

ISSUER IN-DEPTH

4 October 2018

✓ Rate this Research

RATINGS

Faroese Islands, Government of

Domicile	Denmark
Long Term Issuer Rating	Aa3
Outlook	stable

KEY METRICS:

	2016	2017	2018e
Population (at year-end)	49,823	50,498	51,000
Real GDP growth (%)	7.1	4.8	n.a.
Financial result (% of tot. rev.)	2.8	7.3	7
Gross operating balance (% of op. rev.)	6.4	11.4	11

Source: Moody's

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Government of the Faroe Islands

Fishing policy reform ensures sustainability of fish stocks, boosts government revenue

The [Faroese Islands \(Aa3 stable\)](#) have implemented a reform to the country's fishing policies that sets controls through introducing an auction system and additional fees that will boost government revenue. The reform aims to ensure fishing rights and profits are more widely distributed, and encourage sustainable fishing and the maintenance of fish stocks. The reform is credit positive because it should ensure the long-term sustainability of the islands' most important industry, discourage overfishing through a new quota system and boost one of the government's main revenue sources through auction proceeds and additional fees.

- » **Fishing industry is crucial to the Faroese economy.** Fish accounts for 95% of the value of exports from the Faroe Islands and the fishing industry accounts for 18% of gross value added (GVA) in the economy¹. Moreover, approximately 15% of the local workforce is employed in the industry in a variety of areas such as fishing and processing. The industry generates substantial corporate and personal income tax revenue for the government and levies on fishing currently make up about 4% of the government's annual revenue in 2017.
- » **Legislative changes control overfishing through government quotas, and redistribute fishing licences.** The reform introduces an annual quota system on fishing². This replaces the previous arrangement whereby companies were given a number of allotted days for fishing. The new arrangements will allow the government to more flexibly adjust quotas in response to the size of fish stocks, which will help to cut the long-term risk of overfishing. Approximately 15-25% of all quotas will be placed under auction.
- » **Reform leads to growing additional revenue source for government.** Total government revenue from fishing levies (fee and auction proceeds) doubled between 2015 and 2017, and the reform is set to increase government revenue sourced from the fishing industry further in 2018, driven largely by increases in auction proceeds. The reform requires all fishing vessels operating in its waters to be registered on the Faroe Islands, thereby complying with Faroese standards and requirements.

THIS REPORT WAS REPUBLISHED ON 8 NOVEMBER 2018 TO CLARIFY THE AIM OF THE REFORM AND THE REVENUE DISTRIBUTION MECHANISM.

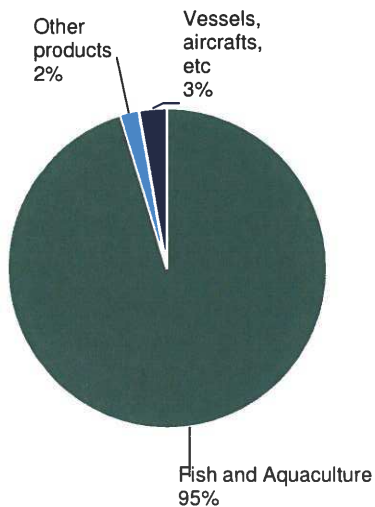
Fishing industry is crucial to the Faroese economy

The economy of the Faroe Islands is heavily reliant on the fishing industry, with fish accounting for 95% of the country's total exports in 2016 (see Exhibit 1), even though the country only accounts for 1% of the fish caught in the world (see Exhibit 2). In addition to the high level of exports, much of the domestic economy is also dependent on the sector. Fishing accounts for 18% of gross value added (GVA) in the economy and it is estimated that approximately 15% of the local workforce is directly employed in the supply chain in areas such as weighing, processing and sales.

