Banking System Outlook: Iceland

Stable Outlook for the Banks' Deposit Ratings Affirmed but Negative Outlook on Bank Financial Strength Ratings (BFSRs) Reflects Intensifying Challenges from a More Difficult Operating Environment

Summary Opinion

Moody’s rating outlook for the Icelandic commercial banks’ financial strength ratings changed to negative from stable in April 2006, reflecting the increased challenges the Icelandic banks were likely to face in a more difficult operating environment. Nervousness in the capital markets with respect to Icelandic risk, combined with the rated Icelandic banks’ heavy reliance on wholesale funding with increasingly more of it being raised in foreign currency, led Moody’s on 4 April 2006 to put the bank financial strength ratings (BFSRs) of Glitnir banki and Landsbanki on negative outlook and that of Kaupthing on review for downgrade. Kaupthing’s BFSR was subsequently downgraded to C from C+, with stable outlook, on 12 September 2006.

However, the banks’ deposit ratings were affirmed with stable outlooks due to Moody’s belief that the importance of the major banks to the Icelandic markets makes government support likely in the event of difficulties or a systemic shock. The rating of the government of Iceland is Aaa, reflecting the country’s high income level and advanced economic structure along with the government’s low debt levels.

In Moody’s view, the changes in the banks’ operating environment threatened to increase their cost of funds, undermining profits or, worse still, provide difficulties in refinancing maturing debts - thereby creating potential problems with liquidity. Furthermore, it was the agency’s view that the economic downturn in Iceland could lead to deterioration in the banks’ asset quality, putting further pressure on earnings. However, we also noted that a considerable proportion of the banks’ loan portfolios are located outside Iceland, which should insulate them from Icelandic shocks. Furthermore, the liquidity profiles of all three should enable them to withstand the turbulence in the funding markets.

Subsequently, the banks completed their refinancing requirements for 2007 around the end of the third quarter 2006 and have begun to extend further the maturity their funding profile.
**Strengths**

- Strong likelihood of state support in the event of systemic shock
- Good financial fundamentals
- Good efficiency levels, even when excluding non-recurring income
- Diversification of income and assets by type of business and geography
- Capable credit risk management and good quality loan portfolios
- Adequate capitalisation

**Challenges**

- Margin pressure arising from fierce domestic competition
- Large exposures and related party lending higher than those of similar European banks, although well within regulatory requirements and diminishing
- Retention of income levels and asset quality given imbalances in Icelandic economy
- Controlling the market risk arising from relatively high levels of equity holdings as a proportion of risk capital
- Reliance on confidence-sensitive wholesale funding
- Maintaining a protective liquidity profile, given fluctuating capital market appetite for Icelandic risk

**Operating Environment Pressured By Macroeconomic Imbalances And Signs Of Overheating**

The Icelandic economy expanded strongly in 2005 with 5.5% real GDP growth, based on large-scale foreign investment in energy-intensive projects and credit-driven private consumption. However, by early 2006, macroeconomic imbalances and signs of overheating had become evident. At that stage, inflation had increased to over 4% and equity prices and income levels were growing at significant rates. These trends, along with rising world interest rates and changing investor preferences for risk, raised concern among market participants about the rated Icelandic banks’ heavy reliance on external market funding, the large proportion that was due to be refinanced in 2006/2007 and the risk of a systemic crisis - should they not be able to roll over these obligations. As investors began to unwind carry trades, the value of the Icelandic krona depreciated.

The Central Bank of Iceland has raised interest rates several more times during 2006 in an effort to calm inflation, which had risen to over 7% by end-September. This was accompanied by stronger fiscal measures, introduced following the government reshuffle in June. The economy is expected to slow considerably, with real GDP growth estimated to drop to 1.5% for the year.

Despite the slowing of the economy and nervousness in the funding markets, the rated Icelandic banks reaped the benefits of extensive international diversification and continued to experience good growth in the first three quarters of 2006, following their strong results in 2005. Furthermore, growth in earnings was accompanied by continued strong profitability.

