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Research Update:

Republic of Iceland Outlook Revised To Stable From Negative On Receding Fiscal Risk; 'BBB-/A-3' Ratings Affirmed

Primary Credit Analyst:
Eileen X Zhang, CFA, London (44) 20-7176-7105; eileen.zhang@standardandpoors.com

Secondary Contact:
Aarti Sakhuja, London (44) 20-7176-7111; aarti.sakhuja@standardandpoors.com

Table Of Contents

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Overview

- We estimate that Iceland's proposed mortgage debt relief program will have a cumulative fiscal cost of about 6% of GDP over the next four years.
- We expect the government to finance the program through increased taxation and not higher deficits.
- We are therefore revising the outlook on Iceland to stable from negative. At the same time, we are affirming our 'BBB-/A-3' ratings on Iceland.
- The stable outlook reflects what we see as a balanced risk from the continued economic recovery and the uncertainties related to the lifting of capital controls.

Rating Action

On Jan. 24, 2014, Standard & Poor's Ratings Services revised the outlook on the Republic of Iceland to stable from negative. At the same time, we affirmed our 'BBB-/A-3' long- and short-term foreign and local currency sovereign credit ratings on Iceland.

Rationale

The outlook revision reflects our opinion that Iceland's proposed mortgage debt relief program would not materially increase general government debt, provided that the program is financed through increased budgetary revenue. However, we believe that some of the government's proposed revenue measures could face court challenges from creditors of the old, defaulted Icelandic banks, who are estimated to bear about three-quarters of the cost of the debt relief through a levy on financial institutions. As long as uncertainty persists over the collection of these revenues and their potential impact on foreign investor sentiment, we anticipate that Iceland's lifting of capital controls will be delayed further.

The new government, a majority coalition of the Progressive Party and the Independent Party, was formed after the April 2013 election. Both parties had made strong election pledges to grant additional household debt relief. Three years previously, the then-government implemented debt relief for households with mortgage debt greater than 110% of house value. In addition, the supreme court ruled that household loans that were indexed to foreign currencies were illegal, offering substantial debt relief to the borrowers. The new proposed measures would offer debt relief to a broader cross-section of households.

In November 2013, the government announced an action plan to provide household debt relief of Icelandic krona (ISK) 150 billion (amounting to 8.4% of GDP), comprising a direct write-off of ISK80 billion for households with index-linked mortgages and ISK70 billion from redirecting private pension contributions (through tax incentives) to loan repayment. The government estimates that the cost associated with direct write-offs will be about ISK20 billion for 2014-2017. Including foregone personal income tax receipts and lower dividends from banks, the annual cost is estimated to be around ISK27 billion, or 1.5% of GDP, in 2014 and roughly 6% of GDP for the next four years. The government has proposed to match this cost with an increased levy on financial undertakings, both on new banks and bankruptcy estates. The design of the measures could result in foreign creditors of the defaulted Icelandic banks bearing around three quarters of the cost of the household debt forgiveness.

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. The ratings are constrained by high external and public-sector debt. We believe Iceland's debt burden could have been higher still if capital controls were not present to limit 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; measured as loans to borrowers with at least one loan over 90 days in default) remain high at 14% of total loans.

Since the onset of the 2008 financial and economic crisis, the Icelandic economy has shown resilience by reining in its fiscal and external deficits. After contracting by more than 10% during 2009-2010, Iceland's GDP began to recover. The 36% depreciation of its real effective exchange rate between 2007 and 2012 has helped its economic rebalancing.

We expect the Icelandic economy to continue growing on average by nearly 2% annually in 2014-2017. The export sector is growing due to strong tourism and an increased fishing quota after years of conservation. This offsets subdued investment, which remains well below pre-crisis levels. We expect the current account--omitting the accrued interest of the defaulted banks' external debt--will remain in surplus from 2012 to 2015, but could move to a slight deficit when domestic demand picks up. Medium- to long-term growth will depend largely on business investment, which faces several uncertainties related to policy changes regarding the use of natural resources; a potential undersea electric cable to Europe; external financing conditions; and the lifting of capital controls.

In our view, although lax financial-sector oversight contributed to the boom-bust cycle in Iceland, other established economic policies have served it 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 foreign direct investment will bear fruit, enhancing already-high capital intensity and productivity levels in the small and increasingly open economy.

The recovery of domestic demand since 2011 has improved tax collections. This has narrowed the general government headline deficit to an estimated 2.0% of GDP in 2013, from around 10% in 2009 and 2010. Following the issuance of a five-year bond in June 2011, the Icelandic government successfully issued a 10-year bond equivalent to 7% of GDP in May 2012 and used the proceeds to prepay some official borrowing from the IMF and Nordic countries. This transaction has significantly lengthened the maturity of the government's external liabilities. We believe that gross general government debt is likely to continue to decline from the estimated 101% of GDP in 2013. We also anticipate a decline over the next few years in central and local government guarantees (principally related to the Housing Financing Fund and power companies Landsvirkjun and Reykjavik Energy), which add contingent liabilities amounting to a further 79% of GDP. That said, government fiscal assets, relating to its deposit at the central bank, amount to an estimated 27% of GDP as of the end of 2013.

High external debt burdens, however, remain key ratings constraints. We expect Iceland's gross external financing requirement, including errors and omissions, to make up 30% of current account receipts over the next few years, not counting any distributions from the bankruptcy estates. Although Iceland's economy was able to adjust after the crisis through currency depreciation and private sector defaults, a nonresident holding of ISK-denominated assets presented a large overhang to the currency markets. The Central Bank of Iceland addressed this through foreign exchange controls implemented in 2008. Its plans to lift the controls have been hampered by the country's shallow domestic capital markets and the significant risks of capital flight. The need for continued foreign exchange controls is a credit weakness for the sovereign ratings on Iceland.