Exhibit 1

Fish and Aquaculture dominate Faroese exports

Faroese exports 2016, fish species and aquaculture grouped together for clarity

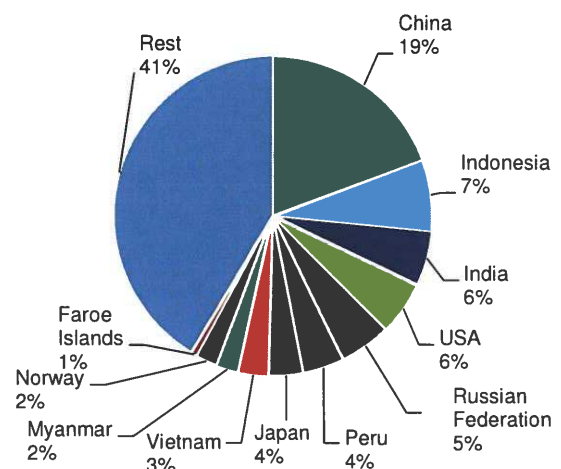


Source: Statistical Office of the Faroe Islands, National Accounts

Exhibit 2

Faroe Islands make up 1% of global world catch

Distribution of global Top 10 fish and aquaculture countries in 2016 and Faroe Islands



Source: FAO 2016 Yearbook Fishery and Aquaculture Statistics

The industry as a whole, which includes the fishing and production supply chain, generates substantial revenue for the government through corporate and personal income taxes. In addition, fees and auction proceeds from the fishing industry grew to make up around 4% of the government's annual revenue in 2017. If fishing stocks can be well managed, we expect this to increase in line with growth in global demand for seafood and because the country is able to flexibly shift between markets. For example, as the country is not a member of the European Union, it is not subject to EU sanctions against Russia and is able to expand into the Russian market (see Highlight Box: The Faroe Islands).

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Legislative changes control overfishing through government quotas, and redistribute fishing licences

A new total allowable catch (TAC) quota sets an annual quota on catches for all longliners and trawlers, and will replace the previous system whereby longliners and trawlers were given a number of allotted fishing days. ⁽³⁾ Previously, fisheries had limits on the days spent at sea (known as the effort-quota system). The government have determined that this has led to overfishing in the past as fisheries were incentivised to use all their allotted days.

Under the new system, approximately 15-25% of the TAC quota will be allocated through public auctions. The remainder of the quota will chiefly be distributed among fishing companies that are established in the sector, known as "grandfathering," but they will be required to pay annual fees for each species. In addition, the Ministry of Fisheries has discretionary powers to define a "development quota" on the TAC, which would be capped at 8.5%. The TAC quota will be reviewed annually to enable the government to assess fish stock levels and be flexible in their response to setting appropriate limits to fishing. As a result, the government will be able to actively address concerns about preserving fish stocks of different species, which is credit positive as it mitigates long term risk to the fishing sector. The Faroese government will work with experts to determine appropriate measures to maintain fish stocks, affirming its clear commitment to the development of a sustainable and environmentally conscientious fishing industry.

Boats are set to face a total ban on discarding fish, to ensure efficient utilisation of catches. Other legislation already in place includes regulations over the size of nets that can be used, to minimise the amount of young fish caught. Boats will be inspected to ensure they are equipped appropriately, before being granted a fishing permit.

Marine Resource Management Law and Resource Fee

In 2007, the Faroese government approved a motion that all fishing licenses would expire on 1 January 2018 to pressure future governments into amending the previous fishing laws by that point. The reform aims to ensure fishing rights and profit are more widely distributed to the wider Faroese society and encourage sustainable fishing and the maintenance of fish stocks. Under the previous system, licenses dictated how many days a boat was allowed to fish⁴. However, under the new law, licenses now give the right to catch up to a specific weight limit. The changes in the law affect commercial longliners and trawlers, rather than individual fishermen.