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**Loan Distribution by Country**

*30 September 2006*

**Landsbanki**
- Luxembourg 13%
- Nordic & Cont. Europe 6%
- UK/Ireland 18%
- Iceland 63%

**Kaupthing Bank**
- Luxembourg 9%
- UK 18%
- Scandinavia 32%
- Other 3%

**Glitnir**
- Iceland 45.5%
- Norway 39.2%
- Denmark 3.0%
- Germany 1.3%
- Other 4.7%
- Canada 1.4%
- UK 4.9%
Franchise and Strategy

LARGE NUMBER OF PLAYERS IN COMPARISON TO SIZE OF MARKET

Moody’s rates the three largest commercial banks - Kaupthing Bank hf, Glitnir banki hf and Landsbanki Íslands hf - and HFF, which together represent over 80% of the total assets of approximately ISK5,364 billion (US$79 billion) in the banking system at end September 2006. Furthermore, there is a special purpose commercial bank, Sparisjóðabanki Íslands (Icebank), which is owned by the 24 savings banks that operate in the country and functions as their central banking institution.

Given that Iceland’s population is only around 300,000, the country appears to be significantly over-banked with four commercial banks, 23 savings banks and a state-owned mortgage company. The highly competitive nature of the Icelandic market has led to a degree of margin pressure on the banks’ core domestic businesses. Despite this, Kaupthing’s attempt in 2004 to acquire SPRON (Reykjavik Savings Bank), the largest savings bank in Iceland, in full agreement with the latter’s management, resulted in a political move to change the regulations. It has thus become virtually impossible for any of the commercial banks to acquire a savings bank. However, a merger among the larger savings banks, SPV and SPH, has been concluded and endorsed by the Financial Supervisory Authority (FME). Further mergers among the savings banks are on the horizon. Moody’s believes that there is scope for consolidation within the wider financial market.

GOVERNMENT HAS BEEN REDUCING ITS OWNERSHIP IN THE BANKING SECTOR...

Although the government had been significantly involved in the banking sector, it began selling its holdings in 1999. Most recently, it sold the assets and liabilities of the Agricultural Loan Fund to Landsbanki in September 2005 and the government is now only involved in the sector via its ownership of the specialised lender, HFF. However, this still provides the government with a significant role given that HFF provides home loans against property collateral and is the largest lender to Icelandic households. With the banks and savings banks starting to compete strongly for housing loans, a government committee was set up to consider possible changes to HFF’s future role and has made certain proposals. These are discussed further below.

BUT STATE SUPPORT IN THE EVENT OF SYSTEMIC SHOCK IS STILL HIGHLY LIKELY

Despite the government’s stated intention to further reduce its involvement in the banking sector, in Moody’s view there is a strong likelihood that the central bank would provide support to any or all of the three rated commercial banks were they to encounter difficulties. These financial institutions are too important to fail and the size of the banking sector represents a large portion of the country’s economy. In this context, it is worth noting that the largest, Kaupthing Bank, accounts for more than 23% of the equity market capitalisation of all companies on the Icelandic stock exchange. HFF, being owned by the Icelandic state, already enjoys ownership support.
STRONG COMPETITION IN HOUSEHOLD LENDING

Until 2004, HFF dominated the residential mortgage market in Iceland. With implied state support and tax-exempt status, the specialised mortgage lender was able to lend at very low interest margins due to its low-cost funding. The commercial banks had wanted a change in the status of the HFF for years when finally, in early 2004, the Bankers and Securities Dealers Association of Iceland (SBV) made a complaint to the European Free Trade Association (EFTA) regarding an alleged contravention of European Economic Area (EEA) competition rules. The SBV claimed that HFF held a competitive advantage relative to other potential Icelandic mortgage providers due to its unfairly benefiting from state aid. The complaint was rejected in July 2004, but was later successfully appealed with the consequence that a formal investigation was launched in June 2006. The results are expected in 2007.

The savings and commercial banks had found it difficult to compete with HFF. However, in August 2004, HFF’s advantage had lessened due to (i) the margin compression that accompanied low interest rates, (ii) the relatively low absolute lending limits that made it difficult to compete in the growing mid- and higher-value properties. By linking together several banking products and having the scope to extend larger mortgages to buyers of mid- to higher-value housing, the savings and commercial banks managed to match or improve upon the terms offered by HFF. The step put pressure on margins but helped the commercial and savings banks gain access to household lending secured by property, a large market that had escaped them until then. Since then, HFF has experienced a dramatic drop in its overall market share from a high of 80% in 2003 to 45% at end-June 2006 (56% if one includes its mortgage-backed loans to other Icelandic financial institutions).

