MOODY'S INVESTORS SERVICE

CREDIT ANALYSIS

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Iceland, Government of

RATINGS

Iceland

	Foreign Currency	Local Currency
Gov. Bond Rating	Baa3	Baa3
Country Ceiling	Baa3	Baa2
Bank Deposit Ceiling	Baa3	Baa2

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Analyst Contacts:

LONDON +44.20.7772.5454

Kathrin Muehlbronner +44.20.7772.1383
Vice President - Senior Credit Officer
kathrin.muehlbronner@moodys.com

Yves Lemay +44.20.7772.5512
Managing Director - Banking & Sovereign
yves.lemay@moodys.com

FRANKFURT +49.69.70730.700

Dietmar Hornung +49.69.70730.790
Associate Managing Director
dietmar.hornung@moodys.com

» contacts continued on the last page

This Credit Analysis provides an in-depth discussion of credit rating(s) for Iceland, Government of and should be read in conjunction with Moody's most recent Credit Opinion and rating information available on Moody's website.

Overview and Outlook

Among Iceland's key credit strengths are its high levels of wealth, which acted as a cushion during the severe adjustment of the past several years, and the return to reasonably strong economic growth. We also believe that the economic recovery is on a more sustainable footing than in the past. The country's public finances have improved significantly and the public debt burden – while still high – has started to decline from 2012 onwards. If the government's large cash buffers are taken into account, the public debt is a moderate level in the European context. In addition and in contrast to many other highly-indebted European countries, Iceland has a fully funded private pension system, which together with favourable demographics bodes well for long-term fiscal sustainability.

Iceland's key credit challenge is how to maintain macroeconomic and financial-sector stability as and when the stringent capital controls in place since the crisis are lifted. The Icelandic authorities have used the "shelter" of the capital controls well and corrected many of the weaknesses that contributed to the crisis, including in the area of banking supervision and regulation. They are also well aware of the risks of a disorderly liberalization process. However, the potential outflows are very large at over half of Iceland's GDP. The Icelandic economy is inherently volatile given its small size and undiversified nature.

While we expect the liberalization process to be gradual, probably taking several years, the next steps have the potential to affect Iceland's sovereign rating. The rating would come under upward pressure if the key obstacles identified by the authorities can be resolved in a orderly fashion. Conversely, the rating could be downgraded if the government's commitment to fiscal consolidation showed signs of waning, thereby halting the declining trend in the public debt ratio.

This Credit Analysis elaborates on Iceland's credit profile in terms of Economic Strength, Institutional Strength, Fiscal Strength and Susceptibility to Event Risk, which are the four main analytic factors in Moody's Sovereign Bond Rating Methodology. The report also provides an analysis on the current status of the capital controls in place and the prospects for their removal.

Special Topic

Status of capital controls and prospects for their removal

Iceland imposed capital controls in late 2008, restricting all capital transactions between domestic and foreign entities. At present, the central bank determines whether to grant an exemption from the controls, taking into consideration the impact of the transaction on Iceland's economic, financial sector and balance of payments stability.[1] Transactions involving the purchase of goods & services or the payment of interest and principal on foreign obligations of Icelandic entities are not restricted. New investors to Iceland (after 2009) – either in financial or real assets – are also not constrained by the controls, with the exception of those that invest through the central bank's foreign-currency auctions, who have to commit to a five-year investment.

The capital controls played an important role in stabilizing the Icelandic economy, its financial system and the Icelandic krona (ISK), following the collapse of the three large banks in November 2008. They were always intended as a temporary emergency measure to avoid potentially large and disruptive capital outflows from Iceland that in turn would put excessive pressure on Iceland's foreign-currency reserves and the exchange rate. As time progressed, the size of these potential outflows has become much clearer and the authorities have made important progress in reducing some of the potential pressure. More specifically, the so-called "overhang" of foreign investors who were trapped by the capital controls has been reduced from 37% of GDP when the controls were imposed to 17% of GDP as of April 2014. Those non-residents that have remained invested in Iceland are probably not a material risk for the liberalization process, given that they have shown little desire to divest thus far. According to the liberalization strategy developed jointly with the IMF in 2011, they could be allowed to divest at some stage with the penalty of an exit tax.

According to the Icelandic authorities, two other sources of large capital outflows need to be addressed before the lifting of the controls can be considered:

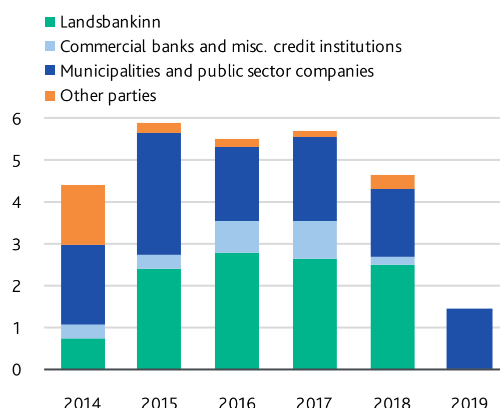
(1) **The heavy foreign debt redemptions of domestic entities.** Apart from the central government and the central bank, other domestic entities have foreign-currency debt payments coming due in the coming years equivalent to around 5.5% of GDP on average, while most have only limited (if any) foreign-currency earnings and no access to international credit markets at present (see Exhibit 1). Using central bank estimates, the accumulated "gap" between the payments due and the estimated foreign-currency inflows generated through the current account could amount to 5% of GDP by the end of 2019, unless the entities manage to refinance or extent their payments or obtain foreign funding through asset sales or foreign investment. However, the single largest payment stream – arising from foreign-currency bonds issued by Landsbankinn to its predecessor bank LBI – is currently in the process of being renegotiated, which would reduce the pressure significantly (Exhibit 2).[2]

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moodys.com for the most updated credit rating action information and rating history.

[1] Above a certain threshold the Minister of Finance must also approve the exemption. This applies in particular to the estates of the failed banks.

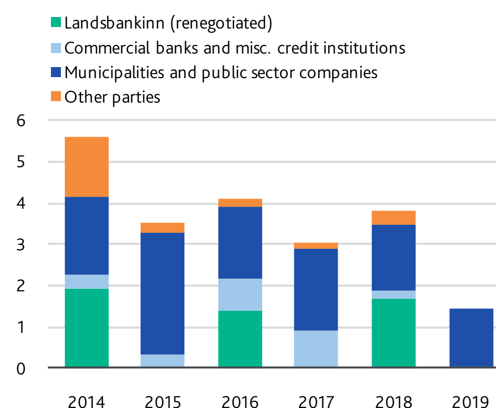
[2] Landsbankinn and LBI have agreed to extend the bond maturities by eight years, with bi-annual repayments. Their agreement is subject to the Minister of Finance and the central bank granting an exemption from the capital controls.

EXHIBIT 1
External debt redemptions of domestic entities are high in the coming years
(% of GDP)



Source: Central Bank of Iceland, Statistics Iceland

EXHIBIT 2
But maturity extension for Landsbankinn bond would alleviate pressure
(% of GDP)



Source: Central Bank of Iceland, Statistics Iceland

(2) **Outflows to foreign creditors following the failed banks' resolution**. Total FX and ISK assets owned by the estates of Glitnir, Kaupthing and LBI are currently valued at around 140% of Icelandic GDP.[3] The underlying problem is a large mismatch between the distribution of domestic and foreign claims on one side and the estates' assets on the other: 94% of creditors are foreign, but only around 64% of assets are denominated in foreign currency and held abroad. According to the calculations of the central bank, (net) domestic assets of 44% of GDP will revert to the foreign creditors upon settlement of the estates.[4]

As the estates' stakes in the "new" banks form the largest portion of their domestic assets, the most likely resolution will centre on a reassessment of the appropriate value of the shareholdings in the new banks. Two broad roadmaps for the settlement of the estates are currently being debated in Iceland: A consensual agreemet that allows the conversion of the estates into holding companies with an agreed timetable for payments to the creditors (so-called composition) or liquiditation of the estates and conversion of all claims into ISK, which would increase the "overhang" of ISK assets held by foreign investors. It remains to be seen whether a consensual agreement can be found with the creditors.

The timing of the lifting of the capital controls hinges most crucially on reaching an agreement on (2), so as to allow the Icelandic authorities to conclude that the settlements do not endanger Iceland's balance of payments over the medium term. In addition, the government has made equal treatment with domestic investors an important consideration, implying that the process could be even more drawn-out.[5] In our view, it is likely that the capital controls will be lifted only gradually over several years. From a sovereign rating perspective, it is important that an orderly resolution be found that respects property rights and maintains investor confidence in the rule of law.

[3] The estates of Glitnir and Kaupthing have repaid all priority creditors already, while LBI (the former Landsbanki) has made four payments to Icesave deposit holders. It is clear that a large part of their accumulated liabilities will never be repaid as the asset recoveries will be far smaller.

[4] Taking into account domestic assets backed by foreign assets, the extended Landsbankinn bonds and the bank levy that the estates will have to pay, the central bank estimates that the net outflow could be closer to 20% of GDP rather than 44% as estimated up to now.

[5] The IMF estimates that domestic entities (mainly pension funds but also Icelandic companies) might want to invest between 20-45% of GDP abroad over several years once the capital controls are lifted. See IMF: Fourth Post-Program Monitoring Discussions, July 2014.