The financial sector has been significantly restructured since the bank defaults of 2008. New commercial banks have made notable progress in restructuring their balance sheets. Loan-loss provisions have declined steadily and we expect restructuring will continue in 2014. However, NPLs remain significant; concentration risk--given the economy's dependence on the fisheries and aluminum sectors--is still high; and further meaningful losses cannot be ruled out, especially if the banking sector has to participate in a partial write-off of household debt.

Outlook

The stable outlook reflects what we see as a balanced risk from the continued economic recovery and the uncertainties related to the lifting of capital controls in Iceland. We expect the proposed write-down of household debt to support private consumption, and a coalition that is more open to energy-intensive investments could support business investment. We could raise the ratings if the net general government debt burden declines faster than our current assumption, through higher primary fiscal surpluses or stronger growth.

On the other hand, Iceland's high pending external liquidity pressure, currently held at bay by the exchange controls, poses a risk to the ratings. We could lower the ratings if the lifting of the controls resulted in a significant decline in reserves or renewed pressure on the Icelandic financial system. In addition, pressure on the ratings could build before the lifting of controls if the recent favorable trends in Iceland's fiscal or current account were to reverse.

Key Statistics

Table 1

Republic of Iceland - Selected Indicators												
	2006	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**	**2013e**	**2014f**	**2015f**	**2016f**	**2017f**
Nominal GDP (US$ bil)	16.7	20.4	16.8	12.1	12.6	14.0	13.6	14.7	16.1	16.3	16.8	17.8
GDP per capita (US$)	55,525	66,396	53,357	37,936	39,558	44,107	42,491	45,909	50,363	50,857	52,669	55,729
Real GDP growth (%)	4.7	6.0	1.2	(6.6)	(4.1)	2.7	1.4	2.0	2.2	2.1	2.3	2.4
Real GDP per capita growth (%)	2.5	3.3	(1.3)	(7.7)	(3.6)	2.4	1.0	2.0	2.2	2.1	2.3	2.4
Change in general government debt/GDP (%)	7.8	1.7	52.2	22.6	8.7	20.3	(9.9)	2.0	1.5	(2.4)	(0.8)	1.0
General government balance/GDP (%)	6.3	5.4	(13.5)	(9.9)	(10.1)	(5.6)	(3.8)	(2.0)	(1.5)	(1.0)	(1.0)	(1.0)
General government debt/GDP (%)	30.0	28.5	77.4	99.1	105.4	119.7	104.9	101.3	97.6	90.3	84.7	81.0
Net general government debt/GDP (%)*	11.9	12.4	50.2	58.1	65.3	66.9	68.1	66.5	64.6	62.3	60.0	57.7
General government interest expenditure/revenues (%)	4.5	5.4	7.6	16.1	13.3	12.4	12.9	11.3	10.4	10.0	9.2	8.6
Oth dc claims on resident non-govt. sector/GDP (%)§	256.3	311.2	208.1	153.7	147.1	146.4	139.1	133.7	130.6	127.8	124.5	121.2
CPI growth (%)	6.8	5.0	12.4	12.0	5.4	4.0	5.2	4.0	3.8	4.0	4.0	4.0
Gross external financing needs/CARs +use. res (%)†	287.8	317.7	653.9	157.6	139.5	113.1	91.1	94.6	91.8	89.0	89.3	90.3
Current account balance/GDP (%)‡	(23.8)	(15.7)	(18.0)	(0.2)	(2.1)	(0.5)	0.6	2.4	2.4	1.0	(0.3)	(1.6)
Current account balance/CARs (%)‡	(50.1)	(28.0)	(35.1)	(0.4)	(3.7)	(0.8)	0.9	3.8	3.8	1.6	(0.5)	(2.5)
Narrow net external debt/CARs (%)**	439.4	433.4	158.1	175.4	145.8	92.8	84.4	72.8	60.2	56.5	54.5	53.1
Net external liabilities/CARs (%)	223.5	205.6	69.6	54.5	74.2	48.0	(0.3)	1.5	4.7	11.0	19.4	29.4

Table 1

Republic of Iceland - Selected Indicators (cont.)

*General government debt includes Central Bank of Iceland's borrowings from the IMF and Norway. §Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. †Gross external financing needs are defined as current account payments, plus short-term external debt at the end of the prior year, plus nonresident deposits at the end of the prior year, plus long-term external debt maturing within one year. Iceland's external accounts are adjusted to exclude the assets and liabilities of the defaulted banks. ‡Iceland's current accounts are adjusted to exclude the accrued interest of the defaulted banks. **Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts.

The data and ratios above result from S&P's own calculations, drawing on national as well as international sources, reflecting S&P's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Republic Of Iceland Outlook Revised To Negative On Fiscal Risk; 'BBB-/A-3' Ratings Affirmed, July 26, 2013
- Sovereign Defaults And Rating Transition Data, 2012 Update, March 29, 2013

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts. The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook.

Ratings List

Ratings Affirmed; CreditWatch/Outlook Action

	To	From

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Iceland (Republic of)
 Sovereign Credit Rating                BBB-/Stable/A-3    BBB-/Negative/A-3

Ratings Affirmed

Iceland (Republic of)
 Senior Unsecured Debt                  BBB-
 Short-Term Debt                        A-3
 Commercial Paper                       A-3
 Transfer & Convertibility Assessment   BBB-
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Additional Contact:
SovereignEurope; SovereignEurope@standardandpoors.com

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