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PUBLIC SECTOR EUROPE

CREDIT OPINION
5 August 2016

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RATINGS

Faroe Islands, Government of

Domicile	Denmark
Long Term Rating	Aa3
Type	LT Issuer Rating - Fgn Curr
Outlook	Stable

Please see the ratings section at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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Faroe Islands, Government of

Update to Key Credit Factors

Summary Rating Rationale

The Aa3 issuer rating with stable outlook for the Faroe Islands reflects its fiscal autonomy and revenue and expense flexibility with a track record of prudent budgeting. An additional strength includes the stable and historical relationship with the Kingdom of Denmark (Aaa, Stable), with joint matters clearly defined under the 1948 Home Rule Act, as well as the government's strong liquidity buffer. The rating also takes into account the Faroese economy's dependence on the fishing and fish farming sector and continued, albeit declining, accrual financing deficit and reliance on short-term borrowing.

Credit Strengths

» Fiscal autonomy allows for revenue and expenditure flexibility

» Reforms will improve long term public finances

» Stable relationship with the Kingdom of Denmark (Aaa, Stable)

» The successful implementation of a long term deficit reduction plan

» A large liquidity buffer which mitigates refinancing risk

Credit Challenges

» Faroese economy dependence on fishing and fish farming sector

» High debt levels, albeit expected to peak and trend downwards

» Refinancing risk due to debt structure and reliance on short term borrowing

Rating Outlook

The stable outlook reflects the successful implementation of a long term deficit reduction plan (2008 to 2015) and the anticipation of debt reversal from 2016 onwards.

Factors that Could Lead to an Upgrade

A combination of the following could have positive rating implications:

» A return to long-term structurally balanced budget

» Steady debt reduction to pre-financial crisis levels

» Less reliance on short-term borrowing

Factors that Could Lead to a Downgrade

One or a combination of the following could have negative rating implications:

» Failure to implement their deficit reduction as planned

» Increased debt levels above current levels

» A weakening of the Faroe Islands' relationship with Denmark

» An adverse shock impacting the Faroese fishing industry

Key Indicators

Exhibit 1

Faroe Islands, Government of	2011	2012	2013	2014	2015	2016(F)
Interest Payments/Operating Revenue (%)	3.0	3.0	2.3	1.8	1.6	0.8
Accrual Financing Surplus(Requirement)/Total Revenue (%)	-5.3	-5.6	-3.8	-3.8	-1.2	0.2
Gross Operating Balance/Operating Revenue (%)	-2.0	-2.4	-2.4	1.4	4.1	3.3
Net Direct and Guaranteed Debt/Operating Revenue (%)	104.6	106.3	109.8	104.6	107.2	106.3
Short-term Gross Direct Debt/Gross Direct Debt (%)	34.4	30.8	19.9	40.2	29.7	37.4
Intergovernmental Transfers/Operating Revenue (%)	13.6	13.5	13.9	12.7	14.0	13.6
Real GDP growth (%)	0.1	0.9	8.2	6.9	8.1	7.0

Source: Moody's

Detailed Rating Considerations

The rating assigned to the 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 ALLOWS FOR REVENUE AND EXPENDITURE FLEXIBILITY