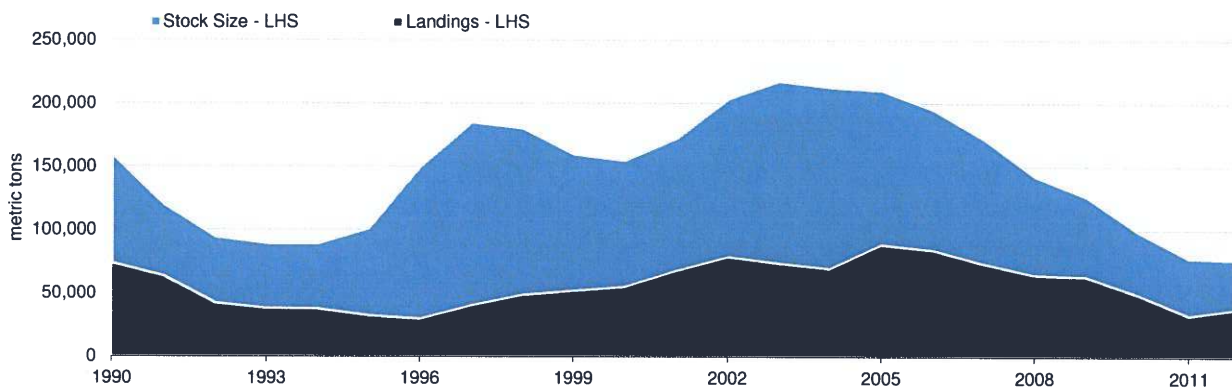
The aim of the new system is to affirm that the Faroese fishing stock is under the ownership of its population, and have part of the fishing licences be more equally distributed through auction. Licences offered on auction are valid for periods of one year, three years and eight years following its introduction.

A key change is the pricing system. Licenses put up for auction are sold to the highest bidder, and a resource fee (Act on Fishing Fee) is applied to companies whose catch quotas have been "grandfathered." The future structure of the fee is currently under political discussion. The reform aims to extract extraordinary profit from the industry and it establishes a redistribution scheme, which distributes, via the government's Economic Fund, any revenue exceeding DKK250 million from fishing companies and any revenue exceeding DKK150 million from fish farming, over several years to the government budget. This scheme is designed to smooth a relatively volatile revenue source.

Estimates from the Ministry of Fisheries for the fish stock of the Faroe Islands highlight the risk of overfishing as a result of the previous system. While the government and fishing industry were attentive to fish stock conservation following the depletion of cod stocks in the 1990s and slight decreases in the early 2000s, the stock began decreasing again after 2005, highlighting the need for a new management system (see Exhibit 3). These supply shocks have been the result of overfishing driven by high prices and improved fishing technology that maximise a landing from one day at sea. The Faroese government previously struggled to respond to such developments and the compulsory annual review in the new law is an attempt to ensure it is able to quickly and effectively deal with such challenges in the future.

Exhibit 3

Declining fish stocks highlighted the need for fishery reforms Faroese fish stock and landings (1990-2012)



Source: IECS, Statistical Office of the Faroe Islands, Moody's Investors Service

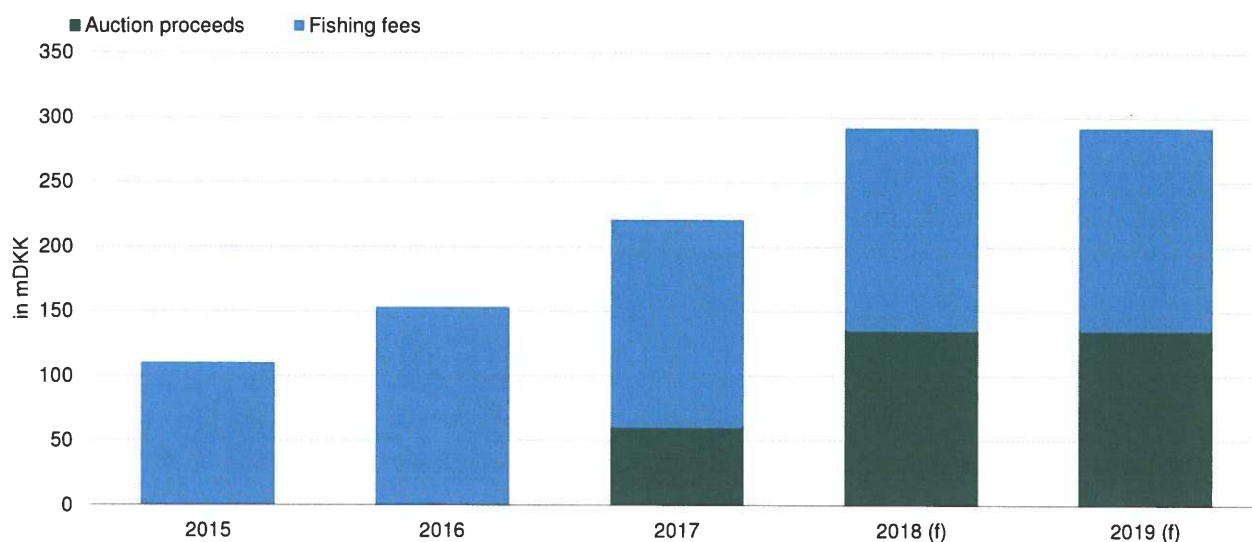
Reform leads to growing additional revenue source for government