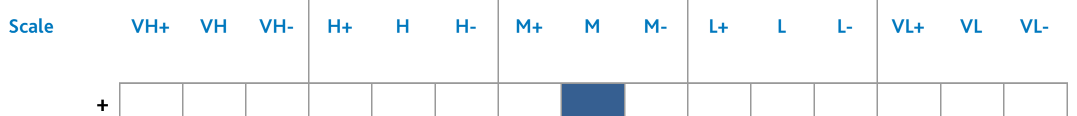
Rating Rationale

Our determination of a sovereign's government bond rating is based on the consideration of four rating factors: Economic Strength, Institutional Strength, Fiscal Strength and Susceptibility to Event Risk. When a direct and imminent threat becomes a constraint, that can only lower the preliminary rating range. For more information please see our Sovereign Bond Rating Methodology.

Economic Strength: Moderate

Small and volatile economy but high wealth levels provide important buffer

Factor 1



Economic strength evaluates the economic structure, primarily reflected in economic growth, the scale of the economy and wealth, as well as in structural factors that point to a country's long-term economic robustness and shock-absorption capacity. Economic strength is adjusted in case excessive credit growth is present and the risks of a boom-bust cycle are building. This 'Credit Boom' adjustment factor can only lower the overall score of economic strength.

Iceland's economy is one of the smallest in our rated sovereign universe, with nominal GDP at $14.6 billion (as of 2013), compared to the median of $131.2 billion for the Baa rating category. Similar to other small and open economies, Iceland's economic performance is relatively volatile, with GDP growth driven to an important extent by the prices of its key export products aluminium and marine products, as well as the timing of mostly foreign-financed investments in its abundant renewable energy sector. The tourism sector is rapidly gaining importance for the Icelandic economy, accounting for 15.4% of Iceland's nominal GDP in 2013 compared to around 10% in 2009 and 26.8% of exports of goods and services, up from 19.6% in 2009. While adding to the diversification of the economy, tourism is a highly seasonal industry, thus potentially increasing the volatility of Iceland's growth performance. However, efforts have been made to broaden the tourism season beyond the traditional summer months.

Iceland's GDP per capita is among the highest in Moody's universe of rated sovereigns, despite the significant loss in wealth due to the banking and currency crisis, with the five year average at $38,716 on a PPP basis as of 2013. This positions Iceland in the same category as Aa-rated sovereigns (median per-capita GDP of $35,492) and as a clear outlier in the Baa rating range ($13,813). In addition to high income levels, Icelandic households possess substantial pension assets amounting to 145% of GDP (May 2014). This is not only positive for the long-term underlying fiscal position of the country, but has also allowed a smoothening of the adjustment process as households could temporarily withdraw money from their pension savings for debt repayment and consumption purposes during the crisis years.

Economic recovery increasingly driven by domestic demand

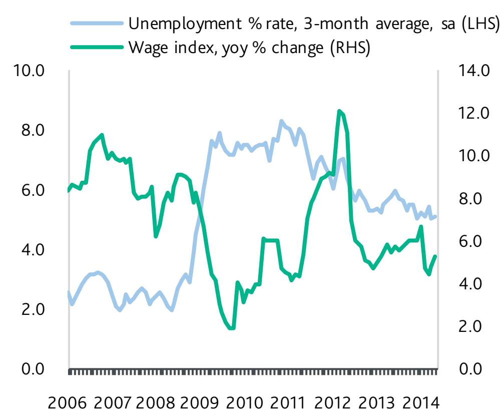
Iceland's economy is recovering at a strong pace now, after several years of relatively moderate GDP gains. In 2013, real GDP growth accelerated to 3.3%, much stronger than expected, driven mainly by (services) exports and to a lesser extent a recovery in private consumption. For 2014, we expect domestic demand to play a stronger role, with private consumption and investment (both construction and business investment) contributing positively to growth. Import growth has started to pick up as a

consequence of stronger investment and will limit the positive contribution from net trade.[6] For the year as a whole, we expect real GDP growth of 3%. For 2015, we expect some further acceleration to 3.2%, as the recovery in Europe is expected to gain speed, which in turn should further support Iceland's exports. Our forecasts are similar to those of the IMF and Statisics Iceland, while the central bank expects even stronger growth of 3.7% this year and 3.9% in 2015.

Households in particular will receive an additional boost to their disposable income from mid-year onwards as they benefit from the government's household debt-relief plan, announced in late 2013.[7] In addition, the labour market continues to improve, with the unemployment rate standing at 4.6% in May (seasonally adjusted) compared to 5.0% a year earlier and a peak of 8.9% in April 2011. Inflation has been on a declining trend since mid-2012 and is now below the central bank's target of 2.5% for the first time since March 2011. This is important in an economy such as Iceland's where a large share of household debt is indexed to inflation.

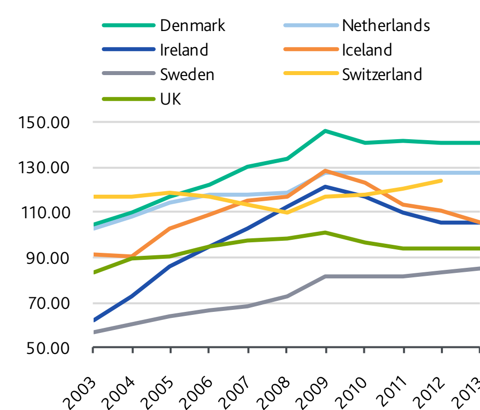
At the same time, wage growth has remained solid at around 5% compared to a year earlier (see Exhibit 3), ensuring significant real income gains for households. In the first quarter of 2014, private consumption increased by 3.3% in real terms compared to a year earlier, much stronger than the increase in 2013 of 1.2%. Household debt has declined to 105% of GDP as of Q4 2013 from a peak of 134% of GDP in Q1 2009, mainly due to extensive debt restructuring and write-downs. The debt level of Icelandic households is now broadly in line with that of households in Ireland and lower than in Denmark, Netherlands and Switzerland (see Exhibit 4), while still higher than most other EU countries, even if the high home ownership rate in Iceland is taken into account. However, Icelandic households hold large pension assets, amounting to 145% of GDP in aggregate.

EXHIBIT 3
Labour market is improving



Source: Statistics Iceland

EXHIBIT 4
Household debt level similar to peers (% of GDP)



Source: Eurostat, Statistics Iceland, Central Bank of Iceland

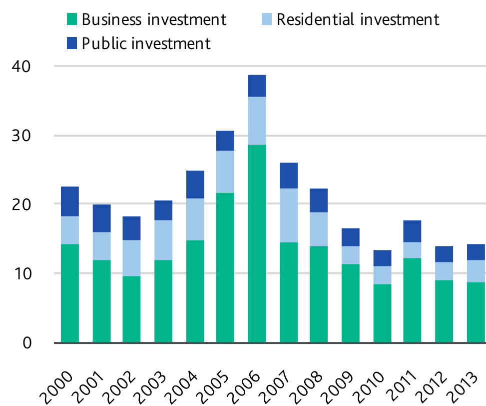
Investment has also started to recover from historically low levels, expanding by 17.6% in Q1 2014 in real terms compared to a year earlier, after a contraction of 3.4% for the whole of 2013. Residential construction has posted positive growth rates since Q1 2012 but recently business investment has picked up as well, and even without new large, foreign-financed investments in the renewable energy sector which used to drive strong increases in capital formation. At the same time, the high debt levels

[6] In Q1 2014, strong import growth led to a contraction of 0.7% compared to Q4 2013 and -1.7% compared to a year earlier. However, quarterly growth rates are very volatively in Iceland. Source: Statistics Iceland.

[7] See Iceland: Mortgage Debt-Relief Plan Is Credit Positive for Housing Financing Fund, Without Detriment to Sovereign Creditworthiness

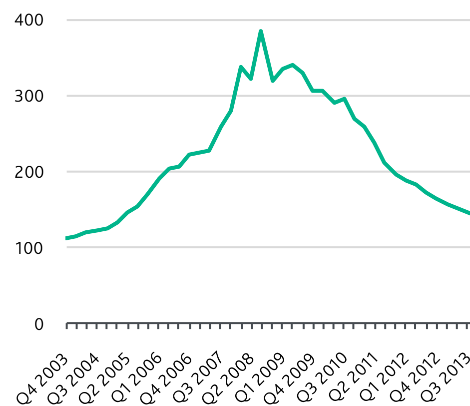
of the corporate sector have continued to decline, mainly due to extensive debt restructuring. Corporate debt stood at 141% of GDP in end-2013, compared to a peak of over 380% of GDP in Q3 2008 (see Exhibit 6). Investment prospects for renewable energy projects remain positive given that Iceland is highly competitive in its key industries and benefits from some of the lowest energy costs globally, as well as a well-educated workforce and a still very favourable exchange rate.

EXHIBIT 5
Investment has been low
(% of GDP)



Source: Statistics Iceland

EXHIBIT 6
Corporate debt levels are declining
(% of GDP)

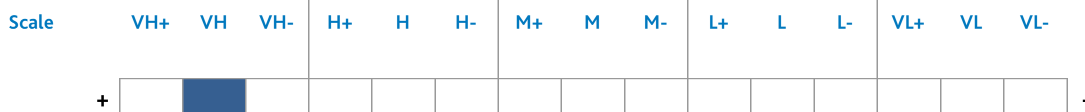


Source: Statistics Iceland, Central Bank of Iceland

Institutional Strength: Very High

Important improvements to institutional framework as crisis exposed weaknesses

Factor 2



Institutional strength evaluates whether the country's institutional features are conducive to supporting a country's ability and willingness to repay its debt. A related aspect of institutional strength is the capacity of the government to conduct sound economic policies that foster economic growth and prosperity. Institutional strength is adjusted for the track record of default. This adjustment can only lower the overall score of institutional strength.