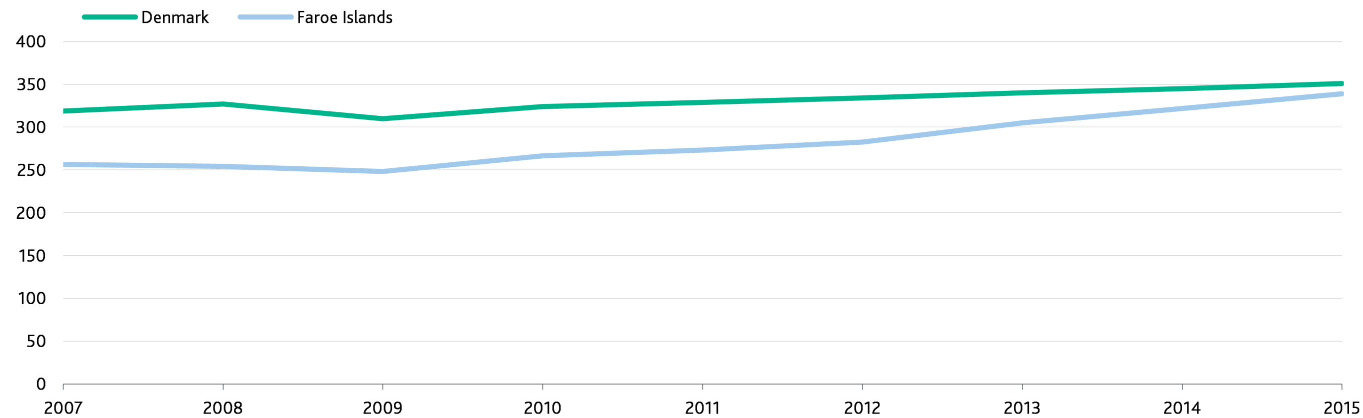
The Faroe Islands consist of 18 islands located in the Atlantic Ocean, between Scotland and Iceland with a population of approximately 49,000 inhabitants. While part of the Kingdom of Denmark (Aaa, Stable), the Faroe Islands are governed by the Home Rule Act, which gives the Faroese government full powers to set its tax rates and fees. This broad control over revenue supports Faroese financial flexibility; approximately 90% of the Faroese government's operating revenues are derived from sources under its control. The Kingdom of Denmark provides an annual block grant of DKK700 million which accounts for 10% 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).

The Faroese government has in the past implemented substantial cuts in spending when required. During the banking crisis of the early 1990s, the government demonstrated their expenditure flexibility by reducing expenditure by 15% in just two years. However, following the global economic crisis in 2008-09, instead of spending cuts, the government used their autonomy and opted for a loose fiscal policy. More recently, as the Faroese economy has entered a stage of recovery (real GDP growth of 7.7% between 2013-2015) GDP per capita has improved substantially (see Exhibit 3).

Exhibit 2

Faroese GDP per capita is improving and inching towards the Danish average

GDP per capita in DKK thousands, 2007 to 2015



Source: Statistics Faroe Islands

REFORMS WILL IMPROVE LONG TERM PUBLIC FINANCES

The recent government (elected in September 2015) has pledged to deliver fishing and pension reforms that will enhance and sustain the government's long term public finances. The fishing reform is expected to introduce legal and administrative frameworks to promote equal rights and wider access to the fish stock while increasing government revenue. This fishing reform is expected to be implemented before January 2018 as existing fishing rights are set to expire by the end of 2017. Moody's expects the government to introduce an auction-based market system, and this should result in additional revenue uplift when compared with the existing allocation model. The existing fishing fees model is expected to generate DKK165 million in fishing fees in 2016, a level deemed well below market value. Future fishing rights could generate up to double the amount under the new market based model, however this revenue uplift has prudently not been incorporated in the governments future budget.

In addition, the proposed pension reforms aims to control public pension liabilities in the medium and long run. We anticipate increased employee and employer requirements (by 1% altogether) and potentially an increase in the retirement age. The pension reform is ongoing and will reduce the government's pension liability and improve fiscal sustainability. This fund will be a "pay as you go fund" and should not represent any liabilities to the government. The fund will continue to be managed by the government's debt management department (Gjaldstovan). The Faroe Islands already have one of the oldest retirement ages in the world (at 67 years) and under the reform we could see a further increase to the retirement age if deemed necessary.

The Faroe Islands are introducing tax reform and are considering municipal reforms. The islands' 30 municipalities vary widely in terms of size, from fewer than 50 inhabitants to approximately 20,000, with some including Klaksvikar and Torshavnar delivering strong surpluses, while others like Runavikar realising budget deficits. Tax reform and an equalisation system similar to that seen in other Nordic countries could be credit positive[1].

STABLE RELATIONSHIP WITH THE KINGDOM OF DENMARK

The Faroese relationship with Denmark (Aaa, Stable) is stable. In 1948, the Faroe Islands were 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 education 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 had some influence in Danish politics, particularly in parliaments with thin majorities. As previously mentioned, Denmark provides an annual block grant to the Faroe Islands. Historically this grant played a bigger role in the Faroese economy but now only represent 10% of Faroese operating revenue. The grant is intended and indeed spent on social welfare, schools and health sectors, though the Faroese government does maintain freedom over how the grant is used.

