STANDARD & POOR'S

RATINGSDIRECT®

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Research Update:

Iceland Foreign Currency Rating Lowered To 'BBB-' On Mounting Debt Burden; Outlook Negative

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Rationale

On Nov. 24, 2008, Standard & Poor's Ratings Services lowered its long-term foreign currency rating on Republic of Iceland to 'BBB-' from 'BBB' due to the sovereign's mounting public sector debt burden. The Transfer & Convertibility assessment on Iceland was also lowered to 'BBB-' from 'A-' in response to controls on the capital account and some current account transactions, which have been in place since early October. At the same time, Standard & Poor's affirmed its 'BBB+/A-2' local currency ratings, and its 'A-3' short-term foreign currency sovereign credit ratings. The outlook is negative.

In conjunction with these rating actions, Standard & Poor's also lowered its long-term foreign currency rating on Ibudalanasjodur (Housing Financing Fund; HFF), the government-owned enterprise for housing finance, to 'BBB-' from 'BBB'. The 'BBB' long-term local currency rating and the 'A-3' short-term foreign and local currency ratings were affirmed. The outlook is negative.

The downgrade reflects Iceland's substantially higher debt burden compared with our projections when we last lowered the ratings on Iceland on Oct. 6, 2008, as the Icelandic government will assume a greater share of its banks' overseas operations in exchange for multilateral and bilateral balance of payments support. As a result of the steep rise in debt from the collapse of the banking system, coupled with a projected 10% contraction of the economy in 2009 and our forecast of double-digit fiscal deficits in 2009 and 2010, we expect gross general government debt to surge to over 130% of GDP, from the 29% at of the end of 2007. The sustainability of such a high foreign currency debt level depends on the ability of authorities to stabilize the Icelandic krona (ISK), as well as the capacity of national savings to rise from their current level of 12% of GDP.

Outlook

The negative outlook reflects execution risks on the IMF program, which fall into three areas. First, the amount of the program ($5 billion including other official support) may not be enough to restore stability and liquidity in the foreign exchange markets, particularly if there are uncertainties regarding the timing with which bilateral assistance is disbursed, or if there is heavy selling of the ISK293 billion stock of glacier bonds. Second, the amount allocated to recapitalize the financial system (ISK385 billion) may be insufficient if HFF needs additional capital to cover its ISK8-12 billion losses from its exposure to Icelandic banks or from rising defaults on home loans. Third, beginning in 2011, the government coalition may come under strain as it will have to undertake a sharp fiscal adjustment through measures that so far haven't been identified. Any materialization of these risks would result in the foreign currency rating being lowered. On the other hand, successful stabilization of the exchange rate, and accumulation of foreign currency reserves via a shift of the balance of payments into surplus, could alleviate political and monetary tensions and pave the way for an economic recovery. This would in turn make fiscal consolidation possible, and hence lead to an improvement in the outlook for sovereign creditworthiness.

Ratings List

	To	From
Iceland (Republic of)		
Sovereign Credit Rating		
Foreign Currency	BBB-/Negative/A-3	BBB/Negative/A-3
Local Currency	BBB+/Negative/A-2	BBB+/Negative/A-2
Transfer & Convertibility Assessment	BBB-	A-
Commercial paper	A-3	A-3
Ibudalanasjodur (Housing Financing Fund)		
Foreign currency	BBB-/Negative/A-3	BBB/Negative/A-3
Local Currency	BBB/Negative/A-3	BBB/Negative/A-3

NB: This list does not include all affected ratings.

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Ratings information is available to subscribers of RatingsDirect, the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at www.ratingsdirect.com. It can also be found on Standard & Poor's public Web site at www.standardandpoors.com; select your preferred country or region, then Ratings in the left navigation bar, followed by Credit Ratings Search. 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) 495-783-4017.