The public’s improved access to housing loans, based on a further opening of financial markets and reductions in long-term interest rates, led to a significant rise in property prices beginning in the latter half of 2004 and was seen by the central bank as a major cause of accelerating domestic inflation. As house prices rose, the banks gradually tightened their lending criteria and raised their pricing. Mortgage finance in Iceland is price-sensitive and, for a few months, HFF appeared to be regaining some of its market share as a low-cost provider of mortgages, but at the end of June 2006 a series of measures to ease inflation included new restrictions on HFF’s lending guidelines. These may contribute towards levelling the competitive playing field once again.

THE GOVERNMENT HAS YET TO RESOLVE THE FUTURE ROLE OF HFF

HFF’s future role is currently under review. In January 2006, the Icelandic government formed a working party to review the role of the HFF and explore what changes, if any, should be made to its activities. The working party consulted widely with all interested stakeholders and published its conclusions in October 2006. It recommended that HFF continue in its special role of promoting home ownership on equal terms anywhere in the country. However, it also proposed that a new covered bond law be passed, thereby enabling HFF to fund its lending programme with covered bonds instead of unsecured bonds carrying implied government support. This would end what the banking sector considers an unfair cost advantage, derived from issuing bonds with implied government support. In that connection, the proposal also recommended that the Ministry of Commerce initiate legislation to allow covered bond issuance in Iceland.

The SBV is disappointed with these proposals because it believes they do no go far enough. The SBV maintains that the banks can provide appropriate funding for all those wishing to own homes and that the government’s efforts to make special provisions for those who are financially disadvantaged should stop short of a continuing participation in the banking sector. In any event, it is not believed that steps will be taken to resolve the role of HFF going forward until after the election in early 2007.

Moody’s Aaa long-term debt rating for HFF is largely based on implied government support, given its status as a government-owned institution.1 A weakening of such support would have negative implications for its rating. Moody’s will therefore be monitoring the result of EFTA’s investigation and the government’s final resolution on HFF’s future role.

THE QUALITY OF RESIDENTIAL MORTGAGES HOLDING UP

Although house prices have climbed considerably since the end of 2004, they have now begun to stabilise and, in some locations, ease off. The market is predicting a soft landing but, if the landing were harder than predicted, it should be mitigated to some extent as unemployment levels are expected to remain low and relatively stable. With mortgages being index-linked, a sharp deterioration in the quality of mortgage lending is thus not anticipated. Furthermore,

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1. For more information on the application of Joint Default Analysis for Government Related Issuers, please refer to Moody’s Rating Methodology listed at the end of this publication under Related Research.
Moody’s derives comfort from the fact that the rated banks’ average LTV ratios have until now remained reasonably contained and that stress testing for an increase in interest rates has largely been performed against household income before determining the amount of a mortgage loan.

ICELANDIC BANKS DIGEST ACQUISITIONS IN 2006
The three rated commercial banks have diversified their activities by making meaningful acquisitions outside Iceland, with a view to reducing their dependence on a small banking market with limited growth opportunities. Each bank has approached this in different ways, as described below. In 2006, however, with disruption to what had previously been a smooth pattern to their wholesale funding operations, attention was turned largely to developing organic growth. Consequently, only smaller, bolt-on acquisitions were made during the year.

Kaupthing Bank has for many years defined itself as a northern European bank - an ambition that it further cemented in 2005 with the acquisition of Singer & Friedlander. In 2004, the bank acquired FIH (Denmark), a specialised lender to small and medium-sized Danish enterprises. With these acquisitions, Kaupthing Bank is now more active outside Iceland than domestically. The bank concentrated its efforts in 2006 on (i) consolidating the business after having made major acquisitions three years in a row and (ii) providing a more complete product offering in every geographical area in which it is represented. New shares were raised by the end of November and a fair number of investors were from abroad, thus broadening the base of ownership.

Íslandsbanki changed its name to Glitnir banki in 2006. Glitnir banki continued to make a number of smaller acquisitions in Norway in order to broaden its base of business in that country. Norway is now defined as the bank’s second home market following its acquisition of Norwegian banks Kreditbanken and BNbank in 2004/2005. It also established representative offices during 2006 in Canada and China as part of its approach to leverage its expertise in the fisheries sector as well as offshore supply vessels and ‘green’ energy production. In addition, Glitnir banki has activities in Luxembourg, the UK, Denmark and Sweden.

