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Iceland (B): Redefining Aaa-Rated Sovereigns

The evaluation of Iceland prompted an intense internal discussion aimed at precisely defining the attributes of a Aaa in the sovereign universe.

—Pierre Cailleteau, managing director of the 'Moody's Sovereign RiskUnit, May 2008.[1]

On May 20, 2008 Moody's Investor Service, a ratings agency, downgraded the long-term sovereign debt issued by the government of Iceland from Aaa to Aa1 (see **Exhibit 1**). According to Pierre Cailletau, managing director of Moody's Sovereign Risk Unit and author of the report that made the official announcement of the downgrade, "Despite its considerable credit strengths, Iceland displayed characteristics that seemed increasingly at odds with a Aaa-rated country." According to Joan Feldbaum Vidra, assistant vice president and analyst of Moody's Sovereign Risk Unit, "Moody's downgrade reflects the country's potential liquidity constraints given the scale of possible, although highly unlikely, foreign currency needs" in case of a banking crisis. She further argued that "hardly any other Aaa sovereign possesses this foreign currency liquidity risk."[2]

What Does It Mean to Be a Triple-A Sovereign?

Before downgrading Iceland's sovereign data, the Moody's sovereign ratings team had an intense discussion to define, and indeed redefine, Aaa-rated sovereign debt, culminating in a report entitled "What Does It Mean to Be a Triple-A Sovereign." The report noted that difficulty of using existing metrics to assess Aaa ratings, and instead focused on a government's ability to obtain funds. According to the Moody's report,

> [t]here is no single quantitative or qualitative factor, but instead a combination of factors that lifts a country into the top rating category. Even debt metrics can be deceptive: what makes a sovereign a Aaa credit is not so much its low debt metrics but rather its ability to raise debt, even by large amounts, without increasing its default risk in any discernible fashion.[3]

The Decision to Downgrade

Iceland presented the Moody's team with a dilemma. Although Icelandic economic fundamentals appeared to be strong, the Moody's sovereign unit recognized that, given Iceland's substantial economic imbalance, it would be irresponsible to reaffirm Iceland's Aaa rating. Thus, Moody's outlined a new series of sovereign debt guidelines. According to Moody's, the four key characteristics of Aaa countries are:

Professor Aldo Musacchio prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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1. High degree of economic resilience, including:
   - High per capita income
   - Economic diversification and low volatility
   - Well-developed financial structures;

2. High degree of government balance-sheet flexibility;

3. Strong and credible institutions, including
   - Strong institutions, including credible monetary authorities
   - Solid consensus on policies; and

4. Unquestioned government access to finance under plausible stress scenarios.

In considering Iceland's sovereign debt, therefore, Moody's acknowledged that precise metrics alone could not define a Aaa sovereign. Although Moody's acknowledged that Iceland exhibits high per capita income and strong economic institutions, the sovereign unit was wary of Iceland's economic volatility, the fragility of Icelandic's highly leveraged financial sector and the government's inability to raise sufficient funds in the event of financial turmoil (see **Exhibit 3**). Under the new guidelines outlined above, Moody's was forced to downgrade Iceland's sovereign debt.

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Exhibit 1 Ratings for Iceland's Long-Term Foreign-Currency Sovereign Debt