Since the financial crisis, the Icelandic authorities have made significant progress in returning the economy, the banking sector and the public finances to a sounder footing and implemented wide-ranging changes to the institutional and regulatory frameworks so as to avoid another crisis. Supervision and regulation of the banking sector have been significantly strengthened and collaboration between the central bank and the banking regulator FME has been improved markedly. Parliament has passed a bill to establish a Financial Stability Council that should help to improve the monitoring of systemic risks. The banking sector's much smaller size, high capitalisation and purely domestic focus limit the risks emanating from the sector.

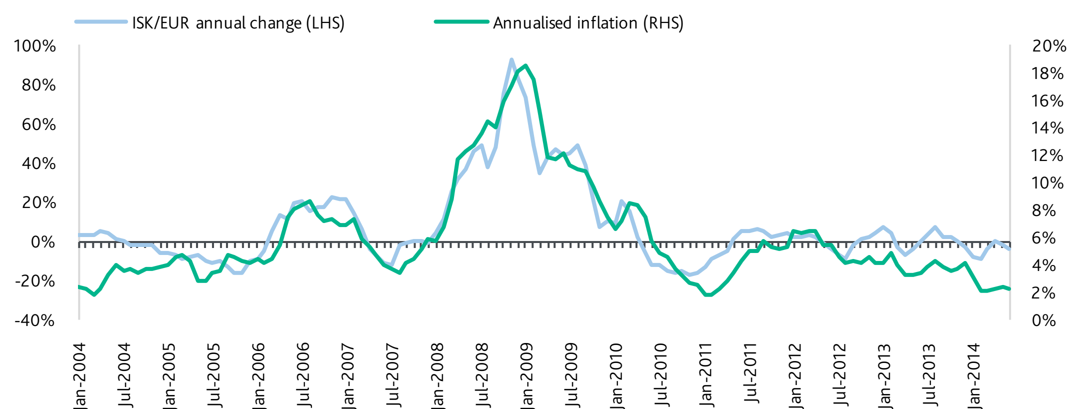
The government presented a draft bill on a new Organic Budget Law to parliament earlier this year. Its implementation would be an important step towards ensuring public finances have a more medium-term focus in the future. As pointed out by the IMF, Iceland's public finances have traditionally been

pro-cyclical, thereby contributing to the economy's volatility. According to the draft law, an incoming government is required to present a fiscal strategy for the next five-year period, which needs to respect the following fiscal rules: (1) the general government budget deficit in any single year cannot exceed 2.5% of GDP; (2) the budget needs to be in surplus for the five-year period overall; (3) general government net debt should be below 45% of GDP[8]; and (5) if the debt ratio exceeds 45%, the deviation from the threshold should be reduced by at least 5% per year. In addition, the bill foresees the establishment of an independent fiscal council to monitor budget execution and provide an independent assessment of the government's fiscal policy. The bill is set to be voted on in autumn 2014.

The crisis also exposed the weak fiscal framework of local governments, some of which had to restructure their liabilities with domestic and international lenders. A new Local Government Act was passed in September 2011, which restricts the local authorities' ability to run large budget deficits and raise new debt, and aligns their fiscal policy stance more closely with that of the central government. The revised framework is working well, with the local government sector running a small annual deficit of around 0.3% of GDP since 2011, compared to deficits of close to 1% of GDP over the period 2008-10.

Monetary policy has been relatively successful in the recent past, with the inflation rate now at the target of 2.5% for the first time since March 2011. The relatively stable exchange rate, which in turn is due to the capital controls and the central bank's interventions in the foreign-exchange market, coupled with low imported inflation have contributed to the positive results. However, as the central bank points out the output gap has nearly closed and longer-term inflation expectations are still above the target. There is also some uncertainty over the longer-term outlook for wage growth given the favourable situation on the labour market. As a small, open economy, the pass-through of exchange rate movements to inflation is very strong in Iceland, pointing to the need to manage the exchange rate even after the lifting of the capital controls (see Exhibit 7).

EXHIBIT 7
Strong pass-through from exchange rate to inflation



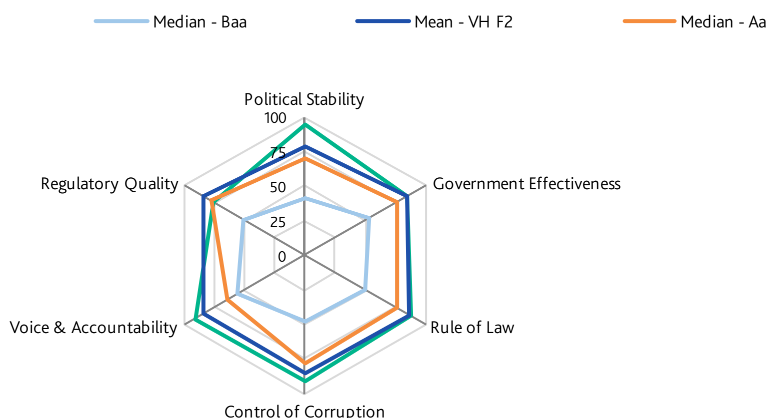
Source: Central Bank of Iceland, Statistics Iceland

[8] The debt definition to be applied is gross debt excluding pension obligations to civil servants and accounts payable.

In terms of quantitative indicators, Iceland scores very highly, although the country's relative position has worsened since the crisis on account of the deterioration in the macroeconomic situation. In 2012, Iceland ranked at the 85th percentile of the World Bank's indicators of "Government Effectiveness" and the 88th percentile of "Rule of Law", well above the Baa and A rating category medians and more consistent with Aa median levels (see Exhibit 8), similar to the peer comparisons related to economic strength. Iceland benefits from clear competitive strengths in areas such as its high-quality education system, an innovative business sector, an efficient labour market and well-developed infrastructure.[9] Also, Iceland has a long tradition of broad cooperation and consensus on economic matters between government, employer and employee associations, which is a credit strength.

EXHIBIT 8

World Bank Governance Indicators more consistent with Aa median

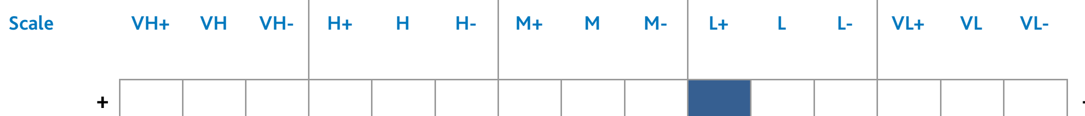


Source: World Bank

Fiscal Strength: Low (+)

Improving fiscal performance and declining debt ratio are key positive developments

Factor 3



Fiscal strength captures the overall health of government finances, incorporating the assessment of relative debt burdens and debt affordability as well as the structure of government debt. Some governments have a greater ability to carry a higher debt burden at affordable rates than others. Fiscal strength is adjusted for the debt trend, the share of foreign currency debt in government debt, other public sector debt and for cases in which public sector financial assets or sovereign wealth funds are present. Depending on the adjustment factor the overall score of fiscal strength can be lowered or increased.

Iceland's public finances have been significantly strengthened over the past several years, with a reduction in the budget deficit from a peak of 13.5% of GDP in 2008 to close to balance in 2013. Last year's fiscal performance was much better than initially expected, although the outperformance

[9] See World Economic Forum: Global Competitiveness Report 2013-14

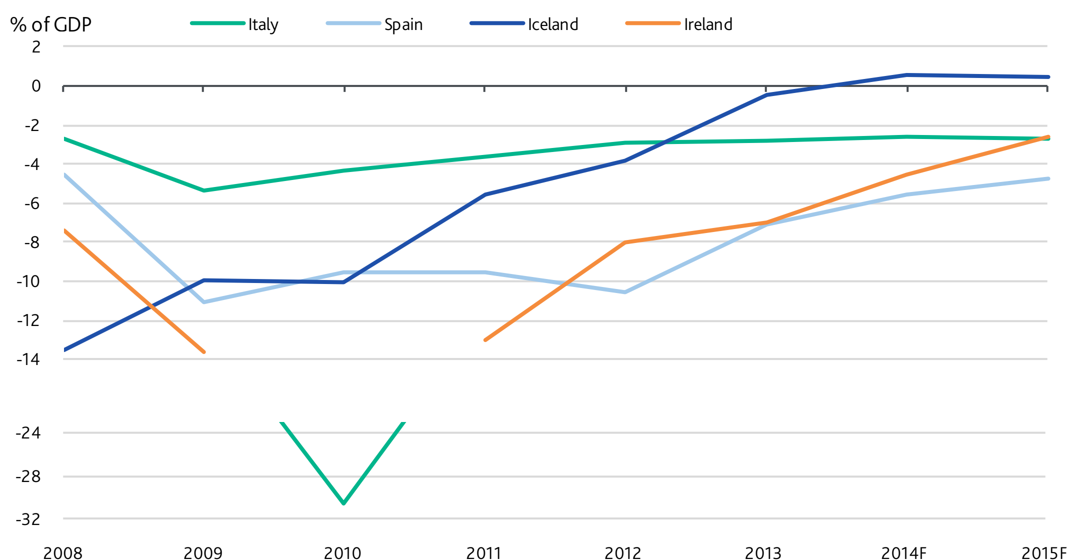
was due in large part to a significantly higher dividend payment from government-owned Landsbankinn.[10] We now estimate the central government deficit to have been around 0.6% of GDP versus a budgeted deficit of 1.7% of GDP.

