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**Research Update:**

# Iceland Sovereign Ratings Lowered On External Funding Risks; Outlook Negative

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## Research Update:

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## Rationale

On April 17, 2008, Standard & Poor's Ratings Services lowered the long-term foreign currency rating on the Republic of Iceland to 'A' from 'A+' and its long-term local currency rating to 'AA-' from 'AA'. The 'A-1' short-term foreign currency and 'A-1+' short-term local currency ratings were both affirmed. In conjunction with this action, Standard & Poor's also lowered the long-term foreign currency rating on Ibudalanasjodur (HFF), the government-owned enterprise for housing finance, to 'A' from 'A+', and its local currency ratings to 'A+/A-1' from 'AA-/A-1+'. HFF's short-term foreign currency rating of 'A-1' was affirmed. The T&C assessment on Iceland has also been downgraded to 'AA' from 'AA+'. The long-term ratings on both Iceland and HFF were removed from CreditWatch negative, where they were placed on April 1, 2008, and are now on negative outlook.

The downgrade of the sovereign reflects increasing economic policy challenges, largely due to pressure on Iceland's external funding for the nation's commercial banks. Iceland's banks rely on wholesale funding, particularly from overseas, and higher funding costs are hurting their profitability and growth. Due in part to banks' financing of their own rapid expansion abroad as well as that of several local entrepreneurs, net external debt of the financial system has risen to 362% of current account receipts in 2007, from 161% in 2003. Domestic credit to GDP has risen to over 384% from 130% during the same period. These are among the highest ratios for rated sovereigns.

The banks' higher funding costs, combined with the recent 27% effective depreciation of the Icelandic krona, increase the chances that the economy will contract more and for a longer period than we had foreseen when we lowered the ratings on Iceland on Dec. 22, 2006. Although pronounced swings have been a recurrent feature of the Icelandic economy, the economy's leverage has reached an unprecedented level. Household and corporate debt combined has risen to over 400% of GDP at Dec. 31, 2007, from 184% in 2004. Domestic demand is expected to contract severely in the next two years as the rapid pass-through of the depreciating krona manifests itself in a temporary surge in the inflation rate, which not only diminishes real income, but also raises the mortgage payments, which are mostly inflation linked. At the same time, cheap credit will also dry up, as the Icelandic banks face high funding costs and increasing difficulties in securing external financing. Net exports will partly offset the effect of shrinking domestic demand, but a recession seems unavoidable.

As a result of difficulties in external financing for Iceland's banks and the ensuing recession, we expect the composition of the country's external debt to change: commercial banks will lower their reliance on external funds by shrinking their balance sheet and the government will increase its share of

external financing. We project that sizable fiscal deficits during the downturn will increase gross general government debt to 36% of GDP by 2010 (comparable to the 'A' median) from 28% in 2007, but the debt burden could rise much faster if the government is forced to provide direct assistance to its country's commercial banks.

The ratings on HFF have been lowered to reflect the lower ratings on the government, as well as the weaker prospects for asset quality in the housing market.

## Outlook

The negative outlook reflects prevailing downside risks. The outlook would revert to stable if the banks or the government take actions to restore market confidence and to induce a narrowing of the Icelandic bank risk premium. Conversely, if banks fail to undergird their financial profile (external and domestic liquidity, profitability, and asset quality), vulnerability in the nation's external profile would fester, and could lead to a further one-notch downgrade of the sovereign rating.

To view the main economic indicators for the Republic of Iceland, please click [here](#) (RatingsDirect subscribers only). RatingsDirect is the real-time Web-based source for Standard & Poor's credit ratings, research, and risk analysis, at [www.ratingsdirect.com](http://www.ratingsdirect.com).

## Ratings List

### Sovereign credit ratings

	To	From
Foreign currency	A/Negative/A-1	A+/Watch Neg/A-1
Local currency	AA-/Negative/A-1+	AA/Watch Neg/A-1+

### Transfer & Convertibility

AA	AA+
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CP	A-1	A-1
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### Ibudalanasjodur (Housing Financing Fund)

Foreign currency	A/Negative/A-1	A+/Watch Neg/A-1
Local currency	A+/Negative/A-1	AA-/Watch Neg/A-1+

NB: This list does not contain 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](http://www.ratingsdirect.com). It can also be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://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 Hotline (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. Members of the media may also contact the European Press Office via e-mail on: [media\\_europe@standardandpoors.com](mailto:media_europe@standardandpoors.com).

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