Landsbanki has focused on Iceland, the UK and Luxembourg and since 2005 on Ireland and continental Europe. In the UK, in the UK, Landsbanki has its 100% subsidiary, Heritable Bank and its fast growing London branch. During 2005, Landsbanki mainly focused on acquiring securities firms in Europe, namely Teather & Greenwood Ltd., Kepler Equities SA and Merrion Capital as well as growing UK and international banking operations. Together with another financial institution, Landsbanki split up the investment company, Burdaras, and took over part of its investment portfolio. The bank also acquired the assets and liabilities of the former Agricultural Loan Fund in Iceland, adding approximately 2,000 new largely rural customers to its client base. In August 2006, Landsbanki acquired a small Channel Islands business, now renamed Landsbanki Guernsey Limited, to collect deposits from international clients.

Overall, we believe that overseas activities provide the banks with important diversification by geography and type of business. However, weighted against this is the danger that the banks will become involved in areas in which they have only limited familiarity or expertise, or that impact adversely on their risk profiles.

Financial Fundamentals

GOOD RESULTS DESPITE ECONOMIC IMBALANCES IN ICELAND...
Icelandic banks recorded their best-ever results in 2005 and have continued to perform well in 2006, despite the economic imbalances in Iceland. The results of Kaupthing were heavily influenced by the increased value of their equity holdings in the Exista transaction2, but Glitnir and Landsbanki to a lesser extent. Nevertheless, the underlying profits for the core businesses of the three commercial banks have continued to improve in 2006, due to increased loan volumes, fee and commission income, cost-containment and reduced provisioning levels.

The banks’ (excluding HFF) risk-weighted recurring earnings powers3 compare favourably with other Nordic banks, ranging from 2.96% to 4.50% for the year 2005 and dipping only slightly in the first three quarters of 2006 to 2.3% to 3.4%. Excluding trading gains, which are not a recurring source of earnings and can be volatile - as was seen in Q2 2006 - the ranges for 2005 and the end of Q3 2006 were still a respectable 1.71% to 2.54% and 1.6% to 2.4%, respectively. Similar indicators for HFF are considerably lower due to its not-for-profit status and the restrictions on its investment guidelines.

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2. Kaupthing’s trading income was inflated by Exista transaction that took place in the third quarter of 2006. Kaupthing sold a 10% share in the financial services company in conjunction with the listing of the company on the Icelandic Stock Exchange in September. Upon listing, the bank’s remaining 11% holding was booked at fair value, generating considerable ‘financial’ income.

3. Risk weighted recurring earnings power is the ratio of pre-provision income to average risk weighted assets. This ratio is calculated to exclude the non-recurring gains on the sale of VIS and Exista.
From 2000 through 2005, the commercial banks made substantial investments abroad, thereby (i) achieving diversification in their lending operations, (ii) establishing their investment banking and capital markets businesses in deeper markets that offer a wider range of opportunities and (iii) developing increased fee income from the exploitation of additional business lines. The proportion of net operating revenue generated outside Iceland was as follows for the three banks at Q3 2006:

- Glitnir banki: 38%
- Landsbanki: 47%
- Kaupthing: 63%

Trading gains have made a significant contribution to the Icelandic banks’ profits in recent years. This has largely resulted from appreciation of the banks’ equity holdings, which were concentrated in Icelandic companies in the early 2000s but have broadened geographically in recent years. Trading income as a proportion of operating revenues were as follows up to Q3 2006:
While Moody’s recognises the banks’ overall prudent risk management, we also note that this source of income is heavily dependent on market performance and that these investments can bring volatility to their income and profitability over time. Kaupthing and Landsbanki have both announced that they now limit their proprietary equity holdings as a proportion of the capital base or risk-weighted assets, respectively. Glitnir banki has not made a similar announcement but in 2005 noticeably de-emphasised its trading and investment activities.

**COST EFFICIENCY REMAINS A KEY RATING DRIVER**

In order to maintain competitiveness, all of the banks focus on cost-containment, especially with regard to their retail branch networks. There have been decreases in costs in recent years and we expect this trend to continue. However, this should be viewed in the context of the large population migration to Reykjavik, where almost 60% of the Icelandic population currently resides, and a couple of other growth centres on the island. In addition, Moody’s notes that all of the banks have acquired institutions abroad which operate without extensive branch networks and hence have a positive impact on group consolidated efficiency indicators. However, all three banks have also grown fee-generating investment banking activities, which entail heavy personnel costs in the form of bonuses. While the related costs are thus flexible, they tend to be high.