This year's budget performance will likely also exceed the budget, again helped by one-off and irregular revenues, such as higher dividend payments from the central bank and financial institutions, which the government estimates at around 1% of GDP. In addition, this year's accounts benefit from the renegotiation of the Treasury bond issued to the central bank to recapitalize the institution in 2008, which is estimated to have a similar revenue effect of around 1% of GDP.[11] However, a portion of these one-off revenues will be offset by higher-than-budgeted expenditures, which have increased by 5.7% in the first five months of the year compared to a budgeted increase of 2%. For the year as a whole, we expect a surplus of around 0.6% of GDP compared to a target balanced budget. The surplus on the primary balance (excluding interest payments) will likely reach close to 5% of GDP, the third year with a primary surplus.[12]

Even when these one-off revenue items are excluded, Iceland's public finances are on an improving trend, helped by the strengthening recovery. In the first five months, central government tax revenues increased by 12.4% year-over-year, compared to a budgeted increase of 11.3%. For 2015-16, the government also targets small overall budget surpluses. It also intends to implement reforms to VAT and import taxes in 2015-16, with the main aim of simplifying the tax system. Overall, Iceland's fiscal performance compares very favourably with its closest European peers, such as Ireland (Baa1 stable) and Spain (Baa2 positive).

EXHIBIT 9

Iceland's fiscal accounts compare favourably with peers



Source: Haver Analytics, Moody's

[10] The government's stake in Landsbannkin is 97.9%. Its shareholdings in the other two "new" banks are much smaller (13% in Arion and 5% in Islandsbanki).

[11] The bond had an original maturity of five years and paid a real interest rate of 2.1%. The amendment lengthens the maturity to 30 years, and sets a nominal interest rate based on the central bank's current account rate. The Treasury will use the dividend payments from the central bank to repay the bond. The nominal outstanding amount of the recapitalization bond was ISK170 billion (9.5% of GDP) as of end-2013.

[12] The government uses net interest payments when calculating the primary balance. According to its calculations, the target for this year is a surplus of 3.1% of GDP.

Public debt on declining trend

Iceland's debt trend is also more favourable than in its closest peers as a result of stronger GDP growth and a better fiscal position. Iceland's public debt ratio reached its peak in 2011 at close to 120% of GDP and has started to decline rapidly from then onwards, reaching 97.6% of GDP at the end of 2013.[13] We forecast a further decline over our forecast horizon towards 92.2% of GDP by the end of 2015.

While we mainly focus on gross debt in our analysis, we also take into account significant cash buffers and liquid assets that a government can potentially use to reduce its debt burden. In the case of Iceland, these liquid assets (essentially cash and deposits) are significant at 24% of GDP as of end-2013. Accounting for these assets, the net debt ratio is a more comfortable 72% of GDP as of December 2013. In addition, the government still holds substantial equity stakes such as its stake in Landsbankinn which it intends to sell in the coming years.

An additional and significant strength of Iceland consists in the existence of a fully funded private pension system in combination with favourable demographics.[14] This is in sharp contrast to most of the highly-indebted EU countries, which are faced with unfavourable demographic developments and largely unfunded pension systems (see Exhibit 10).

EXHIBIT 10

Iceland has a fully-funded pension system and favourable demographics

Source: Eurostat, OECD Global Pension Statistics

Debt structure and maturity profile are favourable and contingent liabilities are declining

Despite the still elevated debt level, Iceland's funding position is manageable. The government mainly funds its diminishing borrowing requirements in the domestic market, where it has increased the average maturity of the outstanding debt to 7.5 years. Iceland's annual borrowing requirements are low by European standards at around 5% of GDP.[15] On the other hand, the government currently benefits from artificially low interest rates which are unlikely to prevail once the capital controls are lifted and the pension funds are again allowed to invest abroad.

[13] Our public debt numbers include the IMF loan (5.5% of GDP as of end-2013) and the loan from Norway (1.8% of GDP) which were extended directly to the central bank.

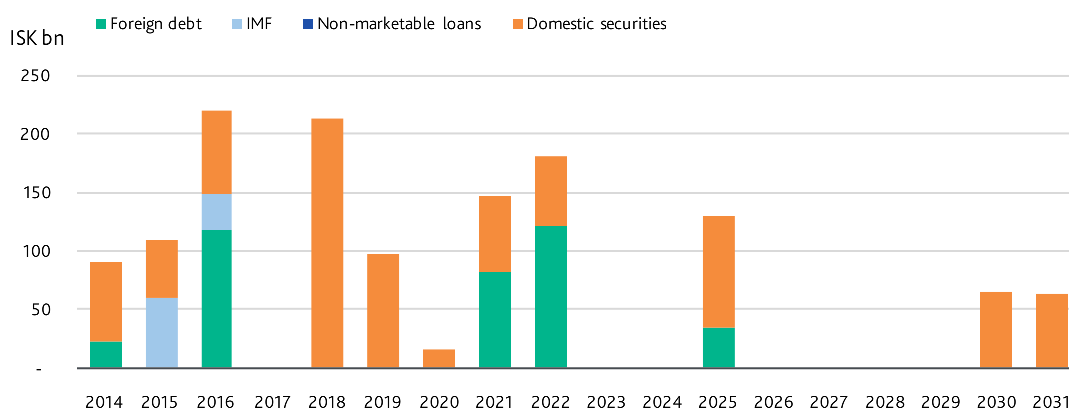
[14] Only the pensions for the civil servants are not funded, amounting to an estimated 26% of GDP. In contrast to many European countries, Iceland' Statistics Institute has started to include these into the public debt numbers.

[15] According to the latest IMF Fiscal Monitor from April 2014, Iceland's average borrowing requirement for 2014-16 stands at 5% of GDP. For comparison: Germany: 6.4%, Ireland: 7.8%, Spain: 20.3% of GDP.

The government's foreign repayments are easily manageable as well, and the recent return of Iceland to the Eurobond market clearly signals that the government is able to obtain funding in international markets at attractive interest rates. The proceeds from the bond issue will be used to repay early a large part of the bilateral loans that the Scandinavian governments extended to Iceland in the crisis, which mature in 2019-12 (total outstanding is approximately €930 million).[16]

EXHIBIT 11

Government's domestic and foreign redemption profile is manageable



Source: Government Debt Management, Moody's

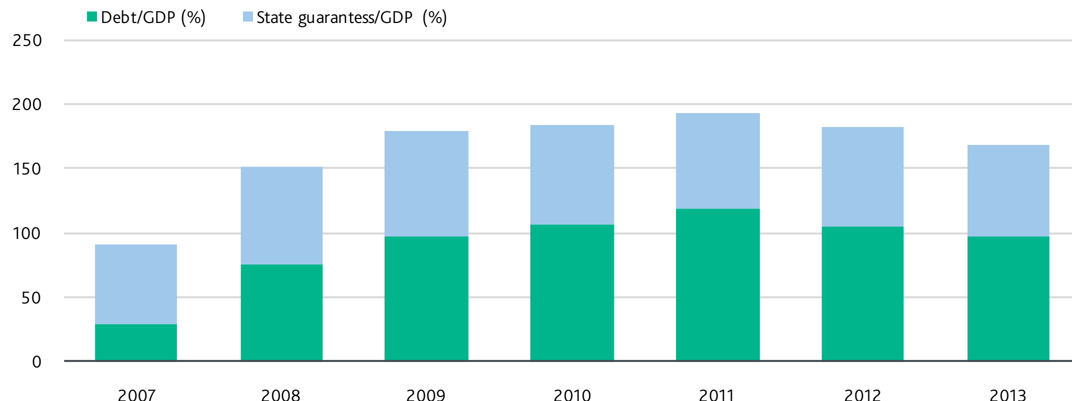
The government also intends to finally address its key contingent liability, namely its outsized guarantees for the Housing Financing Fund (HFF, rated Ba1 stable), which amount to close to 50% of GDP (May 2014). The proposal presented by external consultants to the government earlier this year would reduce the HFF's role to social housing while mortgage lending would be offered by specialized private mortgage lenders.[17] HFF's current portfolio of loans and bonds would be managed down until maturity of the bonds. While the government might still be required to provide further support for HFF in the process, in particular if prepayments on mortgage loans remain high, the risk to government should be manageable in our view, with the outstanding guarantees for HFF declining over time as HFF bonds mature. Between 2010 and 2013, the HFF has received capital injections from the government amounting to ISK 46 billion (2.6% of GDP) and a further ISK 4.5 billion in included in the 2014 budget. We are less concerned about the state-owned utility Landsvirkjun (rated Baa3 stable), whose operating performance has improved substantially and which has obtained funding from abroad since 2011 (government guarantees to Landsvirkjun amount to 15.8% of GDP).

[16] The government plans to only refinance half of the 2016 bond maturity of $1 billion.

[17] The consultants' report can be found on http://globenewswire.com/news-release/2014/03/18/619346/0/en/A-Report-on-the-Proposals-of-Independent-Consultants-regarding-the-Housing-Policy-in-Iceland.html.

EXHIBIT 12

Government guarantees are still substantial

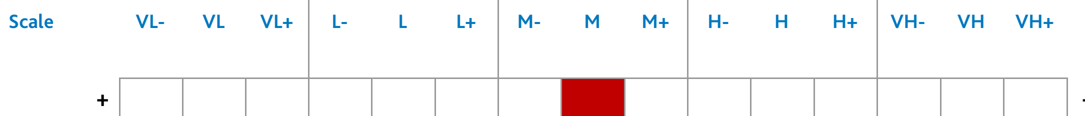


Source: Government Debt Management, Moody's

Susceptibility to Event Risk: Moderate

Lifting of capital controls remains key risk factor

Factor 4



Susceptibility to Event Risk evaluates a country's vulnerability to the risk that sudden events may severely strain public finances, thus increasing the country's probability of default. Such risks include political, government liquidity, banking sector and external vulnerability risks. Susceptibility of Event Risk is a constraint which can only lower the preliminary rating range as given by combining the first three factors.

