MOODY'S
INVESTORS SERVICE

Announcement: **Moody's affirms Iceland's Baa3/P-3 ratings and maintains negative outlook**

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London, 20 April 2011 -- Moody's Investors Service has today affirmed Iceland's Baa3 local and foreign currency government bond ratings and their negative outlook, as well as the Prime-3 rating for the country's short-term debt.

Today's announcement comes despite the recent majority "no" vote in the country's referendum on the revised Icesave agreement, which Moody's had previously said (February 2011) would most likely result in a negative rating action. However, today's affirmation of the rating recognizes the following developments that led Moody's to reach a more benign assessment of the referendum outcome:

(1) Despite the rejection of the revised agreement to resolve the dispute over the Icesave offshore bank deposit scheme, the British and Dutch governments are now expected to receive initial payments from the Landsbanki estate soon for the costs they incurred in covering their citizens' Icesave deposits. In addition, the Landsbanki estate now expects to be able to make significantly higher payments to priority claimholders as asset recoveries have been much higher than expected earlier. The outstanding Icesave obligation and potential liability to the government might therefore be reduced significantly in the coming months regardless of the referendum outcome.

(2) Moody's also expects Iceland's programme of support from the International Monetary Fund (IMF) to remain on track. The fifth review was scheduled for 27th April and there will certainly be a delay while the IMF assesses the implications of the referendum outcome. However, it seems unlikely that there will be a significant delay or blockage of the programme as occurred in 2009.

(3) Public statements indicate that the Nordic governments will likely continue to provide funding to the Icelandic authorities under their loan agreements. Apart from the IMF, the Nordic governments' financing has been an essential external funding source for the Icelandic authorities.

The outlook on the rating remains negative given the ongoing uncertainty. Moody's understands that the underlying issue of whether the Icelandic government has a liability under the EU directive on deposit-guarantee schemes will now most likely be resolved through the court of the European Free Trade Association (EFTA). This legal process may take at least a year. There are also uncertainties regarding the timetable for the relaxation of the capital controls and the economic outlook, in particular related to investment.

RATIONALE FOR AFFIRMATION OF CURRENT RATING

The primary driver of today's affirmation of Iceland's ratings is Moody's recognition that the size and importance of the government's liability related to the Icesave dispute will likely decline substantially in the coming months. This is because the Landsbanki Resolution Committee now estimates that asset recoveries will ultimately amount to approximately 90% of priority deposit claims, which is significantly higher than earlier estimates. The Resolution Committee is expected to start paying out to priority claimants (such as the UK and Netherlands governments) after the summer. Given the substantial cash reserves that the estate has accumulated, the potential liability to the government (if found liable) might well have declined to less than half by the time the legal process has run its course. However, Moody's continues to view the full resolution of the Icesave issue -- most likely through further legal proceedings -- to be an important pre-requisite for normalizing Iceland's relations with the international investor community.

The second driver underlying the rating affirmation is Moody's expectation that the IMF programme will not undergo any material changes and remain on track, despite a short delay while the IMF re-assesses its macroeconomic framework. Overall, Moody's considers the IMF programme to be a crucial anchor for Iceland's economic and financial recovery, especially in terms of the ongoing fiscal consolidation. A related third driver is the rating agency's expectation that the Nordic governments will also continue to provide funding to Iceland under their loan agreements (EUR888 million still available). The deadline for draw-downs has recently been extended until December 2011.

These drivers address Moody's previous concerns that a possible rejection of the Icesave agreement might put the external funding from the Nordics (and consequently the IMF) at risk, thereby undermining Iceland's economic recovery, fiscal sustainability and the ability of the Icelandic authorities to relax the strict capital controls that are in place.

Additionally, Moody's notes that the government recently announced a buyback offer at par for all holders of the two Eurobonds maturing in December 2011 and April 2012. The government has already bought back a significant amount of these bonds but approximately EUR800 million worth remain outstanding. The May 5 auction will provide a good indication of the sentiment of non-resident investors towards Iceland and will probably influence the timing of the first steps to relax capital controls.

RATIONALE FOR MAINTAINING A NEGATIVE OUTLOOK

Moody's notes that there are still significant risks that warrant maintaining a negative outlook on the rating. While the size of the Icesave liability will shrink, the government could still be found liable for accrued interest and any uncovered portion of the principal, the amount of which is unclear at this point in time. Litigation risks relating to the Emergency Act and the priority status of deposits claims are another source of uncertainty, but Moody's expects these lawsuits to be resolved in the coming months.

Moreover, the risks to Iceland's economic recovery are significant. In particular, Moody's believes that the economy might be negatively affected due to lower capital inflows because of possible delays to the liberalization of the strict capital controls that are currently in place. The positive GDP growth, which Moody's expects Iceland to record in 2011, relies mainly on a strong rebound in investment -- but this may not materialize if foreign investors delay investment decisions, pending a full resolution of the Icesave issue. A longer-term question is whether the rejection of the Icesave agreement will have more fundamental implications for the outlook for FDI and the attractiveness of Iceland as a place of doing business.

WHAT COULD CHANGE THE RATING DOWN

Moody's would downgrade Iceland's rating if the above-mentioned legal risks related to the priority status of deposits were to materialize. This would result in a much higher liability for the government because of lower payouts from the Landsbanki estate to the British and Dutch governments. The rating would also come under downward pressure if Nordic funding was disrupted against our expectations or the economic recovery turns out to be slower than Moody's is expecting, possibly due to delays to important investment projects or slower-than-expected corporate and household debt restructuring. Indications of a declining commitment to fiscal consolidation would also be negative for the rating. The speed and sequencing of capital account liberalization will become a more important ratings driver going forward, and Moody's will closely monitor the impact of the steps the Icelandic government will take on the exchange rate.

WHAT COULD CHANGE THE RATING UP

Moody's would consider returning the rating outlook to stable and potentially upgrading the ratings if the economy were to recover much faster than is currently expected and if the foreign exchange rate were to remain stable following the gradual relaxation of capital controls.

PREVIOUS RATING ACTION AND METHODOLOGY

Moody's last rating action affecting Iceland was implemented on 29 July 2010, when the rating agency assigned a negative outlook to Iceland's Baa3 rating. The rating action prior to that was taken on 23 April 2010, when the rating agency returned the outlook on the Baa3 rating to stable from negative.

The principal methodology used in rating the government of Iceland is Moody's "Sovereign Bond Methodology", published in 2008.

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