If the Faroe Islands were to choose to separate from Denmark, a referendum would be assumed. The debate over independence has received less attention and political support in recent years. The recent general elections held in September 2015 resulted in a Social Democrat led coalition, which sees the link with Denmark as favourable. We therefore do not expect any changes toward independence in the medium term, and such a transition would be gradual. Nevertheless, although deemed unlikely, any push for separation from Denmark would exert downward pressure on the credit.

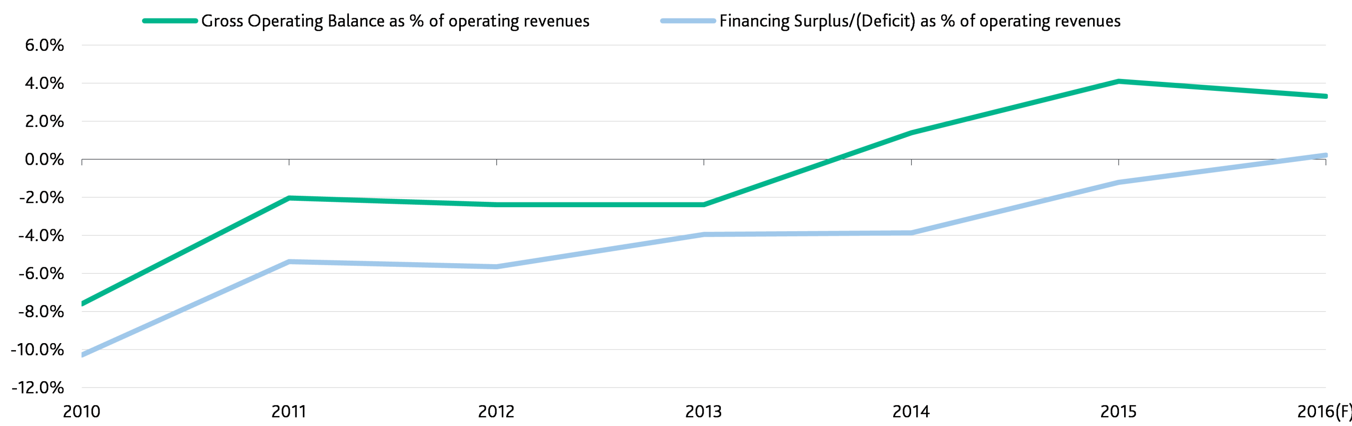
THE SUCCESSFUL IMPLEMENTATION OF A LONG TERM DEFICIT REDUCTION PLAN

The Faroe Islands reported a strong increase in its gross operating surplus to DKK269 million in FY2015 from DKK90 million in FY2014, which we recognize as a concrete step toward a positive financing surplus anticipated in 2016. Operating revenue increased by 20% between 2010 and 2015, while operating costs only increased by 7% over the same time frame. Direct tax growth drove operating revenue, increasing by 27% over the same period. The incumbent government seeks to cut capital expenditures in FY2016 to DKK288 million, a reduction of approximately 25% compared to the average yearly spend over the last three years (DKK380 million). This is expected to generate a financial surplus of DKK14 million in 2016 (see Exhibit 4).

Exhibit 3

The Faroe Islands expect their first surplus in 2016 since 2007

Gross operating balance and financing surplus as % of operating revenues, 2010 to 2016(F)



