MOODY'S
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Credit Opinion: Faroe Islands, Government of

Global Credit Research - 02 Oct 2014

Ratings

Category	Moody's Rating
Outlook	Negative
Issuer Rating	Aa3

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Key Indicators

Faroe Islands, Government of

	2009	2010	2011	2012	2013
Interest Payments/Operating Revenue (%)	4.2	3.4	3.0	3.0	2.3
Accrual Financing Surplus(Requirement)/Total Revenue (%)	-12.7	-10.1	-5.3	-5.6	-3.8
Gross Operating Balance/Operating Revenue (%)	-8.8	-7.6	-2.0	-2.4	-2.4
Net Direct and Guarantees/Operating Revenue (%)	76.2	93.7	104.6	106.3	109.8
Short-term Gross Direct Debt/Gross Direct Debt (%)	32.5	15.5	34.4	30.8	19.9
Intergovernmental Transfers/Operating Revenue (%)	15.1	14.6	13.6	13.5	13.9
GDP growth (%)	-1.7	7.0	2.4	3.0	5.1

Opinion

SUMMARY RATING RATIONALE

The Aa3 issuer rating with negative outlook for the Faroe Islands reflects its fiscal autonomy and revenue and expense flexibility with a track record of prudent budgeting, as well as the islands' ample liquidity buffer. The rating also takes into account the Faroese economy's dependence on the fishing industry and continued, albeit declining, budget deficits.

Credit Strengths

Credit strengths for the Faroe Islands include:

- Fiscal autonomy allowing for greater revenue and expense flexibility

- Stable relationship with the Kingdom of Denmark (Aaa, stable)

- A large liquidity buffer which mitigates refinancing risk

Credit Challenges

Credit Challenges for the Faroe Islands include:

- Increase in debt in recent years

- Faroese economy dependence on the fishing sector

- Budget continues to be in deficit, but plans to bring back to surplus by 2016

Rating Outlook

The negative outlook reflects continued budgetary pressures due to the long deficit reduction period (2008 to 2015).

What Could Change the Rating Up

A return to structurally balanced budgets combined with steady debt reduction could put upward pressure on the rating.

What Could Change the Rating Down

The rating could come under pressure if the Faroe Islands were to incur materially larger deficits than currently projected and fail to implement their deficit reduction plan and/or materially increase borrowing above current projections. A weakening of the Faroe Islands' relationship with Denmark could also put the rating under pressure.

Issuer Profile

The Faroe Islands an autonomy, which forms part of the Kingdom of Denmark and consists of 18 islands located in the Atlantic Ocean, between Scotland and Iceland. It has a population of approximately 48,000.

DETAILED RATING CONSIDERATIONS

The rating assigned to Faroe Islands combines (1) a baseline credit assessment (BCA) of a2 and (2) a strong likelihood of extraordinary support coming from the Danish Government (Aaa stable).

Baseline Credit Assessment

FISCAL AUTONOMY ALLOWING FOR GREATER REVENUE AND EXPENSE FLEXIBILITY

While part of the Kingdom of Denmark, the Faroe Islands have been governed by the Home Rule Act since 1948, which gives the Faroese government full powers to set its tax rates and fees, and to set levels of spending on the services it provides.

This broad control over revenue supports Faroese financial flexibility; 89% of the Faroese government's operating revenues are derived from sources under its control, such as income and company taxes, VAT, import duties, sales of products and services, and other sources. The Kingdom of Denmark provides an annual block grant which accounts for the remaining 11% of the Faroes' operating revenues. This grant is for "Joint Matters" that have not been transferred to Faroese control (see below for relationship with Denmark).

Historically the Faroese government has implemented substantial cuts in spending when required (e.g., during the crisis of the 1990s when the government cut spending by 5% in 1992 and 10% in 1993). However following the global economic crisis in 2008-09, instead of spending cuts, the Faroes opted to increase debt. More recently, the Faroese government has announced spending reductions as part of its deficit reduction plan, though details are still to follow.