A significant component of the reform concerns a resource fee applied to extraordinary profits. We understand that this element of the reform is currently discussed by the government. It is expected to be imposed on all fisheries that catch fish under the proportion of the TAC that is not auctioned. The resource fee, coupled with the auction proceeds, provide additional sources of revenue for the government.

Government revenue generated from fishing fees and auction proceeds has doubled since 2015, driven by increases in auction proceeds (Exhibit 4). Forecasts from the Faroese Ministry of Fisheries forecast that this revenue will remain stable in 2019. However, we consider this to be a conservative assumption, as the TAC quota may grow if fishing stock supply is managed well. Additionally, increases in global demand would push up prices for seafood, which is likely to be reflected in rising auction proceeds. The reform also requires all companies that utilise Faroese fishing rights to be located and registered in the Faroe Islands, thereby ensuring the government is able to capture all activity occurring in its waters, apply the appropriate quotas to it and generate fees and/or auction proceeds from it; thus further enhancing revenue.

Exhibit 4

Revenue achieved by the Faroese government from fishing doubled between 2015-2017, and is forecast to grow in 2018
Government revenue generated from fishing fees and auction proceeds (2015-2019 (f))



Source: Faroese Ministry of Fisheries

The fishing policy reform enables the government to directly control the amounts landed to mitigate supply shocks and sustainably maintain fishing stocks. As such, the reform provides the government with the appropriate tools to ensure the long-term sustainability of its most important sector, as well as expand its revenue base.

The Faroe Islands

The [Faroe Islands \(Aa3 stable\)](#) are a collection of 18 islands with an estimated population in 2018 of around 51,000 inhabitants located between Scotland (not rated) and [Iceland \(A3 positive\)](#). Although formally part of [Denmark \(Aaa stable\)](#), the islands became self-governing with the 1948 Home Rule act. This allowed the Faroe Islands to opt out of joining the EU, while Denmark became a member. The only areas where Denmark still exerts a significant influence on the islands is in monetary policy and defence policy.

Moody's related publications

- » [Credit Opinion: Government of the Faroe Islands](#), February 2018
- » [Credit Opinion: Government of Denmark](#), May 2018
- » [Issuer in Depth: Frequently Asked Questions About the Sub-Sea Tunnel Plans](#), March 2017
- » [Issuer Comment: Faroe Islands Settlement of Fishing Dispute with European Union Is Credit Positive](#), June 2014

Endnotes

- 1** Latest public statistics show Fishing and Aquaculture contributed 18% to gross value added in the Faroese economy in 2015
- 2** The reform will impose varying quotas for auctioning, for the demersal fish fleet around the Faroe Islands. These quotas will be subject to change per year in line with fish stock supply, but it is estimated that the fish stock in 2018 and 2019 will be approximately 15-25% across all fish quotas for auction
- 3** The coastal fleet (for example, small liners and coastal boats) will still be entitled to fishing days.
- 4** This is applicable to the Faroese home fleet

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