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CREDIT OPINION
28 February 2019

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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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Government of Faroe Islands

Update to credit analysis

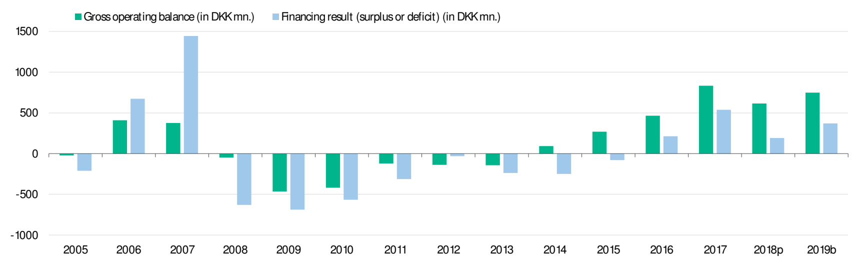
Summary

The credit profile of the Government of Faroe Islands (Aa3, stable) reflects its fiscal autonomy resulting in a high level of revenue and expense flexibility combined with a track record of prudent budgeting. The stable and historical relationship with the Government of Denmark (Aaa, stable), with joint matters clearly defined under the 1948 Home Rule Act, is also credit positive. While the Faroese economy has a high dependence on the fishing industry, this is somewhat offset by regular fish stock control and a push to diversify the country's trade partners. The rating also takes into account the government's very strong liquidity buffer, which mitigates refinancing risk. Debt metrics are on a moderate level but declining.

Exhibit 1

Financial surplus to be reported

Gross operating balance and financing result (in DKK million)



Note: 2018 is preliminary data (Moody's adjusted); 2019 shows budget data
Source: Gjaldstovan; Moody's Investors Service,

Credit strengths

» Fiscal autonomy and flexibility allow for reform implementation

» Stable relationship with the Kingdom of Denmark

» Financing surpluses and large liquidity buffer

Credit challenges

» Faroese economy's dependence on fishing and fish farming sector

» Moderate debt levels and some off-balance liabilities

» Some refinancing risk due to debt structure

Rating outlook

The outlook is stable. This reflects the successful implementation of a long term deficit reduction plan, improved macroeconomic metrics and a stable relationship with the Kingdom of Denmark.

Factors that could lead to an upgrade

A combination of the following could have positive rating implications: 1) a return to long-term structurally balanced budgets; 2) a steady reduction in debt to pre-recession levels; or 3) a reduced reliance on short-term borrowing.

Factors that could lead to a downgrade

One or a combination of the following could have negative rating implications: 1) a weakening of the Faroe Islands' relationship with Denmark; 2) an adverse shock impacting the Faroese fishing industry; and 3) a materially increased debt level or guarantees above current projections.

Key indicators

Exhibit 2

Faroe Islands, Government of

	2014	2015	2016	2017	2018p
Net direct and indirect debt / operating revenue (%)	104.6%	107.2%	99.8%	97.9%	89.7%
Gross interest expenses / operating revenue (%)	1.8%	1.6%	0.9%	1.1%	0.3%
Gross operating balance / operating revenue (%)	1.4%	4.1%	6.4%	11.4%	8.5%
Cash financing surplus (requirement) / total revenue (%)	-3.8%	-1.2%	2.8%	7.3%	2.6%
Intergovernmental revenues / total revenue (%)	12.7%	14.0%	14.5%	10.0%	9.5%

Note: 2018 is preliminary data.
Source: Issuer, Moody's Investors Service; Moody's adjusted figures