The cost-efficiency ratios for the three commercial banks ranged from 32% to 43% as at Q3 2006 - which is a considerable improvement from previous years and more in line with the banks’ Nordic peers. HFF’s cost-income ratio was low, 31.22% at year-end 2005, but Moody’s notes that the specialised mortgage company has no branch network.

While there has been a real decline in the banks’ cost bases in recent years, we note that improvements in their cost-income ratios are also attributable to trading gains. In the event of a decline in these volatile and unpredictable sources of income, cost-income ratios could increase considerably. Excluding trading income, the cost-income ratios for the three banks as at Q3 2006 ranged from 41% to 51%. In our view, it remains important for the Icelandic commercial banks to further contain costs in case trading gains prove to be less sustainable than core profits.
ADEQUATE CAPITALISATION

In recent years, capital levels for the Icelandic banks have been high in comparison to their Nordic peers, driven by both the banks’ ambitions to expand and the inherent volatility in their investment portfolios. However, Moody’s notes that regulations in most of the other Nordic countries have more restrictive limits than those of Iceland with respect to the proportion of Tier 1 capital that can be comprised of hybrid securities. During 2005 and 2006, all of the commercial banks issued hybrid capital. At end-September 2006 the levels of hybrid capital in relation to Tier 1 capital ranged from 19% to 33%. Moody’s takes comfort from the Icelandic institutions’ somewhat higher capitalisation and, overall, we consider capital levels to be adequate given the banks’ risk profiles and their ability to generate capital.

Risk Management

CREDIT RISK REMAINS WELL CONTAINED

The banks’ loan portfolios are mainly focused on corporate lending, with retail lending accounting for only 16-28%. These figures have recently risen slightly with the banks’ entry into residential mortgage lending in Iceland. It should be noted that Icelandic households are among the most indebted in Europe. One of the reasons is the high level of home ownership - almost 90% - which is encouraged by the central government and supported via HFF loans and, as of August 2004, the commercial banks as well. It should be noted that most mortgage lending is index-linked and it is market practice to run stress tests to ensure that families can still afford their mortgage payments should interest rates rise.

Loan Sector Distribution (31 December 2005)

All of the banks’ corporate loan portfolios are well diversified, both geographically and by sector. It is worth noting that the "service industry" sector has seen particularly strong growth as a result of the Icelandic authorities’ redefining of sector codes, with many holding companies being redefined as belonging to this sector. Therefore, the composition of banks’ underlying portfolios in their public accounts has become less clear. Nonetheless, Moody’s believes that the rated banks continue to have well-diversified corporate loan portfolios.

4. At the end of November, Kaupthing Bank raised new shares for more than ISK 50 billion.
That said, we note that all of the commercial banks have relatively large exposures to single customers compared with other Nordic banks, although they remain well within the regulations for Icelandic banks.

Over 65% of the overall loan portfolio is denominated in foreign currencies, reflecting the banks' activities outside Iceland and also Icelandic companies' appetite for loans in foreign currencies. Such loans are chiefly provided to borrowers with foreign currency-denominated revenues.

According to the financial supervisor’s quarterly statistics, non-performing loans (NPLs) for both the retail and the corporate sector are at their lowest levels since 2001. The proportion of NPLs to gross loans for the four rated banks ranged from 0.24% to 0.96% at the end of 2005. NPL ratios in Iceland are now more in line with those in other Nordic countries, having historically been higher (this is thought to be because the previously high inflation levels discouraged companies from paying on time). However, it is important for the banks to continue monitoring credit quality closely in the domestic market as the economic downturn could negatively impact private individuals’ as well as companies’ ability to service their bank borrowings.

Loan-loss reserves as a percentage of NPLs ranged from 77.87% to 305.21% at the end of 2005, generally in line with the average for other Nordic countries.

PREPARATIONS FOR BASEL II WELL UNDER WAY
All the commercial banks have made good progress in their Basel II implementation projects. The larger banks plan to implement the internal ratings based (IRB) approach for their domestic exposures, some of the banks starting initially with the Foundation approach and then upgrading to the Advanced approach at a later stage. Over time, they should add on the non-Icelandic exposures, to which the standard method will most likely be applied; however, Glitnir banki has decided it will implement the IRB approach for their non-Icelandic exposures as well.