A disorderly relaxation of capital controls continues to constitute the largest event risk for Iceland going forward, as the potential capital outflows are substantial and could easily destabilise the currency (see more detailed discussion in Special Topic section). An important mitigating factor is that the Icelandic authorities' are fully aware of these risks and have therefore pursued a very gradual approach thus far. The parliament has also removed any explicit expiration date of the controls last year, allowing the authorities greater flexibility. In addition, with time progressing, the Icelandic authorities have obtained more clarity and information about the size and timing of potential capital outflows, which is a prerequisite to being able to manage the relaxation of the capital controls smoothly. The authorities are in the process of adjusting their liberalization strategy.

At the same time, it is clear that maintaining the capital controls for too long has a clear cost to the economy, in terms of investment that is not taking place as the needed external funding is not forthcoming and investor confidence is low. In the latest Global Competitiveness Report (2013-14) by the World Economic Forum, foreign-currency regulations were cited by Icelandic business owners as the most problematic factor by a large margin. There is also an increasing risk of asset-price distortions given the limited investment options for both households and the Icelandic pension funds. House prices in the Greater Reykjavik area have been rising at above 10% year-over-year since the beginning of the year, following price rises of 7-9% in the preceding two years. Turnover has also picked up from the lows, although it remains lower than in the pre-crisis years. Also, in real terms house price increases

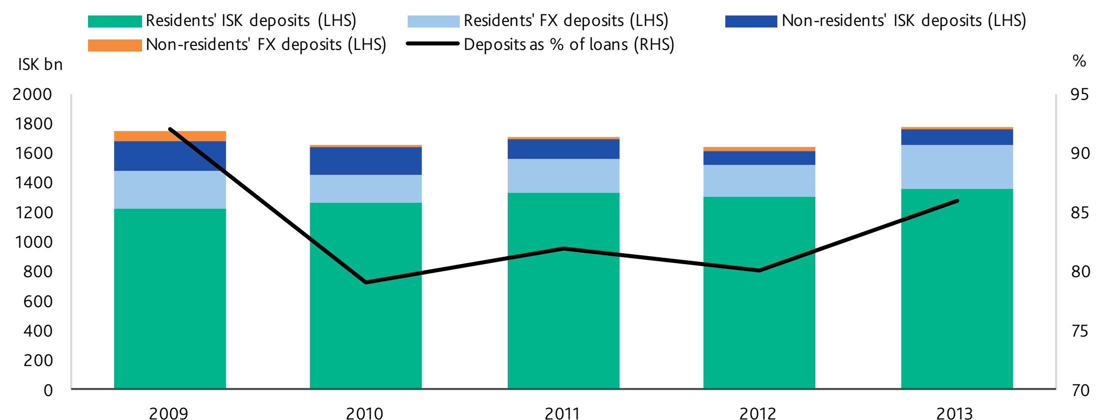
have been far more moderate and key ratios of affordability are in line with long-term averages, unlike the situation in other European countries.[18]

Banking sector not a significant risk to the sovereign

Overall, we do not consider the banking sector to be a material risk to the sovereign's balance sheet (with the exception of the HFF, see discussion above). The banking sector, in particular the three large commercial banks which account for around 73% of all banking-system assets, is now relatively small, highly capitalised and purely focused on the domestic market. The combined capital ratio at the three large commercial banks stood above 26% as per end-2013. Funding for the banks is predominantly in the form of deposits (82.3% of outstanding loans as of May 2014, excluding deposits from credit institutions). The central bank has repeatedly tightened liquidity rules, adopting Basel III standards early and in particular requiring the banks to fully cover their foreign-currency deposits with liquid assets in foreign currency. A loosening or lifting of the capital controls should therefore be manageable by the banks. Given Iceland's experience over the past few years, it is to be expected that even after the lifting of the capital controls, the banks will be subject to stringent macroprudential rules that will restrict their foreign exposures and potential for currency mismatches. According to the central bank, the prudential rules may also include tools that can be used in response to excessive volatility in capital movements.

EXHIBIT 13

FX deposits at the commercial banks do not pose risks as they are fully hedged

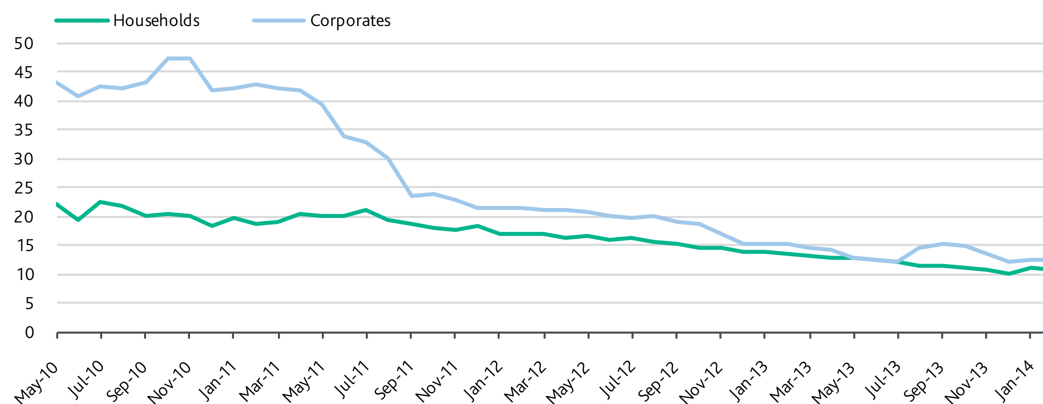


Source: Central Bank of Iceland

At the same time, the banking sector still has weaknesses: Non-performing loans have been on a declining trend, mainly driven by extensive restructuring and debt write-offs, although they are still at a relatively high level (see Exhibit 14). Uncertainty over future prospects for the banking sector remain: While banks have returned to profits in 2013, part of this performance is based on increased loan valuations and does thus not reflect improving underlying profitability. The increased bank tax (to finance the household debt relief plan) will also dent profits.

[18] See Central Bank of Iceland: Monetary Bulletin May 2014 for more details.

EXHIBIT 14
Non-performing loan ratios of the three commercial banks and the HFF have declined substantially

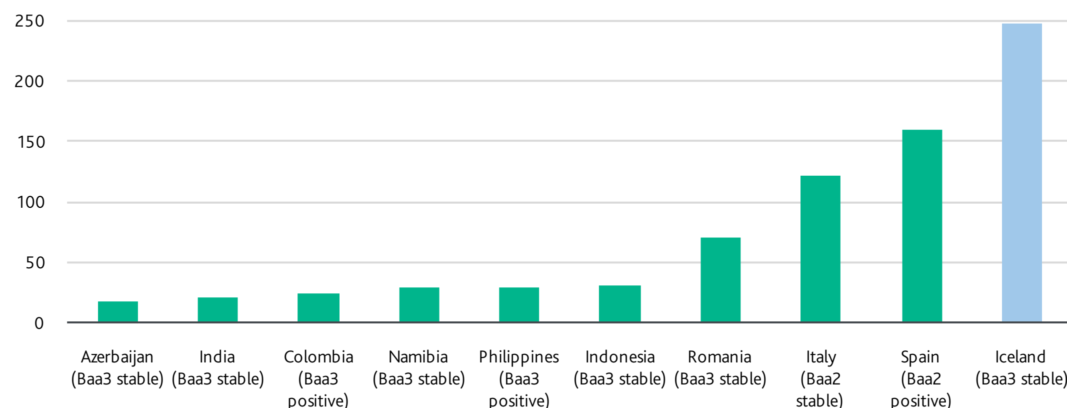


Note: Non-performing loans are defined as loans more than 90 days in arrears or those for which payment is deemed unlikely. If one loan taken by a customer is in arrears by 90 days or more, all of that party's loans are considered non-performing (cross-default).
Source: CreditInfo, Financial Supervisory Authority, Central Bank of Iceland

External vulnerability is lower than headline numbers suggest

Iceland's external position is heavily influenced by the settlement of the estates of the failed banks and other Icelandic entities in winding-down proceedings. It is highly likely that a large share of their external liabilities will have to be written-off upon settlement of the estates. The central bank has started to calculate the underlying external position of Iceland taking into account only the part of the external liabilities that is likely to be repaid eventually. According to these calculations, Iceland's underlying net external debt amounts to around 247% of GDP as at year-end 2013, compared to the headline external debt of 690% of GDP. Going forward, Iceland's external vulnerability will therefore be considerably smaller than the current headline numbers suggest. Still, Iceland's external debt levels continue to be significantly higher than those of most other sovereigns. At the same time, Iceland's foreign-currency reserves are substantial at above 24% of GDP.

EXHIBIT 15
Iceland's external debt is among the highest of Baa-rated sovereigns (% of GDP, 2013)



Source: Haver Analytics, Moody's. Ireland's external debt stood at 1015% of GDP last year.

