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Issuer Comment: Moody's: Iceland's recent Supreme Court decision on foreign-exchange-linked bank loans reduces uncertainty but no rating impact

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Iceland's Supreme Court has issued a second ruling related to foreign-exchange-linked automobile loans. The new ruling specifies that interest rates for FX-denominated automobile loans, which the Court had previously determined to be unlawful, should be set in accordance with domestic interest rates published by the central bank. Moody's understands that the government will soon introduce legislation that will clarify further to which other loans the Supreme Court ruling should apply. The ruling and the expected further clarification are an important and positive step in reducing the substantial uncertainty over the banking sector's ability to deal with the currency redenomination of loans.

The Supreme Court's first ruling on the legality of foreign-exchange linked loans, which was issued on 16th June, was an important factor behind Moody's decision on 29th July to assign a negative outlook to Iceland's Baa3 rating (Press Release). This ruling raised significant concerns about further recapitalisation needs of the Icelandic banking sector and consequently the state of Iceland's public finances and debt position. These specific uncertainties have now been removed. The IMF is scheduled to conclude its review by the end of September, releasing the next tranche of SDR 105 million (around US$ 160 million). This, in turn, should release the next tranche of the other Nordic governments' funding.

However, Moody's believes that there are still considerable uncertainties that cloud the economic and financial outlook for Iceland. The above-mentioned legislation may be challenged in the courts, further delaying a full restructuring of household and corporate debt, with potential negative implications for economic growth. The "Icesave" dispute with the UK and Dutch governments is also still unresolved, although negotiations are said to have recently restarted in earnest. Moreover, the recapitalisation of the Housing Financing Fund (HFF) needs to proceed before year-end, potentially putting further strains on the public finances and the government's debt level.

In addition, Moody's believes that there is still significant uncertainty over the economic outlook for Iceland as GDP growth numbers for the last several quarters have recently been revised down. Earlier estimates had indicated that the economy had been growing on a quarter-on-quarter basis since Q4 2009, but the latest revised figures now show that the economy has actually still been contracting (by an estimated 3.1% quarter-on-quarter in Q2 2010).

Moody's is therefore maintaining the negative outlook on Iceland's current rating of Baa3. As Moody's explained when it assigned the negative outlook, Iceland's sovereign rating could experience downward rating pressure in the event of (1) indications that the ongoing uncertainties will negatively impact the real economy; (2) renewed stress in the banking system and a resultant need for further capital injections by the government, which would further increase the already elevated levels of government debt; or (3) pressure on Iceland's external liquidity, which could be related to an inability to resolve the "Icesave" dispute. Conversely, positive pressure on Iceland's rating could develop if there are signs of a sustained economic recovery and successful solution to these various uncertainties.

The principal methodology used in rating the government of Iceland is "Moody's Sovereign Bond Methodology", published in 2008. This methodology can be found at www.moodys.com in the Rating Methodologies sub-directory under the Research & Ratings tab. Other methodologies and factors that may have been considered in the process of rating these issuers can also be found in the Rating Methodologies sub-directory on Moody's website.

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