The banks introduced new Basel II compliant credit-scoring models for domestic corporate exposures, with the majority of such corporates now being rated under the new models. For example, Kaupthing has implemented FIH’s credit-scoring model for corporates across all of the bank’s operations to ensure a consistent rating process across the group. The banks are also working on developing internal rating models for retail exposures. Discussions with the FME are in a fairly advanced stage.

As regards operational risk, Icelandic banks have developed frameworks to define how operational risk is to be identified, measured and controlled. At this stage, most banks are opting for the ‘standard’ approach.

TRADING PORTFOLIOS RELATIVELY LARGE COMPARED TO PEERS, ARE CLOSELY MANAGED BUT PRESENT SIGNIFICANT MARKET RISKS
Due to the relatively high - but differing - levels of listed and unlisted equity exposures compared to other Nordic banks, all three commercial banks have put significant effort into monitoring and controlling the market risks associated with these types of investments. Market risk (as well as credit risk) is typically controlled centrally; this includes foreign exchange risk, interest rate risk and equity risk. Different methods are used for the calculation and measurement of market risk, including Value at Risk (VaR) models. Moody’s cautions that, although these holdings have historically been well managed, the inherently risky nature of such holdings could lead to increased volatility in the banks’ future results.
LIQUIDITY MANAGEMENT IS PRUDENT

All of the commercial banks are more reliant on market funding than their Nordic peers - a sign of the rapid loan growth combined with market disintermediation in the form of savings in mutual funds and insurance products - rather than deposits. On average, deposits accounted for approximately 24% of total funding at the end of 2005 and approximately 24% at the end of September 2006.

Both Kaupthing and Glitnir banki’s figures reflect the acquisition of wholesale funders such as FIH and BNbank. FIH has to comply with the Danish regulations for available liquidity and has had consistently prudent liquidity management. Likewise, Glitnir banki’s Norwegian acquisitions have to comply with domestic regulations. However, FIH and BNbank began to actively promote the collection of deposits in 2006. Landsbanki acquired a financial institution in Guernsey in August 2006 to enhance its deposit collection among UK and international depositors. All three banks have decided that it is important to gradually change the institutions’ funding mix. HFF is not authorised to take deposits and is therefore completely reliant on wholesale funding.

Another meaningful source of stable, low cost funding was inaugurated in 2006: Icelandic covered bonds. Kaupthing Bank is the only Icelandic bank thus far to set up a covered bond subsidiary to fund its residential mortgage portfolio. However, Moody’s notes that a conversion to covered bonds where most of a bank’s assets are used to provide collateral for its covered bond programme might result in the structural subordination of unsecured creditors. If such structural subordination were to be significant, this might impact the bank’s senior debt rating.

All four rated banks have prudent liquidity management in place. As noted above, HFF is government owned and, we believe, would be supported if it had problems with liquidity. At end-September 2006, the three commercial banks had sufficient on balance sheet liquidity and back-up lines to ensure that, in the event of being unable to approach the market for 12 months, they would still be able to carry out their business.

The high reliance on market funding has also resulted in the development of prudent liquidity management systems. The Central Bank of Iceland requires the three-month liquidity ratio to be above one.

Over the last couple of years, all of the banks have managed to diversify their funding sources as well as increase their debt maturity profiles, thus diversifying rollover times and combining the funding with strong liquidity management. However, Moody’s notes the higher volatility of market funding in comparison with customer deposits, and we caution that such market reliance can create volatility in funding costs and further increase the already-high margin pressure. It is important to note that all commercial banks have increased the size of their back-up facilities, meaning they should have liquidity available in case of market disruptions.
Related Research

Banking Statistical Supplement
Iceland, August 2006 (98454)

Analysis
Iceland, August 2006 (98549)
Glitnir banki hf, October 2006 (100191)
Landsbanki Íslands, October 2006 (100229)
Housing Financing Fund, September 2006 (98945)
Kaupthing Bank hf, October 2006 (99174)

Rating Methodology
Second Request for Comments: Bank Financial Strength Ratings: Update to Revised Global Methodology, December 2006 (101169)
Rating Preferred Stock and Hybrid Securities: Request for Comment, November 2006 (100692)