Detailed credit considerations

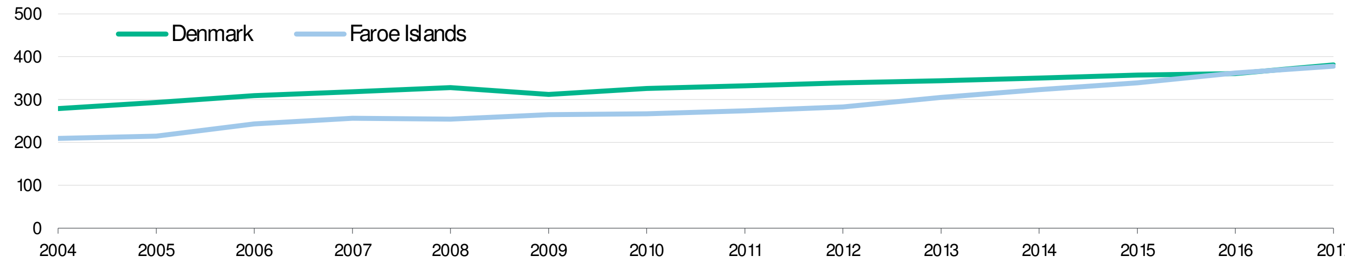
The credit profile of the Faroe Islands, as expressed in an Aa3 stable rating, combines (1) a baseline credit assessment (BCA) of a2, and (2) a strong likelihood of extraordinary support coming from the Government of Denmark (Aaa, stable) in the event that the entity faced acute liquidity stress.

Baseline credit assessment

Fiscal autonomy and flexibility allow for reform implementation

The Faroe Islands consist of 18 islands located in the Atlantic Ocean, between Scotland and Iceland with a population of slightly above 51,000 inhabitants. While part of the Kingdom of Denmark, the Faroe Islands are governed by the Home Rule Act, which gives the Faroese government full powers and flexibility 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 around DKK 0.7 billion which accounts for about 10% of the Faroes' operating revenues. This grant is for “Joint Matters” that have not been transferred to Faroese control. The grant is intended and indeed is spent on social welfare, schools and health sectors, though the Faroese government does maintain freedom over how the grant is used. The Faroese government has in the past implemented substantial cuts in spending when required. Unemployment in the Faroe Islands is currently very low at well below 2%, edging below the Danish national average since the end of 2013. The choice of expansionary spending was effective at stimulating the Faroese economy. More recently, as the Faroese economy has entered a stage of recovery with dynamic real GDP growth[1] of favorable 5% in 2017. GDP per capita has improved substantially and has surpassed the Danish GDP per capita in 2017 (see Exhibit 3) and is expected to have done so in 2018.

Exhibit 3
Faroese GDP per capita exceeded Danish GDP per capita since 2016
Nominal GDP per capita in DKK thousands, by year



GDP per capita for the Faroe Islands for 2014-2017 are estimates
Source: Statistics Denmark, Hagstova Foroya (Statistics Faroe Islands)

The government has pledged to deliver certain reforms, including fishing and pension reforms that will enhance and sustain the government's long term public finances.

The fishing reform was recently implemented, with the Act on the Management of Marine Resources, which was approved by parliament on 18th December 2017, aiming to foster sustainable management of fisheries, including legal and administrative frameworks to promote equal rights and wider access to the fish stock while increasing government revenue (see also: Fishing Policy Reform - Issuer In-Depth Report, published October 2018).

In addition, pension reforms aim to control public pension liabilities in the medium and long run. All citizens have to pay a certain percentage of their income into a pension scheme. Contributions will increase every year by 1% until 2026. This means that by 2026, all citizens will pay at least 12% of their income into a pension scheme[2], helping reduce the public pension liability. The government's pension reform also includes an increase to the retirement age (up to 68 in 2030) as well (currently at 67 years). Beyond 2030, retirement age is planned to further increase with life expectancy, up to the retirement age of 70 years in 2050.

The Faroe Islands are discussing tax reform and are considering municipal reforms. The islands' 29 municipalities vary widely in terms of size, from fewer than 50 inhabitants to approximately 20,000. Municipalities vary also widely in terms of financial strength, with stronger ones including Klaksvikar and Torshavnar. Tax reform and a financial equalisation system similar to that seen in other Nordic countries could be credit positive[3].

Stable relationship with the Kingdom of Denmark

Although there were discussions about a referendum, we do not see that the current government will put this forward. We understand that based on what has been discussed so far, there is not a concern about a material change in the relationship with Denmark. The last general elections held in September 2015 resulted in a Social Democrat led coalition, which sees the link with Denmark as favourable and public debate surrounding the topic has slowed down. The next election is in August 2019.

The Faroese relationship with Denmark 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[4]. “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 have had some influence in Danish politics, particularly in parliaments with thin majorities.