STABLE RELATIONSHIP WITH THE KINGDOM OF DENMARK

The Faroes' relationship with Denmark (Aaa stable) is stable and we view it is unlikely to change in the medium term. In 1948, the Faroe Islands was granted Home Rule, and in 2005 it gained further authority over matters described below.

The Faroese control "Special Matters" covering the economy, finances (independence to raise taxes) , industry, foreign trade, mineral rights, and the educational system. "Joint Matters" are administered by the Danish Government according to the laws of the Kingdom of Denmark, although some may be wholly or partly assigned to the Faroe Islands, or undertaken by Danish and Faroese authorities jointly. Currently matters under the Danish realm comprise the police force, judicial system and banking supervision.

The Faroe Islands elect their own parliament (Lagtinget) and the islands are governed by the Faroese government (Landsstyret), which is responsible for their own finances. In addition, the Faroe Islands have two seats in the Danish Parliament, which historically has lent influence in Danish politics, particularly in parliaments characterised by tight majorities. As mentioned previously, Denmark also provides an annual block grant intended to be used for social welfare and health sectors. These transfers are generally spent on health care and social care but the Faroese government has freedom over how the grant is used.

If the Faroe Islands were to secede from Denmark, it would likely require a referendum; however, the debate over independence has received less attention and political support in recent years. We do not expect any changes in the near term and moreover, we would expect any changes, if they were to occur, to be gradual.

A LARGE LIQUIDITY BUFFER WHICH MITIGATES REFINANCING RISK

The Faroe Islands maintains a large liquidity reserve, with a policy to hold a reserve that is no smaller than 15% of GDP (or approximately 35% of operating revenues) and that always exceeds necessary borrowing in a single year. This ample reserve mitigates refinancing risk. As of 2014, the reserve fund was approximately DKK2.1 billion, or roughly 34% of total revenues and 40% of net debt. The fund is invested in a portfolio of highly rated securities and aims to maximise the return within clearly defined risk limits. Furthermore, current debt-management policies also seek to limit annual debt maturities at less than 70% of the liquidity fund.

INCREASE IN DEBT IN RECENT YEARS

The Faroe Islands has independent borrowing powers, with DKK5.3 billion of outstanding debt (at end 2013). The debt maturity profile requires refinancing of approximately DKK one billion annually with the debt mainly bought by small and mid-sized Danish financial institutions.

Although direct debt has not exceeded 40% of GDP, the Faroe Islands' debt levels have trended upwards in recent years. Direct debt stood at approximately 101% of operating revenues at end 2013, compared with 60% at end 2008. Whilst the debt level is expected to remain high in the near term, debt intake should slow alongside the Islands' deficit reduction plan.

Additionally, Faroe islands has unfunded liabilities under the life insurance company, Foroya Livstrygging (LIV), which we include in the calculation of the government's debt. This pension scheme was fully self-funded until 2008 and until then had not generated any liabilities to taxpayers. However, since the onset of the financial crisis, LIV's funding ratio has fallen below 100%. Unfunded liabilities declined at end 2013 though to DKK506 million from DKK817 million the year previous. Moody's will continue to monitor the progress of the scheme closely, as it increases the government's indirect debt burden.

Indirect debt also includes DKK1.1 billion in municipal debt, which is excluded from net debt as this is deemed self-supporting. The Ministry of Finance is responsible for the supervision of the municipalities, and the Faroese Islands ultimately guarantees all outstanding debt issued by the municipalities. Municipal governments account for more than 20% of general government spending and have considerable flexibility in terms of spending, particularly for capital investments. They can incur debt of up to their level of total tax revenues, and to date have not been well integrated into the national budgeting process. Reforms are proposed to bring their finances more in line with national priorities. The islands' 30 municipalities vary widely in terms of size, from fewer than 50 inhabitants to approximately 20,000; as a result, any reform remains an ongoing and still-unresolved political process. Amongst the measures under consideration current reform priorities include moving responsibility for elderly care to municipalities.