Special Comment
Rating Impact of GRI Methodology for Non Depository Financial Institutions in the EMEA Region, June 2005 (93349)
Request for Comment: Incorporation of Joint-Default Analysis for Systemic Support into Moody's Bank Rating Methodology, October 2005 (94781)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.
Appendix I

Sovereign Rating Opinion: Iceland

Credit Strengths
The credit strengths of Iceland include:
- High and evenly distributed standard of living; longstanding political stability
- Healthy government finances, low public direct debt
- Increasingly diversified economic base

Credit Challenges
The credit challenges facing Iceland include:
- Small, open economy susceptible to macroeconomic volatility sparked mainly by foreign investment activity
- Large contingent liabilities increase the importance of maintaining low government debt levels to ensure flexibility in handling potential systemic problems in the economy.

Rating Rationale
The government of Iceland’s debt is rated Aaa/Prime 1. The foreign currency country ceiling of Iceland is also Aaa, reflecting the Aaa government bond rating and the minimal risk of government bond default or payments moratorium. The ratings are based on the country’s advanced economic development, its longstanding political stability, its high and evenly distributed standard of living, and its healthy government finances. Public debt is expected to register 23.7% of GDP this year, less than half the level of other Aaa-rated sovereigns. Public finances will continue to benefit from favorable labor force demographics going forward, with a young population, low unemployment, and long working lives, along with a very healthy pension situation. The guaranteed debt of state-owned entities such as the National Power Company adds to the government’s contingent liabilities, as do the banks that have grown dramatically in size. Given Iceland’s volatile economic performance by industrial country standards, it is vital that the government’s direct debt remain low in order to be able to absorb any additional payment obligations that could derive from these sources.

Rating Outlook
The rating outlook is stable. Strong private sector expansion in foreign markets and large foreign investment projects continue to help diversify the economy away from fishing, even as they introduce temporary macroeconomic imbalances. The country’s large foreign private sector indebtedness magnifies the importance of managing the consequences of these and other future investments with an appropriate blend of monetary, fiscal, and incomes policies in order to avoid cyclical extremes. The Icelandic economy has proven itself to be unusually flexible and highly capable of withstanding shocks, further substantiating the Aaa rating.

What Could Change the Rating - DOWN
The government’s exceptionally strong government finances are critical to offsetting the risks to macroeconomic stability generated by the large private sector external debt. A substantial, persistent deterioration of public finances would therefore exert downward pressure on the ratings.

Recent Results and Developments
The current largest-ever investment wave in Iceland’s power-intensive industries, and structural changes in the financial markets that have fueled rapid credit creation are resulting in outsized current account deficits (about 16% in 2005 and 18.7% 2006). The Central Bank of Iceland has been aggressively tightening monetary conditions, but the depreciation of the ISK since the beginning of the year continues to fuel inflation way above target. Project and non-project external debt has grown rapidly. Gross external debt is approaching 50% of GDP-- more than double the level just three years ago. In spite of the recent inevitable fall in the nominal exchange rate, an FX-generated banking system crisis is highly unlikely. FX on-lending has overwhelmingly financed borrowers with FX income streams. Large acquisitions abroad have significantly diversified bank balance sheets, insulating the system from Icelandic shocks. The banking system is well-capitalized, amply liquid and has strong oversight. Next year’s large amortizations are already almost fully funded. Regardless, public finances are extremely strong and flexible enough to handle a crisis in the remote event it were to occur, without increasing the risk of a sovereign default.

In face of the overheating conditions (and given the experience of looser fiscal policy during past boom times) fiscal policy was tightened considerably last year, as revealed by major revisions to the accounts. However, because the tightening wasn’t so evident during the year -- in April 2005 the surplus was expected to be a mere 0.9% of GDP -- this gave a boost to demand. The fiscal surplus is expected to shrink to 3.8% of GDP in 2006 because of the deceleration of growth. A few months ago the government pledged to delay planned infrastructure projects and slice planned tax cuts in the face of the inflationary pressures in the economy, but the fiscal budget for 2007, in the run-up to parliamentary elections next year, backtracks on these promises. The result will likely be further interest rate hikes from the already high level of 14%.
Appendix II - Global Comparisons

Average* Bank Financial Strength Ratings by Country
December 2006

* Weighted by Assets
Country Ceilings For Long-Term Bank Deposits
December 2006

[Diagram showing country rankings and ratings for long-term bank deposits]
Average* Long-Term Bank Deposits by Country
December 2006

* Weighted by Assets