Announcement: **Moody's Disclosures on Credit Ratings of Iceland, Government of**

Global Credit Research - 23 Dec 2011

London, 23 December 2011 -- The following release represents Moody's Investors Service's summary credit opinion on Iceland and includes certain regulatory disclosures regarding its ratings. This release does not constitute any change in Moody's ratings or rating rationale for Iceland.

Moody's maintains the following ratings on Iceland, Government of

Iceland, Government of

Long Term Issuer (domestic and foreign currency) ratings of Baa3

Senior Unsecured (domestic and foreign currency) ratings of Baa3

Senior Unsecured MTN Program (foreign currency) ratings of (P)Baa3

Commercial Paper (domestic and foreign currency) ratings of P-3

Other Short Term (foreign currency) ratings of (P)P-3

RATINGS RATIONALE

The Icelandic government's ratings were affirmed at Baa3 on 20 April 2011, despite the rejection of the revised Icesave agreement in a popular referendum on 9 April 2011. The underlying dispute over the government's responsibilities under the EU directive on deposit-insurance schemes will probably be resolved in the EFTA court. The rating has nevertheless been affirmed as the potential liability to the government will most likely be significantly reduced as asset recoveries from the Landsbanki estate are higher than expected earlier. First payments to priority claimholders (such as the UK and Dutch deposit insurance funds) are expected to be made early next year.

On a fundamental assessment, Iceland exhibits moderate economic strength. Although a significant amount of wealth was destroyed during the currency and banking crisis in late 2008, per capita incomes remain comparatively high on a global scale. Offsetting the high level of wealth is the small size of the economy, which increases its vulnerability to shocks. The economy has finally started to improve since Q3 2010 and is expected to rebound moderately this year and over the medium term, stimulated by the weak exchange rate and new investment in power-intensive industries. However, there are significant uncertainties, in particular regarding the outlook for investment which depends to an important extent on the speed with which the strict capital controls will be abolished.

Iceland's ratings are limited by the government's strained balance sheet, which has been significantly damaged because of the assumption of large financial liabilities following the banking and currency crisis. The government has implemented important fiscal consolidation measures since 2009. This year, the budget deficit is forecast to decline to 5.7% of GDP for the general government, compared to a deficit of 13.5% of GDP in 2008. This includes the cost of recapitalising the Housing Finance Fund and several small savings banks in 2011. The public debt ratio is expected to stabilise this year at around 100% of GDP and then decline from 2012 onwards. However, this scenario requires ongoing strong commitment to fiscal consolidation for many years to come. The recently presented 2012 budget proposal and the revised medium-term fiscal strategy give some comfort regarding the authorities' resolve to return public debt to a more easily manageable level. But significant risks to the outlook for public finances remain, in particular (i) the uncertain outlook for economic growth over the next several years and (ii) the possible crystallisation of further contingent liabilities onto the government's balance sheet. The banking sector recapitalisation has been more or less completed although HFF remains thinly capitalised. But the government has guaranteed significant amounts of debt of the Housing Financing Fund and the major Icelandic power company Landsvirkjun. A mitigating factor are the significant financial assets that the government has acquired as part of the recapitalisation of the "new" banking system. Taking those assets into account reduces the government's net debt burden to around 66% of GDP this year (excluding Icesave due to the uncertainty over the eventual obligation). Moreover, the existence of large domestic pension funds allows the government to finance itself in the local capital markets at low interest rates and relatively long maturities, which is an important funding support given the capital controls in place.

Iceland is considered to have a high susceptibility to event risk, mainly on account of the risks entailed in the process of capital control liberalisation. On the one hand, the lifting of the capital controls and renewed access to external funding are crucial elements for a sustained recovery in Iceland. On the other, a too rapid relaxation of capital controls risks creating excessive exchange rate weakness. Foreign investors - trapped in the country when the capital controls were introduced in late 2008 - hold an estimated ISK465 billion (approx. 30% of GDP) in assets in the country. Most, if not all, will want to exit as soon as possible, with significant implications for the exchange rate, if their exit is not properly sequenced and managed. Once there is a track record of successful steps in liberalising the capital controls, we will probably consider moving our assessment of susceptibility to event risk back to moderate.

The risk of a negative impact on the government's balance sheet from litigation has recently been reduced further. The Supreme Court upheld the Emergency Law imposed at the end of 2008 to award priority status to depositors over other creditors. This decision removes a significant (though in our view low probability) risk to the government's finances. In the context of the Icesave issue, it means that the expected asset recovery from the Landsbanki estate will most likely be sufficient to repay the UK and Dutch deposit insurance funds in full. First repayments are expected to be made early next year. Litigation risks related to the eventual resolution of the Icesave issue remain but we note that the high asset recovery from the Landsbanki estate also mitigates this risk to an important degree.

Rating Outlook

The outlook on the ratings is currently negative given the risks to fiscal consolidation and the process of capital control liberalisation.

What Could Change the Rating - Up

The ratings could be upgraded if there are signs of a robust and sustained economic recovery, significant fiscal consolidation continues and the exchange rate remains broadly stable during the process of gradual capital control relaxation.

What Could Change the Rating - Down

The rating could be downgraded if the current commitment to fiscal consolidation showed signs of declining or the remaining legal risks related to a resolution of the Icesave issue resulted in a significantly higher liability for the government than is currently expected.

Going forward, the speed and sequencing of capital account liberalization will become a more important rating driver and Moody's will closely monitor the impact of the next steps on the exchange rate and financial stability.

The principal methodology used in this rating was Sovereign Bond Ratings published in September 2008. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

REGULATORY DISCLOSURES

For ratings issued on a program, series or category/class of debt, this announcement provides relevant regulatory disclosures in relation to each rating of a subsequently issued bond or note of the same series or category/class of debt or pursuant to a program for which the ratings are derived exclusively from existing ratings in accordance with Moody's rating practices. For ratings issued on a support provider, this announcement provides relevant regulatory disclosures in relation to the rating action on the support provider and in relation to each particular rating action for securities that derive their credit ratings from the support provider's credit rating. For provisional ratings, this announcement provides relevant regulatory disclosures in relation to the provisional rating assigned, and in relation to a definitive rating that may be assigned subsequent to the final issuance of the debt, in each case where the transaction structure and terms have not changed prior to the assignment of the definitive rating in a manner that would have affected the rating. For further information please see the ratings tab on the issuer/entity page for the respective issuer on www.moodys.com.

The rating has been disclosed to the rated entity or its designated agent(s) and issued with no amendment resulting from that disclosure.

Information sources used to prepare the rating are the following : parties involved in the ratings, parties not involved in the ratings, public information, and confidential and proprietary Moody's Investors Service information.

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Please see www.moodys.com for any updates on changes to the lead rating analyst and to the Moody's legal entity that has issued the rating.

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