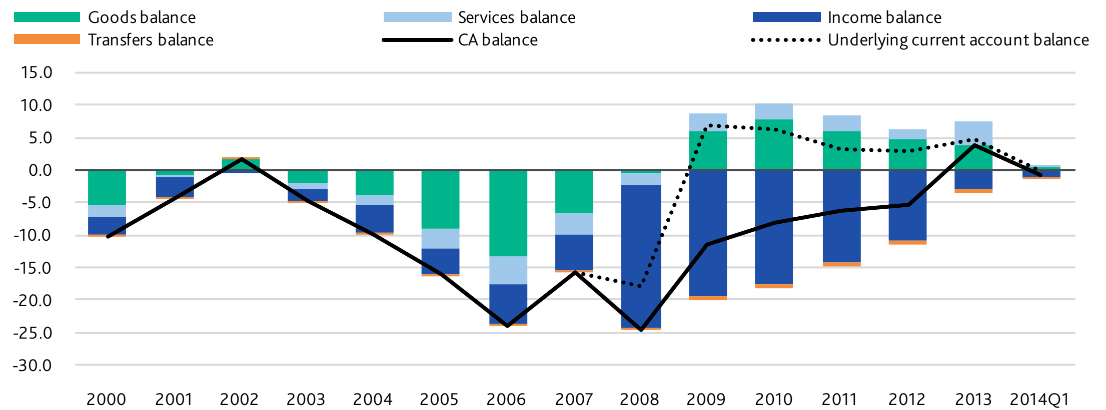
The current account balance presents a similar picture. While the headline balance posted a surplus of 3.9% of GDP in 2013, the underlying balance was in surplus at 6.2% of GDP. For 2014, we expect a surplus of 2.4% of GDP. Iceland's trade balance has shifted into a sustained surplus since 2009,

amounting to 7.4% of GDP in 2013, compared to a peak deficit of 17.5% of GDP in 2006. While this surplus is expected to shrink in the coming years as imports grow more strongly due to the high import content of investments and consumption, the trade balance will likely remain in surplus, a stark contrast to the pre-crisis period. Other risks, in particular political and government liquidity risks (discussed under Factor 3 discussion), are very low.

EXHIBIT 16

Current account has benefitted from rising surplus in trade balance and declining income deficit

(% of GDP)

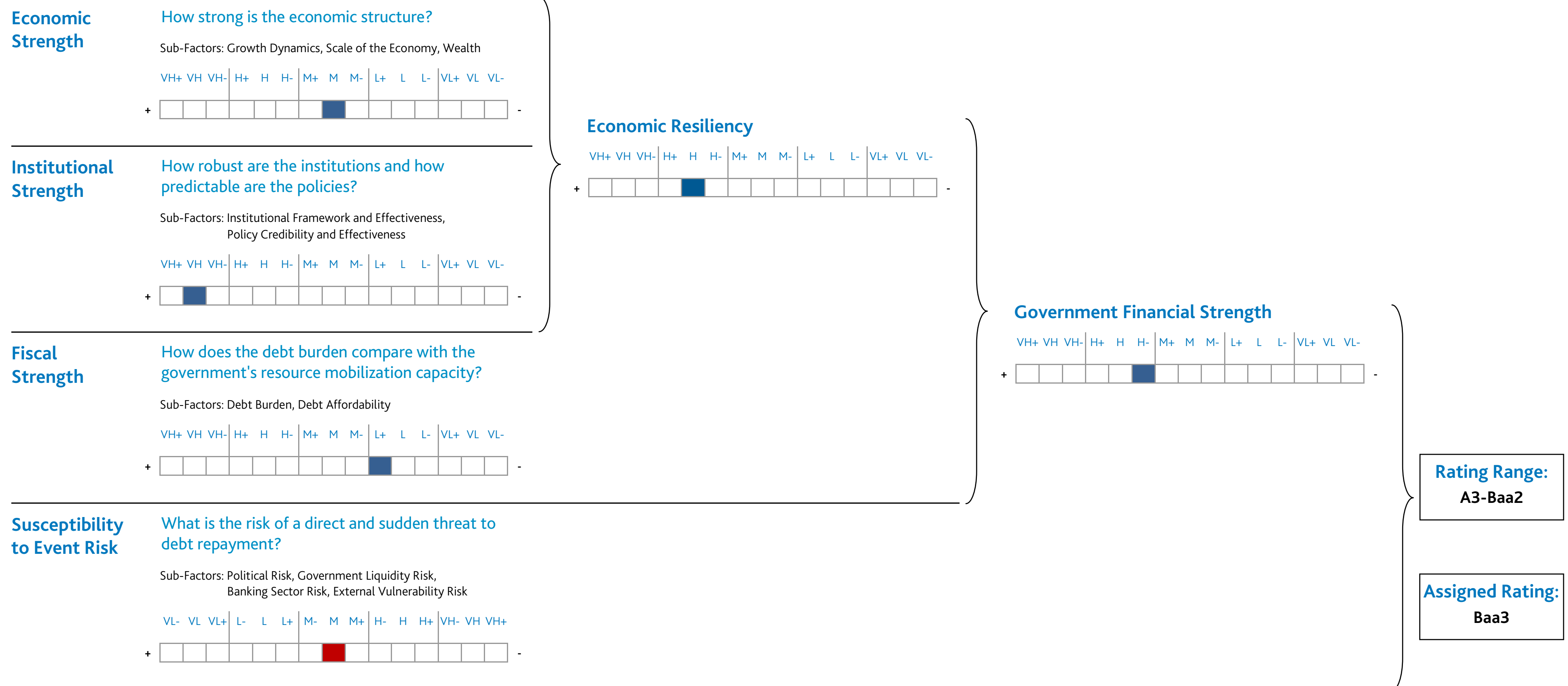


Source: Central Bank of Iceland. Underlying current account balance is based on estimate of final settlement of the old banks' estates and other entities in winding-down process.

Rating Range

Combining the scores for individual factors provides an indicative rating range. While the information used to determine the grid mapping is mainly historical, our ratings incorporate expectations around future metrics and risk developments that may differ from the ones implied by the rating range. Thus, the rating process is deliberative and not mechanical, meaning that it depends on peer comparisons and should leave room for exceptional risk factors to be taken into account that may result in an assigned rating outside the indicative rating range. For more information please see our Sovereign Bond Rating Methodology.

Sovereign Rating Metrics: Iceland



Comparatives

This section compares credit relevant information regarding Iceland with other sovereigns rated by Moody's Investors Service. It focuses on a comparison with sovereigns within the same rating range and shows the relevant credit metrics and factor scores.

Iceland compares favourably to other Baa3 rated sovereigns as far as its wealth levels and institutional strength are concerned. Iceland's key credit weaknesses relate mainly to its elevated public debt level which leads to a comparatively low score on fiscal strength.

EXHIBIT 17

Iceland Key Peers

	Year	Iceland	Hungary	Bahrain	Guatemala	Namibia	Colombia	Baa3 Median	Europe & Central Asia Median
Rating/Outlook		Baa3/STA	Ba1/NEG	Baa2/NEG	Ba1/STA	Baa3/STA	Baa3/POS	Baa3	Baa2
Rating Range		A3 - Baa2	Ba2 - B1	Ba1 - Ba3	Ba2 - B1	Baa1 - Baa3	Baa2 - Ba1	Baa2 - Ba1	A3 - Baa2
Factor 1		**M**	**M-**	**M+**	**L**	**M-**	**H**	**M+**	**M**
Nominal GDP (US$ Bn)	2013	14.6	130.2	32.2	53.8	12.6	378.1	230.5	184.9
GDP per Capita (PPP, US$)	2013	41,000	20,065	34,584	5,282	8,191	11,189	11,117	23,578
Avg. Real GDP (% change)	2009-2018	1.1	0.4	3.6	3.2	4.7	4.3	4.3	1.2
Volatility in Real GDP growth (ppts)	2004-2013	4.7	3.3	2.1	1.5	3.2	1.7	3.0	3.7
Global Competitiveness Index, percentile [1]	2013	73.9	46.0	63.4	29.5	26.0	40.8	51.7	59.1
Factor 2		**VH**	**H**	**H-**	**L**	**M**	**M**	**M**	**H+**
Government Effectiveness, percentile [1]	2012	85.8	61.4	59.8	13.3	48.0	45.6	46.4	64.9
Rule of Law, percentile [1]	2012	88.9	66.1	55.1	6.2	53.5	33.8	48.4	69.6
Control of Corruption, percentile [1]	2012	91.3	59.0	63.7	19.6	62.2	31.4	37.0	60.2
Avg. Inflation (% change)	2009-2018	4.4	3.3	2.3	4.1	5.9	2.9	4.8	2.0
Volatility in Inflation (ppts)	2004-2013	3.4	1.8	1.1	2.8	2.3	1.6	2.7	1.4
Factor 3		**L+**	**L**	**M**	**M+**	**H**	**M**	**M+**	**H-**
Gen. Gov. Debt/GDP	2013	97.7	79.2	43.9	24.6	24.6	34.6	36.1	56.2
Gen. Gov. Debt/Revenues	2013	217.7	166.4	188.7	211.5	70.4	204.3	185.1	149.8
Gen. Gov. Interest Payments/Revenue	2013	11.8	9.3	6.4	13.3	4.2	13.7	10.2	4.9
Gen. Gov. Interest Payments/GDP	2013	5.3	4.4	1.5	1.6	1.5	2.3	2.4	2.0
Gen. Gov. Financial Balance/GDP	2013	-0.5	-2.4	-4.4	-2.1	-2.0	-2.4	-2.1	-2.3
Factor 4		**M**	**M+**	**H+**	**M-**	**L**	**M**	**M-**	**M**
Current Account Balance/GDP	2013	6.2	3.0	11.6	-2.7	-6.1	-3.4	-2.5	0.6
Gen. Gov. External Debt/Gen. Gov. Debt	2013	31.9	61.9	11.3	52.6	39.9	41.0	33.6	56.7
External Vulnerability Indicator	2015F	77.7	121.4	618.0	39.1	70.9	46.6	70.4	104.7

Notes:

[1] Moody's calculations. Percentiles based on our rated universe.