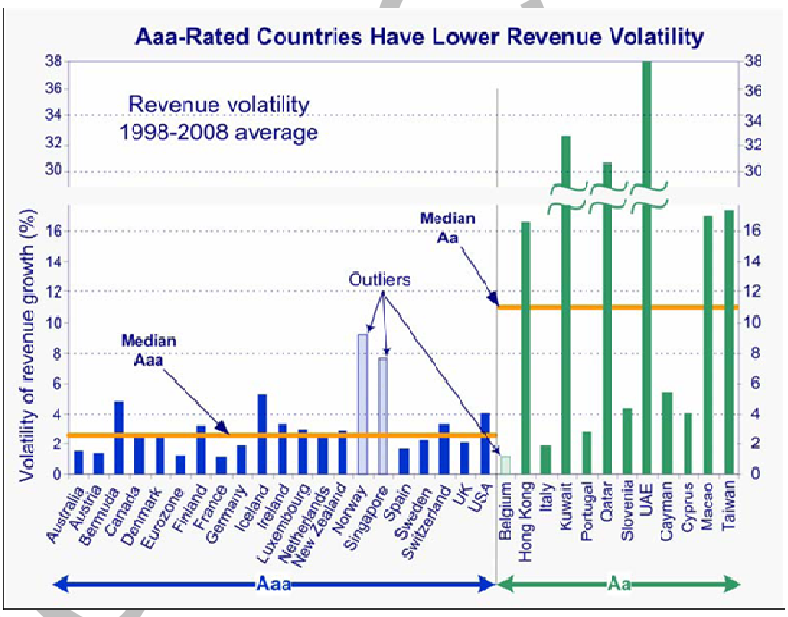
	Moody's Sovereign Rating / Outlook
24-May-1989	A2
10-Apr-1996	A2 / possible upgrade
24-Jun-1996	A1
16-Jun-1997	A1 /possible upgrade
20-Jul-1997	Aa3
21-Oct-2002	Aaa
5-Mar-2008	Aaa /negative
20-May-2008	Aa1 / stable

	S&P Sovereign Rating / Outlook
15-Mar-96	A+ / stable
27-May-98	A+ / positive
21-Mar-01	A+ / stable
22-Oct-01	A+ / negative
15-Nov-02	A+ / stable
16-Dec-03	A+ / positive
10-Feb-05	AA- / stable
5-Jun-06	AA- / negative
22-Dec-06	A+ / stable
20-Nov-07	A+ / negative
1-Apr-08	A+ / negative
17-Apr-08	A / negative

Source: Adapted from Moody's, "Iceland," April 2008, and "Moody's downgrades Iceland's Ratings to Aa1," May 20, 2008 and S&P Ratings Direct, available at www.ratingsdirect.com.

Note: For Moody's, long-term sovereign debt is categorized from highest grade to lowest grade as Aaa, Aa1 ,Aa2, Aa3, A1, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3, B1, B2, B3, Caa1, Caa2, Caa3, Ca, and C. Sovereign bonds categorized as Baa3 and above are investment grade. For S&P, long-term debt is categorized from highest grade to lowest grade as AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-, B+, B, B-, CCC+, CCC, CCC-, CC, C, and D. Sovereign bonds rated as BBB- and above are investment grade.

Exhibit 2 Volatility of Revenue in Aaa- and Aa-rated countries (average for 1998–2008)



Source: Moody's. "What Does it Mean to Be a Triple-A Sovereign." May 20, 2008.

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Exhibit 3 Moody's Characterization of Aaa-Rated Countries (May 2008)

	High per capita income	Diversification and low volatility	Developed financial structures	Balance sheet flexibility	Strong and credible institutions	Unquestioned access to finance
Australia	■	■	■	■	■	■
Austria	■	■	■	■	■	■
Bermuda	■	□	□	■	■	□
Canada	■	■	■	■	■	■
Denmark	■	■	■	■	■	■
Finland	■	■	■	■	■	■
France	■	■	■	■	■	■
Germany	■	■	■	■	■	■
Iceland	■	□	□	■	■	□
Ireland	■	□	■	■	■	■
Luxembourg	■	□	■	■	■	■
Netherlands	■	■	■	■	■	■
New Zealand	■	□	■	■	■	■
Norway	■	□	■	■	■	■
Singapore	■	■	■	■	■	■
Spain	■	□	■	■	■	■
Sweden	■	■	■	■	■	■
Switzerland	■	■	■	■	■	■
UK	■	■	■	■	■	■
USA	■	■	■	■	■	■

Note: ■ = Characteristic is fully present; □ = Characteristic is present to some degree; ☒ = Characteristic is lacking

Source: Moody's, "What Does It Mean to Be a Triple-A Sovereign?" May 20, 2008.

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Endnotes

[1] Moody's Investor Service, "Moody's Downgrades Iceland's Ratings to Aa1," May 20, 2008, p. 1.

[2] Ibid.

[3] Moody's Investor Service, "What Does It Mean to Be a Triple-A Sovereign?" May 2008, p. 1.

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