Source: Faroese Statistical Office

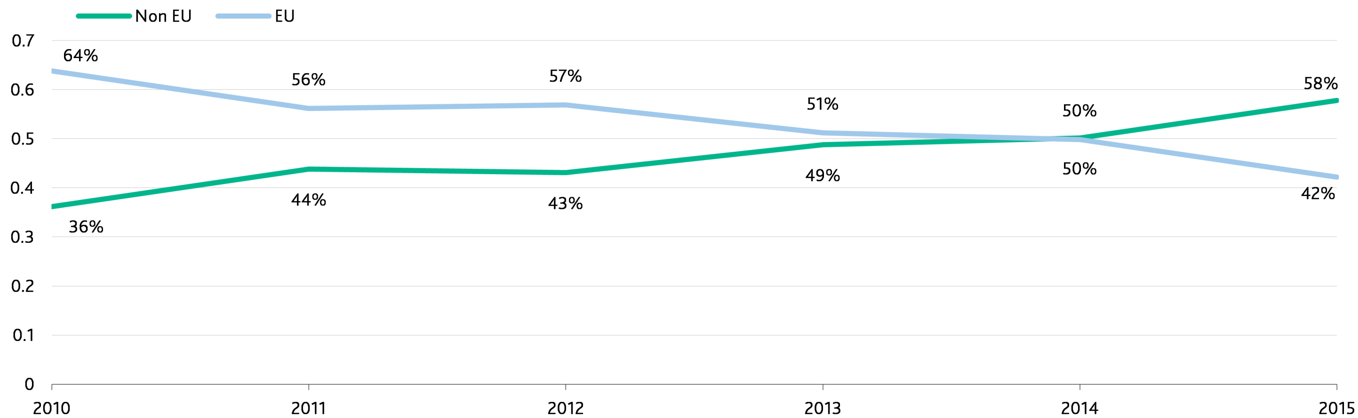
A LARGE LIQUIDITY BUFFER WHICH MITIGATES REFINANCING RISK

The Faroe Islands have a large liquidity reserve, amounting to DKK2.4 billion in May 2016. According to internal best practice, this reserve is only to be used during times of heightened market stress - if the reserve is drawn upon and drops below 15% of GDP, it is expected to be addressed and again reach internal limits during the next borrowing round. The reserve amount exceeds necessary borrowing requirements in any single year and this mitigates the refinancing risk associated with their reliance on short term borrowing (see section "Refinancing risk due to debt structure and reliance on short term borrowing"). The liquidity pool is sufficient to cover scheduled debt repayments for the next two years. The fund is invested in a portfolio of highly rated securities with investments being spread across various assets classes with defined limits in order to maximise the returns. At least 70% of the total liquidity pool is invested in Aaa bonds.

FAROESE ECONOMY DEPENDENCE ON FISHING AND FISH FARMING SECTOR

The Faroese economy continues to rely on the fishing industry with fishing accounting for 97% of exports and almost 20% of GDP. This high exposure introduces economic volatility as the economy is susceptible to exogenous factors. The variability in fish prices, factor inputs such as oil prices, and the risks of stock depletion would have a direct impact on the Faroese economy. Over the last years, a combination of high global demand and low oil prices has benefited the Faroese fishing sector, and indirectly government receipts. This has particularly been true for the pelagic and fish farming industries which have grown substantially and have contributed to the economic growth of the country. Meanwhile, the traditional demersal fishing industry (cod, haddock, etc.) has remained stagnant due to low stock levels. The Faroes have also increased trade with non-EU countries as can be seen in Exhibit 5, which shows how the share of exports to non-EU countries have for the first time surpassed their EU trade partners. We view the diversification in both fish species and trade partners as a partial mitigant to the concentration risk as it reduces exposure to species-specific shocks and potential trade sanctions.

Exhibit 4
Faroe Islands are diversifying their export partners
Share of exports by percentage, 2009 to 2015



Source: Gjaldstovan

HIGH DEBT LEVELS, EXPECTED TO TREND DOWNWARDS

As a result of the deficits recorded since 2007, net direct and indirect debt as a percentage of operating revenue has increased to 107% at FYE2015 from 62% at FYE2007. The upward trend in debt levels over the years is a response to the central government favouring fiscal expansion since the global financial crisis. The government issued debt to finance large scale infrastructure projects, spending an average of DKK244 million per year between 2011-2015, 36% higher than the pre-crisis average annual spend of DKK179 million (between 2003-2007). Whilst the resulting debt level is expected to remain high in the near term, the debt burden is expected to reverse once the Faroe Islands recognises financing surpluses from FY2016 onwards.