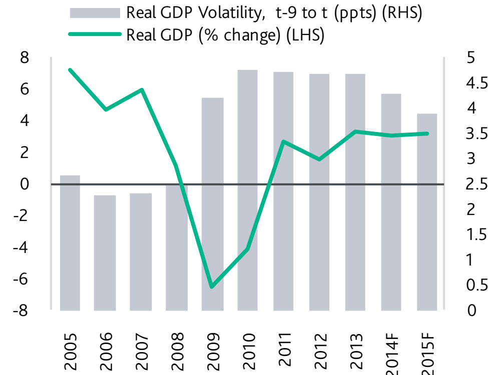
Source: Moody's,

Appendices

Chart Pack

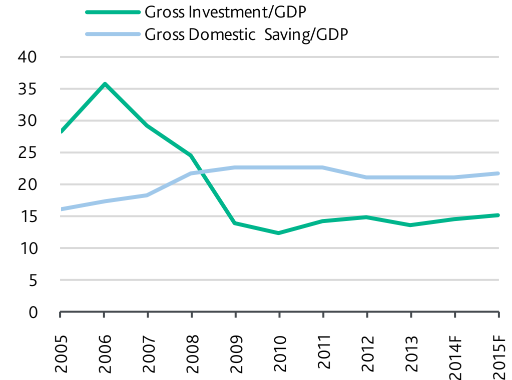
Iceland

EXHIBIT 18
Economic Growth



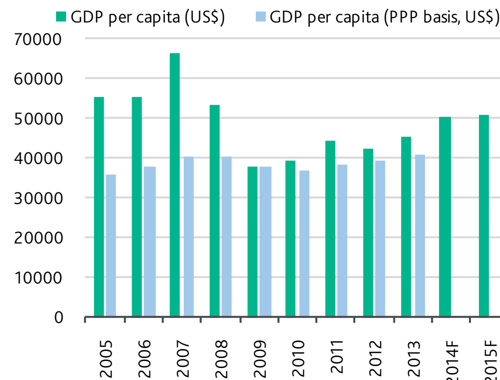
Source: Moody's,

EXHIBIT 19
Investment and Saving



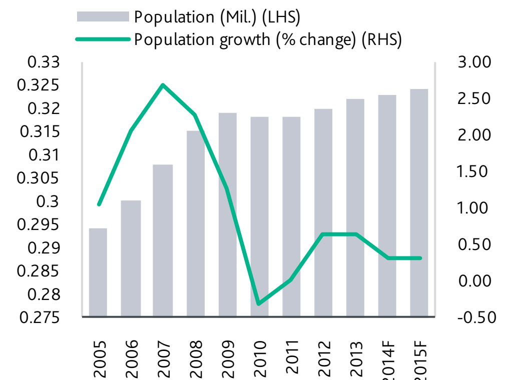
Source: Moody's,

EXHIBIT 20
National Income



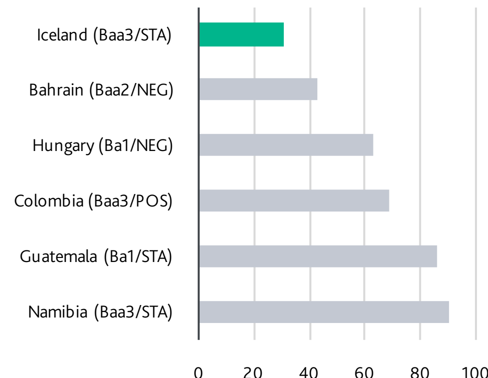
Source: Moody's,

EXHIBIT 21
Population



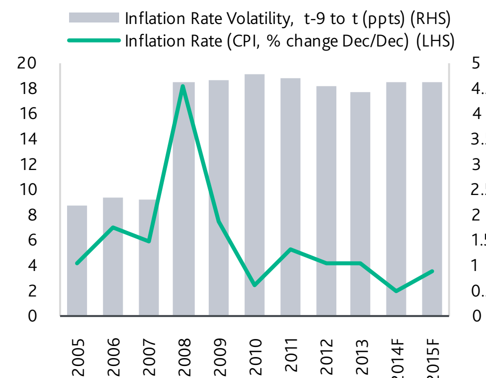
Source: Moody's,

EXHIBIT 22
Global Competitiveness Index
Rank 31 out of 148 countries



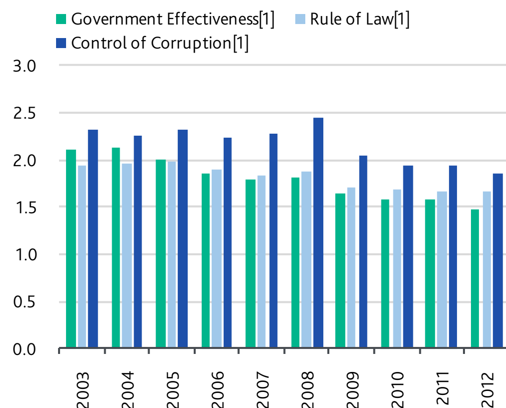
Source: World Economic Forum

EXHIBIT 23
Inflation and Inflation Volatility



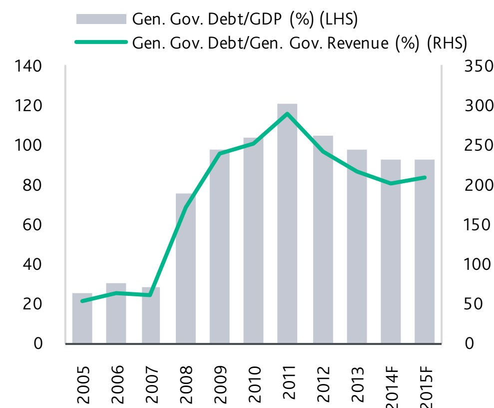
Source: Moody's,

EXHIBIT 24
Institutional Framework and Effectiveness



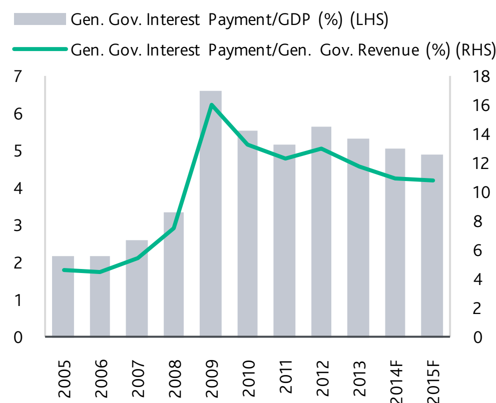
Notes: [1] Composite index with values from about -2.50 to 2.50: higher values correspond to better governance.
Source: World Bank Governance Indicators

EXHIBIT 25
Debt Burden



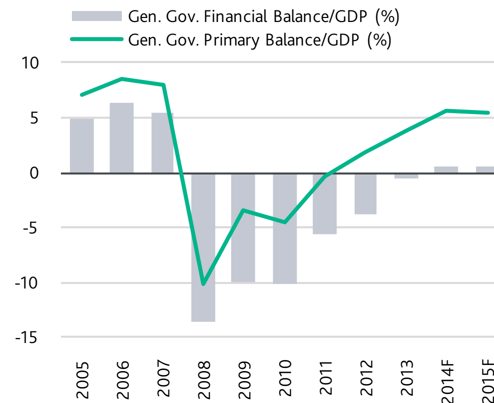
Source: Moody's,

EXHIBIT 26
Debt Affordability



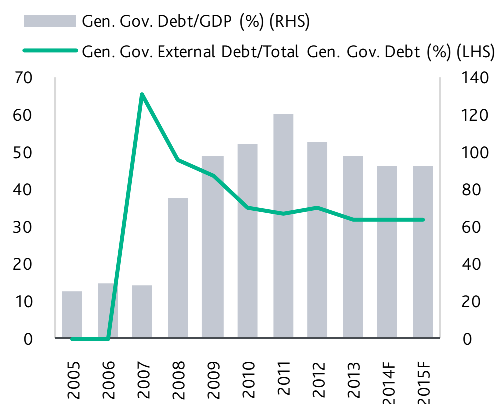
Source: Moody's,

EXHIBIT 27
Financial Balance



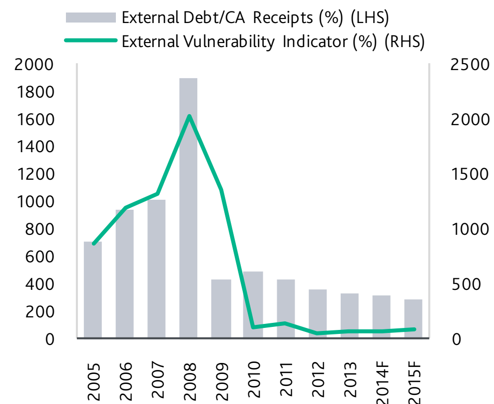
Source: Moody's,

EXHIBIT 28
Government Liquidity Risk



Source: Moody's,

EXHIBIT 29
External Vulnerability Risk



Source: Moody's,

Rating History

Iceland

	Government Bonds			Foreign Currency Ceilings				
	Foreign Currency	Local Currency	Outlook	Bonds & Notes		Bank Deposit		Date
				Long-term	Short-term	Long-term	Short-term	
Outlook changed	Baa3	Baa3	Stable	--	--	--	--	February-13
Rating Lowered	--	--	--	Baa3	--	--	--	November-12
Outlook changed	Baa3	Baa3	Negative	--	--	--	--	July-10
Outlook changed	Baa3	Baa3	Stable	--	--	--	--	April-10
Outlook changed	Baa3	Baa3	Negative	--	--	--	--	April-10
Outlook changed	Baa3	Baa3	Stable	--	--	--	--	November-09
Rating Lowered	Baa3	Baa3	--	Baa2	P-3	Baa3	P-3	November-09
Rating Lowered	Baa1	Baa1	Negative	A2	P-2	Baa1	P-2	December-08
Rating Lowered & Review for Downgrade	A1	A1	RUR-	Aa1	--	A1	--	October-08
Review for Downgrade	Aa1	Aa1	RUR-	--	--	--	--	September-08
Rating Lowered	Aa1	Aa1	Stable	--	--	Aa1	--	May-08
Outlook Changed	Aaa	Aaa	Negative	--	--	--	--	March-08
Rating Raised	Aaa	--	Stable	Aaa	--	Aaa	--	October-02
Rating Assigned	--	Aaa	--	--	--	--	--	July-97
Rating Raised	Aa3	--	Stable	Aa3	--	Aa3	--	July-97
Review for Upgrade	A1	--	RUR+	--	--	--	--	June-97
Outlook Assigned	--	--	Positive	--	--	--	--	March-97
Rating Raised	A1	--	--	A1	--	A1	--	June-96
Review for Upgrade	A2	--	RUR+	--	--	--	--	April-96
Rating Assigned	--	--	--	--	--	A2	P-1	October-95
Rating Assigned	--	--	--	--	P-1	--	--	October-90
Rating Assigned	A2	--	--	A2	--	--	--	May-89