Financing surpluses and large liquidity buffer

Based on preliminary figures, the Faroe Islands have reported a favorable gross operating surplus of DKK613 million in 2018, compared to DKK834 million in 2017. This operating balance amounts to roughly 10% relative to operating revenues, a positive development of results and considerable improvement from a few years earlier. Given strong operating performance, the government could easily cover capital expenses and finally report considerable financial surplusses. In 2018, we expect a financing surplus of DKK192 million, which is DKK500 million lower than the government reported surplus. This is explained by an adjustment made to capital expenses, which included the write-off of a loan granted by the Danish government. The 2017 financing surplus was DKK537 million (see Exhibit 1).

The rapid improvement of financial performance was the result of dynamic tax revenue growth but also some measures on the expenditure side of the budget. Meanwhile, the government seeks to cut capital expenditures, following the end of its 2011-2016 fiscal deficit reduction programme. For 2019, government budget foresees an outcome at slightly above 2018, which we view as realistic (see Exhibit 1).

The Faroe Islands have a large liquidity reserve, amounting to DKK3.7 billion as of end December 2018 (compared to DKK3.4 billion in Dec. 2017), which is well above the internal minimum liquidity threshold of DKK2.8 billion. 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 2018 liquidity reserve represented nearly 20% of Faroese GDP. 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 below). The liquidity pool is sufficient to cover scheduled debt repayments for the next two years. We expect the government to use its excess liquidity (i.e. above 15%-threshold) to pay down a part of the DKK1.1 bn. maturing bond in 2019 an only refinance the remaining amount. 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-rated securities.

Faroese economy's dependence on fishing and fish farming sector

The Faroese economy continues to rely on the fishing industry with fishing accounting for around 20% of national GDP and for around 95% of total export values of goods. 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. In recent years, 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. However most recently, pelagic fishing quotas are slightly lower.

On the other hand, the traditional demersal fishing industry (cod, haddock, etc.) has remained stagnant due to low stock levels. Most recent indicators show however that cod and haddock catches are trending upwards, potentially a result of increasing stocks according to experts.

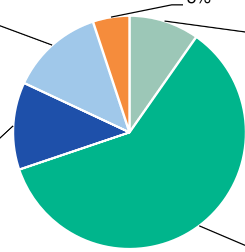
To reduce dependencies, the Faroe Islands have also increased trade with non-EU countries, from around one third ten years ago to more than 50% now. We view the diversification in both fish species and trade partners as a partial mitigant to the concentration risk as it reduces exposure to species-specific shocks and potential trade sanctions.

Moderate debt levels and some off-balance liabilities

The Faroese government's expansionary fiscal policy following the global financial crisis (2008/2009) has resulted in increased debt levels. The government largely issued debt to finance large scale infrastructure projects, spending an average of DKK274 million per year on fixed capital construction between 2012-2017, around 50% higher than the pre-crisis average annual spend of DKK179 million between 2003-2007. As a result of ongoing financing deficits from 2008 to 2015, net direct and indirect debt as a percentage of operating revenue was above 100% of operating revenues from 2011 to 2015, but is now on a declining trend.

Exhibit 4

The Faroese Government's total (direct and indirect) debt portfolio of DKK8.6 billion is made up primarily of direct debt
Total direct and indirect debt in DKK million, 2017



Note: Tunnel debt and municipal debt is considered self-supporting.
Source: Moody's Investors Service; Issuer

The Faroese government has guaranteed an unfunded pension liability of approximately DKK1 billion under Foroya Livstrygging (LIV) and this 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%. We will continue to monitor the progress of this off balance sheet scheme, as it impacts the government's total debt metrics over the long run.

Municipal debt is considered self-supporting as the government does not provide a guarantee on their debt and they may only incur a total debt burden up to their level of total tax income in any one year.

The Faroese government has provided a minimum revenue guarantee, which exposes the government to construction and operational risk by underwriting the major infrastructure project that involves two sub-sea tunnels, Eysturoy and Sandoy. The tunnels represent the biggest infrastructure deal in the history of the Faroe Islands with an expected cost of approximately DKK2.64 billion. (see: FAQs About the Sub-Sea Tunnel Plans, Minimum Traffic Guarantee, published 6th March 2017). The drilling of the Eysturoy tunnel is expected to be completed in May 2019, which will reduce construction risk.