FAROESE ECONOMY DEPENDENCE ON THE FISHING SECTOR

Despite some diversification over the last 10 years, the Faroese economy continues to rely on fishing and fishing related industries. Fishing accounts for more than 90% of exports, 15% of the labour force (including aquaculture) and almost one quarter of GDP, supporting the archipelago's tax revenues. While the share of fishing or fishing related activities in GDP has been on a declining trend, the high exposure introduces economic volatility, largely driven by the variability of fish prices and for inputs such as petroleum, as well as the risks of over exploitation of stocks. However since the 1990s, the Faroes' fishing industry has diversified to species other than cod and haddock and the Faroes have also diversified export markets to non-EU countries, such as Russia (11.5% of exports in 2013), Nigeria (7.4%) and China (6.6%).

In recent years, the Faroe Islands and the European Union (its largest fish export market) have engaged in disputes over fishing quotas. In March 2013, the Faroe Islands unilaterally increased its quota for herring and mackerel and EU member states responded in August 2013 by imposing sanctions on herring and mackerel caught in Faroese waters. The sanctions banned imports of both mackerel and herring products from the archipelago and banned some of its fishing boats from docking in EU ports, including Denmark. The sanctions came at a sensitive time for the Faroese economy as the Faroese government has posted a deficit every year since 2008, and any negative effect on the fishing sector and Faroese economy would have placed further pressure on the country's deficit reduction plan. In June 2014, however, the Faroe Islands and EU reached an agreement to end the sanctions, which was implemented in August 2014. Though evidence so far point to a muted impact from the sanctions, the end of the sanctions is credit positive for the Faroes as the EU trade sanctions constituted an economic threat to the archipelago.

BUDGET CONTINUES TO BE IN DEFICIT, BUT PLANS TO BRING BACK TO SURPLUS BY 2016

The Faroe Islands have reported deficits over the last seven years as the government increased spending to aid economic recovery after the 2008 crisis. As a result of the deficits, net debt (including long and short term debt and guarantees to LIV) has increased significantly from around 62% of operating revenues in 2007 to an average of 104% from 2010-2013.

The government projects further deficits until the end of 2015. The long deficit reduction period means that Faroese reliance on debt financing will remain at historically high levels, at least until the deficit starts declining and returns to balance by 2016.

In recent years, deficits have declined primarily through increases in revenue. Income tax increased by 22% over 2009 through 2013 and indirect taxes registered an increase of 6% over the same period. Plans to return to a balanced budget position in 2016, however, will require measures particularly on the spending side. While there is a general consensus on the return to balance in 2016, there are differences between political parties on how this will be achieved. Detailed plans on how spending will be reduced and deficit targets achieved are still to follow, presenting some implementation risks of achieving spending cuts envisioned. Nevertheless, historical performance shows that Faroese budgets closely match actual performance. We will continue to monitor progress in achieving the fiscal plan and the return to a balanced budget position.

Extraordinary Support Considerations

We assign a strong likelihood of extraordinary support from the Kingdom of Denmark, reflecting our assessment that the current relationship with the Kingdom of Denmark is unlikely to change in the medium term and the intensive extraordinary support provided to the islands in response to the financial crisis of the 1990s.

Denmark has no formal obligation to provide extraordinary support to the Faroe Islands, however, it has historically supported the Faroes on a number of occasions. In the 1990s, the Faroese government borrowed - largely from Denmark, given the scale of the crisis - in order to fund the nationalisation of Føroya Banki and Sjovinnubankin and to bridge the deficits of the recovery plan. As reforms were established, the Faroese began standalone borrowing, ultimately using these and other funds to repay Denmark. In 2010 Denmark (through Finansiel Stabilitet) also assumed control over EiK, a failing bank with operations in both the Faroes and on the Danish mainland. This action is consistent with Denmark being responsible for financial regulation (the banking sector). The relationship with Denmark remains important as a likely source of liquidity support, were independent financing to be again tested.