The Faroe Islands have independent borrowing powers and currently have DKK8.0 billion of total direct and indirect debt outstanding, of which DKK6.1 billion is issued by the government while other debt is composed of municipal and pension guarantees. Of the direct debt, 77% is interest-bearing (government issued bonds) while the remainder consists of rolling creditor debt and non-interest bearing loans. For example the government benefits from a DKK500 million interest free conditional loan by the Danish government that will be written off in 2018 (as long as the Faroese government does not find any oil reserves).

The Faroese unfunded pension liability (DKK0.92 billion) under Foroya Livstrygging (LIV) is guaranteed by the central government and is therefore included in our indirect debt calculations. The previously outlined pension reforms are not expected to impact this government exposure, which was fully self-funded up to 2008. Since the onset of the financial crisis and the subsequent low interest rate environment, LIV's self-funding ratio has fallen below 100%. Although part of our debt calculation, it is important to note that the government will not be exposed to any of LIV's liabilities before their own assets are fully depleted. With a current asset base of DKK2.1 billion, we expect that this will take 20-25 years to be depleted. We will continue to monitor the progress of this off balance sheet scheme, as it impacts the government's total debt burden over the long run.

Additionally, DKK1,013 million in municipal debt was recorded in 2015 (2014: DKK996 million). This number is excluded from our net debt calculation as this is deemed self-supporting. The Ministry of Finance is responsible for the supervision of the financial strength of municipalities, who may only incur a total debt burden up to their level of total tax income in any one year. Furthermore, the central government does not guarantee any of the municipal debt.

Furthermore, Moody's is monitoring the construction of two sub-sea tunnels via a publicly-owned company. We estimate the total combined cost to be approximately DKK2.0 billion. The financing of this project includes a DKK400 million equity investment spread over the next 10 years as well as future toll fees. We expect additional capital funding for the delivery of the project. Any overspend or toll revenues below existing forecasts could impact the governments debt metrics. We will continue to track delivery and debt issued. Downward rating pressure could arise if debt projections increase substantially above existing forecasts.

REFINANCING RISK DUE TO DEBT STRUCTURE AND RELIANCE ON SHORT TERM BORROWING

The Faroe Islands' debt profile requires refinancing of approximately one billion DKK annually. At FYE2015, short-term gross direct debt as a percentage of gross direct debt stood at 29.7%, decreasing from 40.2% in 2014 and 19.9% in 2013. Despite this drop, we consider this to be a high level of debt maturing in any single year and consider that this debt structure exposes the Faroes to refinancing risk. However, this has allowed the Faroe Islands to benefit from the current low rate environment with spreads as low as 0.25% over 5-year DKK swap in June 2016. Mitigating the refinancing risk is the Faroe Islands' liquidity buffer currently at DKK2.4 billion or 15% of GDP (see section titled "A large liquidity buffer which mitigates refinancing risk") which could cover the scheduled repayments coming due over the next two years.

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.

While Denmark has no formal obligation to provide extraordinary support to the Faroe Islands, it has historically supported the Faroese 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 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 tested.

Rating Methodology and Scorecard Factors

In the case of the Faroe Islands, the BCA matrix generates an estimated BCA of aa3 compared to the assigned BCA of a2 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's concentration on the fishing sector; 2) Refinancing risk and 3) small population limiting revenue generation.

Baseline Credit Assessment	Score	Value	Sub-factor Weighting	Sub-factor Total	Factor Weighting	Total
Scorecard						
Factor 1: Economic Fundamentals						
Economic strength	7	94.41	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 (%)	5	2.40	12.5%	4.25	30%	1.28
Interest payments / operating revenues (%)	3	1.79	12.5%			
Liquidity	1		25%			
Net direct and indirect debt / operating revenues (%)	7	107.24	25%			
Short-term direct debt / total direct debt (%)	5	29.74	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						4.5(4)
Systemic Risk Assessment						Aaa
Suggested BCA						aa3

Regional and Local Governments, January 2013 (147779)

Ratings

Exhibit 6

Category	Moody's Rating
FAROE ISLANDS, GOVERNMENT OF	
Outlook	Stable
Issuer Rating	Aa3

Source: Moody's Investors Service

Endnotes

1 See *Credit quality boosted by support expectation and inherent strengths* https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1028654

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