NEWS RELEASE

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R&I Assigns A+, Outlook Stable: Kaupthing Bank hf

Rating and Investment Information, Inc. (R&I) has announced the following:

ISSUER: **Kaupthing Bank hf.**
Issuer Rating

R&I RATING: A+ (Assigned)
RATING OUTLOOK: Stable

RATIONALE:

Kaupthing Bank hf. is the largest financial institution in Iceland. The bank is a product of the merger of the commercial bank Bunadarbanki Islands hf. and the investment bank Kaupthing Bank hf. in 2003. It is one of the three leading commercial banks in Iceland, and the largest domestic institution in capital market activities, investment banking, asset management and private banking (PB). In 2004 the bank acquired FIH Erhvervsbank (FIH), the third largest corporate lender in Denmark, and in 2005 Singer & Friedlander Group Plc (S&F), a mid-sized merchant bank in the U.K. As a result, currently, the majority of the consolidated earnings and assets of Kaupthing comes from international operations.

The rating reflects the bank's strong position in the Icelandic market, the diversification of its earnings and credit risks through the expansions into the U.K. and Scandinavian countries, its good profitability and sound asset quality. It also takes into account the small size and volatile nature of the Icelandic economy and financial market, the risks in the merchant banking business that is operated through its U.K. base, and the latent risks associated with the rapid business expansion. Although the bank has a small deposit base and high reliance on wholesale funding, during the past year it substantially reduced its refinancing risk through efforts to diversify funding sources, lengthen funding tenures, and implement conservative liquidity controls. Based on these considerations, R&I has assigned an Issuer Rating of A+. The Rating Outlook is Stable.

Revenue sources are diversified among several business sectors, countries and regions. For the year ended December 2006, Banking Division, or commercial banking, the largest sector, accounted for 45% of operating income without special items. The Investment Banking Division accounted for 18%, Treasury Division including foreign exchange and interest rates transactions accounted for 17%. The Capital Markets Division and Asset Management and PB Division each accounted for 10%. On the same basis, by geographic region Iceland accounted for 37% of operating income, Scandinavia 30%, the United Kingdom 23% and Luxembourg 8%.

Each country has different business profiles. In Iceland, the bank is active in a broad range of financial services including commercial banking for retail individuals, and the earnings sources are diversified among the business divisions. In Denmark the core business is corporate lending, while in Sweden it is capital market activities. In Finland the main business is asset management, while in Luxembourg it focuses on PB. In the U.K., the bank has inherited a good franchise in various niche financing activities, such as property finance, structured finance and commercial asset finance, from S&F and these are included in the commercial banking division. It also inherited the asset management and PB franchise for high-net worth individuals. In addition, the bank has built its own investment banking franchise, including M&A advisory, leveraged finance and principal investments.

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The operating results in each country or business can be significantly affected by the volatile nature of the Icelandic economy, or by the market- and transaction-driven characteristics of property finance, investment banking and capital market businesses. Because of the diversification of its earning sources, however, such factors will not give a significant effect on consolidated operating results. The fundamental good profitability also should serve as a buffer when the business environment has deteriorated. In 2006 the return on equity (ROE) exceeded 20% for the fourth consecutive year, and the annualized ROE based on the first quarter of 2007 was 27.6%, substantially above the average for European banks.

Kaupthing Bank also continues to geographically diversify its credit risk. As of December 31, 2006, Denmark accounted for 31% of loans to customers, the U.K. 27%, Iceland 22% and Sweden 8%. The loan portfolio is diversified by industry as well. Asset quality is sound. The ratio of non-performing loans to total customer loans stood at 1.00% at the end of the year ended December 2006 and 1.03% at the end of the first quarter 2007, lower than the average level for European banks. From 2004, the loan loss reserve as a percentage of non-performing loans remains above 60%.

In Denmark, FIH has a 13% share of the Danish market for corporate loans. Known for its sound credit management, during the past 17 years from 1990 to 2006, including the period when most Northern European states experienced financial crisis, the average credit losses at FIH were less than 0.2% of total customer loans. Kaupthing Bank found FIH's credit management procedures respectable and has incorporated them into that of the entire group. The credit risk management standards of FIH have not been relaxed after the acquisition by Kaupthing.

The main structure of the acquisition and leveraged finance activities, which are operated through its U.K. base, is short-term bridge financings until the acquisition on a secured basis. The loan portfolio is diversified by country and industry. It can be noted, however, such loans accounted for 18% of customer loans for the entire group as of December 31, 2006. On the other hand, property finance in the U.K. amounts to only several percentage points of the loan portfolio of the entire group, and credit screening standards such as loan-to-value (LTV) and interest coverage (= rents / interest) are strictly applied. Over the past several years, property values in the U.K. have risen substantially, and while some concern remains should the market value collapse in reaction, the effect on the consolidated financial position of Kaupthing would be likely to be limited.

Although real estate values have soared in Iceland over the past several years as well, exposure to real estate and construction firms is small. While mortgage loans to homeowners account for roughly 30% of the lending in Iceland, it represents only about 7% of the loans for the entire group. Given the small and diversified nature of the portfolio, the effect of the severe market downturn will be limited as well. There were wide-spreading practices of cross shareholding in Iceland, and the banking industry as a whole held equity exposures equivalent to 80% of the BIS risk capital at the end 2000. Over the past several years, however, they have rapidly unwound its crossholdings, and as for Kaupthing the equity exposures as percentage of risk capital had declined to 34.5% at the end of December 2006. Among the risk capital, unlisted shares related to the principal investment account for 9.8% of risk capital. Although principal investment is a key aspect of the growth strategy of Investment Banking Division, the bank sets the maximum limit of 15% for this ratio in its internal risk management guidelines. It pays an appropriate attention to the risk aspect. At the end of the first quarter 2007, the core capital ratio (Tier I ratio) was at 9.6%, high for a bank with grade A rating, and it has an adequate degree of risk resilience to withstand a stress case under which a variety of risk events occur simultaneously in each country and business.