Output of the Baseline Credit Assessment Scorecard

In the case of the Faroe Islands, the BCA matrix generates an estimated BCA of aa3 compared to the BCA of a2 assigned by the rating committee. The matrix-generated BCA of aa3 reflects (1) an idiosyncratic risk score of 4 (presented below) on a 1 to 9 scale, where 1 represents the strongest relative credit quality and 9 the weakest; and (2) a systemic risk score of Aaa, as reflected in the sovereign bond rating (Aaa stable). The two notch differential reflects a number of factors not captured in the scorecard including: 1) the Faroese industry concentration on fishing sector which we consider to be insufficiently captured in scorecard; 2) Faroe Islands' reliance on small and mid-sized Danish financial institutions for debt refinancing; 3) small population limiting revenue generation.

The idiosyncratic risk scorecard and BCA matrix, which generates estimated baseline credit assessments from a set of qualitative and quantitative credit metrics, are tools used by the rating committee in assessing regional and local government credit quality. The credit metrics captured by these tools provide a good statistical gauge of stand-alone credit strength and, in general, higher ratings can be expected among issuers with the highest scorecard-estimated BCAs. Nevertheless, the scorecard-estimated BCAs do not substitute for rating committee judgments regarding individual baseline credit assessments, nor is the scorecard a matrix for automatically assigning or changing these assessments. Scorecard results have limitations in that they are backward-looking, using historical data, while the assessments are forward-looking opinions of credit strength. Concomitantly, the limited number of variables included in these tools cannot fully capture the breadth and depth of our credit analysis.

ABOUT MOODY'S SUB-SOVEREIGN RATINGS

National and Global Scale Ratings

Moody's National Scale Ratings (NSRs) are intended as relative measures of creditworthiness among debt issues and issuers within a country, enabling market participants to better differentiate relative risks. NSRs differ from Moody's global scale ratings in that they are not globally comparable with the full universe of Moody's rated entities, but only with NSRs for other rated debt issues and issuers within the same country. NSRs are designated by a ".nn" country modifier signifying the relevant country, as in ".mx" for Mexico. For further information on Moody's approach to national scale ratings, please refer to Moody's Rating Implementation Guidance published in June 2014 entitled "Mapping Moody's National Scale Ratings to Global Scale Ratings."

The Moody's Global Scale rating for issuers and issues allows investors to compare the issuer's/issue's creditworthiness to all others in the world, rather than merely in one country. It incorporates all risks relating to that country, including the potential volatility of the national economy.

Baseline Credit Assessment

Baseline credit assessments (BCAs) are opinions of entity's standalone intrinsic strength, absent any extraordinary support from a government. Contractual relationships and any expected ongoing annual subsidies from the government are incorporated in BCAs and, therefore, are considered intrinsic to an issuer's standalone financial strength.

BCAs are expressed on a lower-case alpha-numeric scale that corresponds to the alpha-numeric ratings of the global long-term rating scale.

Extraordinary Support

Extraordinary support is defined as action taken by a supporting government to prevent a default by a regional or local government (RLG) and could take different forms, ranging from a formal guarantee to direct cash infusions to facilitating negotiations with lenders to enhance access to needed financing. Extraordinary support is described as either low (0% - 30%), moderate (31% - 50%), strong (51% - 70%), high (71% - 90%) or very high (91% - 100%).

Rating Factors

Faroe Islands, Government of

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	7	87.58	70%	7.6	20%	1.52
Economic volatility	9		30%			
Factor 2: Institutional Framework						
Legislative background	1		50%	1	20%	0.20
Financial flexibility	1		50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	7	-2.34	12.5%	4	30%	1.20
Interest payments / operating revenues (%)	3	2.61	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	109.78	25%			
Short-term direct debt / total direct debt (%)	3	19.94	25%			
Factor 4: Governance and Management - MAX						

Risk controls and financial management	1			5	30%	1.50
Investment and debt management	5					
Transparency and disclosure	1					
Idiosyncratic Risk Assessment						4.42(4)
Systemic Risk Assessment						Aaa
Suggested BCA						aa3

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