Despite taking into account the risk of this project during the construction phase, our debt projections now foresee a declining debt level over the next five years. We treat the debt associated with the tunnel as indirect debt given the government-owned tunnel-project company and the minimum revenue guarantee. We note the difference in financial viability between the tunnels, with the future earnings from the Eysturoy tunnel expected to cover the majority of the debt service requirements. The Sandoy tunnel remains financially non-viable on a standalone basis and once operational will only contribute approximately 10% of total combined income over the next 40 years.

Some refinancing risk due to debt structure

The Faroe Islands historically had a relatively high share of short-term borrowing. In 2017, the Faroe Islands refinanced at very low interest rate (on average below 1%) a maturing DKK1 billion loan with long-term new loans[5], which we consider to be credit positive, as it reduces the exposure to interest risk. The government also has rolling short-term creditor debt that is repaid each year.

The Faroe Islands' average maturity of its outstanding debt is relatively low, at a level we consider exposes the Faroes to have some refinancing risk. However, this has allowed the Faroe Islands to benefit from the low interest rate environment in the recent past. Current interest rates are still very low. Mitigating the refinancing risk is the Faroe Islands' liquidity buffer currently at DKK3.7 billion or close to 20% of GDP, which could cover the scheduled repayments coming due over the next few years. We expect the government to use its excess liquidity (i.e. above 15%-threshold) to pay down a part of the DKK1.1 bn. maturing bond in 2019 and only refinance the remaining amount.

Extraordinary support considerations

We consider Faroe Islands to have a strong likelihood of extraordinary support from the Kingdom of Denmark. This reflects 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 government 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 were established, the Faroese began standalone borrowing, ultimately using these and other reforms' 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

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 Denmark's Aaa stable sovereign bond rating.

The assigned baseline credit assessment (BCA) of a2 is below the matrix-generated suggested BCA and the two-notch differential includes an additional factor. This includes the Faroese industry's concentration on the fishing sector and the islands' small population size limiting revenue generation.

For details about our rating approach, please refer to Rating Methodology: Regional and Local Governments, 16 January 2018.

Exhibit 5
Government of Faroe Islands

Faroe Islands Baseline Credit Assessment	Value	Sub-Factor Score	Sub-Factor Weighting	Sub-Factor Total	Factor Weight	Total
Factor 1: Economic Fundamentals						
Economic strength	99.5	5	70%	6.2	20%	1.24
Economic volatility		9	30%			
Factor 2: Institutional Framework						
Legislative background		1	50%	1.0	20%	0.20
Financial flexibility		1	50%			
Factor 3: Financial Performance and Debt Profile						
Gross operating balance / operating revenues (%)	8.9	3	12.5%	4.0	30%	1.20
Interest payments / operating revenues (%)	1.1	3	12.5%			
Liquidity		1	25%			
Net direct and indirect debt / operating revenues (%)	97.9	5	25%			
Short-term direct debt / total direct debt (%)	32.3	7	25%			
Factor 4: Governance and Management						
Risk controls and financial management		1		5	30%	1.50
Investment and debt management		5				
Transparency and disclosure		1				
Idiosyncratic Risk Assessment						**4.14 (4)**
Systemic Risk Assessment						**Aaa**
Suggested BCA						**aa3**

Note: based on 2017 data.
Source: Moody's Investors Service

Ratings

Exhibit 6

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

Source: Moody's Investors Service

Endnotes

1 The Faroe Islands do not have a GDP deflator. Instead, the Consumer Price Index (CPI) in the Faroe Islands is used to calculate real GDP.

2 Those persons who already pay 15% or more of their income into a pension scheme will not be required to pay more than what they already do.

3 See *Nordic Local Governments: Credit quality boosted by support expectation and inherent strengths*, published May 2016.

4 For more information on the division of tasks, see *Delivery of Faroe Islands' Fiscal Plan Supports Creditworthiness*, published July 2015

5 for information on outstanding government bonds, see http://www.landsbanki.fo/en-gb/liquidity-and-debt/debt/national-treasury-bonds

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