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Kaupthing Bank has expressed a management policy to define the U.K. and Scandinavian countries, where many Icelandic firms are expanding their businesses, as "mother market". The policy focuses on providing a broad range of financial services, as a "corporate investment bank", to small and medium-sized firms as well as business owners. Currently, the business profiles in each country reflect the characteristics of the regional companies it acquired in the past; however, the bank is adding human capital in Scandinavia for its investment banking operations and in the U.K. for capital market activities. It aims to strengthen its earnings and customer base through cross-selling in these regions. Although such measures would enhance earnings diversification, they could lead to undesirable changes to the risk profile of the bank unless being managed properly. While Kaupthing has a history of successfully integrating the acquired firms, given that the bank has expanded operations rapidly over the past several years, it is still important to follow whether the management controls continue to function effectively.

With a population of 300 thousands, Iceland is a small country. Blessed with rich fishing grounds and unlimited geothermal and water resources, however, it ranks among the highest income countries in the world with per capita gross domestic product (GDP) in excess of US$ 50,000. Utilizing its low-cost electric power resources, Iceland is globally competitive in aluminum smelting and ferrosilicon manufacturing (used in steel making). The population is highly educated and the gap in wealth distribution is small in general, and the nation is politically and socially stable. Households have a considerable pool of financial wealth, but they have a low tendency to put them in bank deposits. In addition, the recent economic boom has contributed to the robust growth in loan demand. Therefore, the domestic banks have high reliance to the wholesale funding. Because S&F and FIH both lack retail deposit bases, Kaupthing Bank has this characteristic on a consolidated basis as well.

In the first quarter of 2006, concerns were raised in the global financial community about the Icelandic economy, including the overheated growth of the economy, the evaluation of the krona against other major currencies, the sustainability of the large current account deficit and the rapidly growing net external debt. As a consequence, the Icelandic krona fell sharply and issues such as the heavy reliance of major Icelandic banks on wholesale funding and the massive debt maturing in 2007 attracted a considerable attention. The major banks including Kaupthing worked to eliminate the market concerns, by swiftly initiating measures to mitigate the risk accompanying wholesale funding, including diversifying funding sources, lengthening funding tenures, improving the maturity profiles and finishing the refinance for whole 2007 in the beginning of this year. They also set policies to prepare for unanticipated stress events including disruption in the financial market, i.e., the policies to maintain a high level of liquidity with which they can continue to service the debt repayment and operate the business orderly without accessing the capital market for one year. Because of the strict liquidity controls, they have dramatically reduced their potential refinancing risks.

The large current account deficit, a major concern raised about the Icelandic economy, was caused mainly by the temporary increase in capital goods imports in conjunction with construction of large aluminum refinery plants, a surge in consumer durable goods imports and a large deficit in net travel receipts. The last two factors were fueled by an overheated economy and the appreciation of the krona. High domestic interest rates and international capital movements so-called carry trade had contributed to the appreciation until the beginning of 2006. With completion of the aluminum plant construction in 2007, the current account deficit is expected to decline by about 60%, as capital goods imports decrease and exports expand once the plants start operations. This will also remove the demand pressure from the economy. Because there will be an additional improvement in the current account as the economy cools down, the deficit probably will return to a sustainable level against the GDP.

On the other hand, the rapid increase in net external debt was caused mainly by the banking sector that expanded their business aggressively by overseas acquisitions with a portion of the funds raised through subordinated debt. The bank has also been increasing the foreign currency-denominated loans to the Icelandic business sector. Such loans are made to Icelandic companies that are either engaged in foreign operations or exports and thus have incentives to hedge the currency, or, those who wish to avoid high krona interest rates. Kaupthing, the largest bank, has nearly half of all domestic loans denominated in foreign currency. Because the weakening of krona could lead to a higher burden of payment of the borrowers, the bank has a principle to limit such loans to the borrowers that have a large portion of income denominated in foreign currency, such as businesses with significant foreign operations or exporting companies, and as for the customers with a low percentage of foreign currency income, the borrower must have excellent credit quality and the loans must be on a secured basis. Kaupthing Bank itself is prepared for the fall of the krona by managing its balance sheet composition in a manner that results in an improvement in the capital adequacy ratio when the krona falls. The key economic players with external borrowings, including other major banks, generally are taking measures to limit their currency mismatch risk, thus it is unlikely that the high level of net external debt would materialize as a substantial risk factor to the Icelandic economy.

After growing at a rapid rate in the 7% range in real terms during 2004 and 2005, the GDP growth rate in 2006 dropped to the upper 2% range, and the Icelandic economy is making a soft landing. Since mid-2006, the krona has recovered and now at around the average level for the last 6 years. Being a small country, the Icelandic economy is significantly affected by large-scale investment projects, exchange rate and interest rate volatility; however, the economy would not lose its balance significantly. It is very unlikely the country falls into a financial crisis as feared by some corners.

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Issuer Rating is R&I's opinion regarding an issuer's overall capacity to repay its entire financial obligation, and it will be assigned to all issuers. The rating of individual obligations (i.e. bonds and loans etc.) includes the prospect of recovery and reflects the terms and conditions of the agreement and it may be lower or higher than the Issuer Rating.

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