40.5	40.5	40.8	43.1	43.5	41.8	41.6	42.7	44.1	47.0	48.0	48.3	47.2	46.5
Gen. Gov. Expenditures/GDP	43.4	42.0	40.5	41.2	41.9	41.8	42.5	44.1	45.5	44.0	42.0	41.6	43.1	45.3	47.3
Gen. Gov. Financial Balance/GDP	-3.0	-1.6	0.0	-0.4	1.2	1.7	-0.7	-2.5	-2.8	0.0	5.0	6.3	5.2	1.9	-0.8
Gen. Gov. Primary Balance/GDP	1.2	2.1	3.4	3.0	4.5	5.0	2.6	0.4	-0.1	2.5	7.1	8.5	7.7	4.2	1.6
Gen Gov Debt (US$ Bils.)	4.1	4.1	3.9	4.1	3.8	3.3	3.4	4.3	4.8	5.2	4.1	4.9	5.9	4.4	5.5
Gen. Gov. Direct Debt/GDP	58.6	56.2	52.9	47.6	43.2	39.2	43.9	43.3	40.6	35.4	25.5	28.9	28.0	30.0	29.0
Gen. Gov. Debt/Gen. Gov. Revenues	145.1	138.9	130.6	116.7	100.3	90.2	105.0	104.0	95.1	80.3	54.2	60.3	58.0	56.2	58.1
Gen. Gov. Interest Payments/Revenues	10.5	9.2	8.5	8.3	7.9	7.7	8.0	7.2	6.4	5.5	4.7	4.5	5.2	5.1	5.1
Gen. Gov. FX and FX-linked Debt/Total	49.2	49.7	48.0	46.0	48.4	55.6	62.3	61.0	56.1	52.0	40.8	55.6	46.6	44.5	43.7
ST Gen. Gov. Direct Debt/Total	13.4	12.3	9.4	10.0	12.6	14.9	16.1	13.0	10.0	--	--	--	--	--	--
External Payments and Debt															
Nominal Exchange Rate (/$ eop)	65.2	66.9	72.2	69.5	72.6	84.7	103.0	80.6	71.0	61.0	63.0	71.7	61.9	80.0	68.0
REER (% change)[2]	0.3	0.1	3.4	(0.8)	6.6	(6.7)	(10.6)	14.0	1.8	10.6	10.3	(10.6)	1.3	--	
Relative Unit Labor Costs (OECD)	72.8	72.4	76.2	83.0	92.1	100.0	87.4	92.9	97.9	101.5	117.8	113.9	124.5	--	
Current Account Balance (US$ Mil.)	52.4	-130.5	-132.7	-555.3	-588.3	-881.3	-346.2	94.7	-523.0	-1,299.7	-2,633.6	-4,221.0	-3,118.6	-1,673.3	-1,361.8
Current Account Balance/GDP	0.8	-1.8	-1.8	-6.7	-6.7	-10.1	-4.4	1.1	-4.8	-9.8	-16.1	-25.4	-15.6	-9.5	-6.8
Net Foreign Direct Investment/GDP	-0.5	0.3	1.2	0.9	-0.6	-2.6	-2.1	-2.6	-0.4	-13.9	-24.6	-6.0	-5.5	-5.2	0.0
Net Int'l Investment Position/GDP	-51.4	-48.3	-48.2	-50.2	-49.4	-65.1	-78.6	-69.8	-62.7	-67.4	-84.6	-119.6	-125.4	--	--
Official Foreign Exchange Reserves (US$ Mil.)	292.5	438.6	369.5	411.6	452.9	364.6	314.8	414.7	764.6	1,017.3	1,009.1	2,273.2	2,549.1	2,300.0	2,400.0
Net Foreign Assets of Domestic Banks (US$ Mil)[3]	-339.5	-530.1	-722.4	-1,358.8	-1,771.8	-2,383.4	-2,179.0	-2,240.3	-1,453.7	-803.6	3,205.5	9,081.7	8,531.5	--	
Liabilities to BIS Banks/Assets	463.3	445.3	630.7	806.2	940.8	1,360.1	1,146.5	776.4	466.1	359.4	314.1	207.1	229.8	--	
Liquidity Ratio	201.9	185.4	221.7	368.0	444.1	539.4	461.7	322.5	163.8	95.1	111.3	75.3	155.9	--	

[1] Sum of Exports and Imports of Goods and Services/GDP

[2] Real Effective Exchange Rate (IFS) (September 2005)

[3] 2007 as of July

[4] 2007 as of September

Moody's Related Research

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- Iceland, February 2008 (107766)

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- Banking System Outlook: Iceland, November 2007 (106019)

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Special Comments:

- Iceland's Aaa Ratings at a Crossroads, January 2008 (107223)
- Bank Ratings and Government Bond Ratings, August 2007 (103903)
- Analyzing the Tradeoff between Ratings Accuracy and Stability, September 2006 (99100)
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Iceland

Report Number: 108335

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