Annual Statistics

Iceland

	2006	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Economic Structure and Performance										
GDP Nominal (US$ Bil.)	16.65	20.43	16.83	12.12	12.56	14.04	13.59	14.62	16.28	16.5
Population (Mil.)	0.30	0.31	0.32	0.32	0.32	0.32	0.32	0.32	0.32	0.32
GDP per capita (US$)	55,505	66,325	53,435	37,980	39,512	44,160	42,457	45,403	50,390	51,063
GDP per capita (PPP basis, US$)	38,032	40,332	40,581	37,742	36,834	38,464	39,544	41,000	--	--
Nominal GDP (% change, local currency)	13.9	12.0	13.1	1.2	2.5	6.0	4.4	5.1	5.2	5.5
Real GDP (% change)	4.7	6.0	1.2	-6.6	-4.1	2.7	1.5	3.3	3.0	3.2
Inflation Rate (CPI, % change, Dec/Dec)	7.0	5.9	18.1	7.5	2.5	5.3	4.2	4.1	1.9	3.5
Gross Investment/GDP	35.6	29.0	24.6	13.9	12.5	14.4	14.8	13.5	14.4	15.0
Gross Domestic Savings/GDP	17.4	18.3	21.8	22.5	22.6	22.7	21.0	20.9	21.1	21.6
Nominal Exports of G & S (% change, US$ basis)	3.9	31.8	5.6	-14.3	10.6	17.1	-2.7	4.2	11.3	3.2
Nominal Imports of G & S (% change, US$ basis)	17.2	10.2	-14.2	-32.5	8.5	22.5	1.7	1.3	12.9	3.6
Openness of the Economy[1]	82.7	80.0	91.6	97.1	102.6	109.8	112.7	107.7	108.4	110.2
Government Effectiveness[2]	1.87	1.78	1.81	1.65	1.59	1.58	1.49	--	--	--
Government Finance										
Gen. Gov. Revenue/GDP	48.0	47.7	44.1	41.0	41.5	41.8	43.6	44.9	46.2	45.5
Gen. Gov. Expenditure/GDP	41.6	42.3	57.7	51.0	51.6	47.4	47.4	45.4	45.6	45.0
Gen. Gov. Financial Balance/GDP	6.3	5.4	-13.5	-9.9	-10.1	-5.6	-3.8	-0.5	0.6	0.5
Gen. Gov. Primary Balance/GDP	8.5	8.0	-10.2	-3.4	-4.5	-0.4	1.8	3.9	5.7	5.5
Gen. Gov. Debt (US$ Bil.) [3]	4.89	6.03	9.25	11.74	14.20	15.79	13.81	15.09	14.72	14.85
Gen. Gov. Debt/GDP [3]	30.0	28.5	75.4	97.9	106.4	119.0	104.8	97.6	92.9	92.2
Gen. Gov. Debt/Gen. Gov. Revenue [3]	62.5	59.8	170.7	238.7	256.4	284.5	240.7	217.4	201.1	202.7
Gen. Gov. Int. Pymt/Gen. Gov. Revenue	4.5	5.4	7.6	16.0	13.3	12.4	12.9	11.8	11.0	10.8
Gen. Gov. FC & FC-Indexed Debt/GG Debt [3]	55.8	46.8	39.3	37.8	35.9	41.2	33.22	31.47	32.22	36.46
External Payments and Debt										
Nominal Exchange Rate (local currency per US$, Dec)	71.7	61.9	120.6	124.9	115.1	122.7	129.0	115.6	118.7	123.1
Real Eff. Exchange Rate (% change)	-7.0	5.5	-21.4	-19.2	5.1	1.4	-0.3	5.4	--	--
Current Account Balance (US$ Bil.) [4]	-3.97	-3.21	-4.13	0.84	0.90	0.44	0.38	0.91	0.38	0.40
Current Account Balance/GDP [4]	-23.8	-15.7	-24.6	6.9	7.2	3.2	2.8	6.2	2.4	2.4
External Debt (US$ Bil.) [5]	72.5	120.1	122.7	28.9	36.4	36.5	32.3	38.2	36.5	34.3
Public Sector External Debt/Total External Debt [5]	4.7	3.3	5.6	23.4	20.1	23.6	19.9	16.5	17.0	15.8
Short-term External Debt/Total External Debt [5]	16.9	34.3	37.7	10.6	8.1	5.6	5.7	6.4	5.9	6.0
External Debt/GDP [5]	444.3	567.9	999.2	241.3	272.6	275.1	244.876	247.073	230.3	213.2
External Debt/CA Receipts [4] [5] [6]	933.8	1009.8	1897.8	429.9	482.6	437.8	381.6	400.3	373.7	341.3
Interest Paid on External Debt (US$ Bil.) [5]	1.9	3.1	3.3	0.3	0.5	0.5	0.3	0.6	0.53	0.51
Amortization Paid on External Debt (US$ Bil.) [5]	5.1	18.1	10.8	0.9	0.9	5.2	1.54	1.22	0.55	1.04
Net Foreign Direct Investment/GDP	-10.2	-16.5	30.5	-18.2	20.7	7.7	31.1	-1.1	2.4	2.8
Net International Investment Position/ GDP [5]	-100.7	-115.6	-504.7	-72.9	-74.0	-53.1	-27.8	-17.1	--	--
Official Foreign Exchange Reserves (US$ Bil.)	2.3	2.5	3.5	3.6	5.6	7.7	4.0	4.1	4.1	4.1

Iceland

	2006	2007	2008	2009	2010	2011	2012	2013	2014F	2015F
Net Foreign Assets of Domestic Banks (US$ Bil.)	9.1	-24.3	-0.8	-0.1	0.7	1.7	2.0	2.7	--	--
Monetary, Vulnerability and Liquidity Indicators										
M2 (% change Dec/Dec)	19.6	56.6	32.1	-1.1	-9.9	8.7	-2.7	4.2	--	--
Monetary Policy Interest rate (% per annum, Dec 31)	14.3	13.8	18.0	10.0	4.5	4.8	6.0	6.0	--	--
Domestic Credit (% change Dec/Dec)	43.1	15.4	-33.0	-0.5	-6.5	-5.9	1.4	0.3	--	--
Domestic Credit/GDP	304.6	314.0	185.9	182.8	166.7	148.0	143.9	137.2	--	--
M2/Official Forex Reserves (X)	4.8	7.8	3.9	3.5	2.3	1.7	2.9	3.3	--	--
Total External Debt/Official Forex Reserves	3,187.7	4,713.4	3,518.9	795.2	655.0	473.5	798.0	926.2	889.7	837.4
Debt Service Ratio [7]	88.0	184.2	159.5	17.6	19.1	63.6	21.2	20.3	10.7	15.0
External Vulnerability Indicator [8]	1,242.7	1,333.2	2,039.5	1,350.1	109.1	145.5	46.3	75.6	72.8	77.7
Liquidity Ratio [9]	74.9	162.4	233.9	309.7	151.1	147.9	54.1	28.8	--	--
Total Liab. due BIS Banks/Total Assets Held in BIS Banks	205.9	305.2	401.0	525.0	231.5	246.7	127.2	88.4	--	--

Notes:

[1] Sum of Exports and Imports of Goods and Services/GDP

[2] Composite index with values from -2.50 to 2.50: higher values suggest greater maturity and responsiveness of government institutions

[3] Includes loans from the IMF and Norway

[4] 2009-2013 excludes DMBs undergoing winding-up proceedings

[5] 2009-2013 excludes DMBs undergoing winding-up proceedings

[6] Current Account Receipts

[7] (Interest + Current-year Repayment of Principle)/Current Account Receipts

[8] (Short-term External Debt + Currently Maturing Long-Term External Debt + Total Nonresident Deposits Over One Year)/Official Foreign Exchange Reserves. Excludes total nonresident deposits over one year

[9] Liabilites to BIS Banks Falling Due Within One Year/Total Assets Held in BIS Banks

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Analyst Contacts:

NEW YORK	+1.212.553.1653
Bart Oosterveld	+1.212.553.7914
Managing Director - Sovereign Risk	
bart.oosterveld@moodys.com	
Kristin Lindow	+1.212.553.3896
Senior Vice President	
kristin.lindow@moodys.com	

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Author
Kathrin Muehlbronner

Associate Analyst
Michail Michailopoulos

Production Associate
Amanda Kissoon

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